

**Supporting Statement for the  
Recordkeeping and Reporting Requirements Associated with  
Regulation KK (*Margin and Capital Requirements for Covered Swap Entities*)  
(Reg KK; OMB No. to be assigned)**

***Margin and Capital Requirements for Covered Swap Entities*  
(Docket No. 2011-1415) (RIN 7100-AD74)**

**Summary**

The Board of Governors of the Federal Reserve System, under delegated authority from the Office of Management and Budget (OMB), proposes to implement, the Recordkeeping and Reporting Requirements Associated with Regulation KK (Margin and Capital Requirements for Covered Swap Entities) (Reg KK; OMB No. to be assigned). These margin and capital registration and swap entity regulation requirements are contained in section 4s of the Commodity Exchange Act and a new section 15F to the Securities Exchange Act of 1934 (15 U.S.C. § 78o-11), as added by sections 731 and 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act or the Act).<sup>1</sup> The Paperwork Reduction Act (PRA) classifies these requirements as an information collection and the PRA requires, subsequent to implementation, the Federal Reserve to renew these requirements every three years.

On May 11, 2011, the Agencies<sup>2</sup> published a notice of proposed rulemaking (proposed rule) in the *Federal Register* for public comment (76 FR 27564). The proposed rule would implement the Board's new Regulation KK. In the proposed rule the Agencies requested comment on establishing margin and capital requirements for registered swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants (collectively, swap entities<sup>3</sup>) for which one of the Agencies is the prudential regulator. The comment period for this proposed rule expires on June 24, 2011.

The information collection pursuant to Regulation KK is triggered by specific events. Although there are reporting requirements contained within Regulation KK, there are no required reporting forms. Under the PRA, the Federal Reserve accounts for the paperwork burden associated with Regulation KK for state member banks, bank holding companies, savings and

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<sup>1</sup> The Dodd-Frank Act was enacted on July 21, 2010. Pub. L. No. 111-203, 124 Stat. 1376 (2010).

<sup>2</sup> The Agencies that are party to this rulemaking are the Office of the Comptroller of the Currency (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); Federal Housing Finance Agency (FHFA); and Farm Credit Administration (FCA) and are collectively referred to as the Agencies.

<sup>3</sup> The Board's covered swap entities comprise: any state member bank (as defined in section 208.2(g) of the Board's Regulation H (12 CFR 208.2(g)), any bank holding company (as defined in section 2(a)(1) of the Bank Holding Company Act of 1956 (12 USC 1841(a)(1)), any savings and loan holding company (as defined in section 10 of the Home Owners' Loan Act (12 USC 1467a(a)), any foreign banking organization (as defined in section 211.21(n) of the Board Regulation K (12 CFR 211.21(n)), any state branch or agency of a foreign bank (as defined in section 1 of the International Banking Act of 1978 (12 USC 3101), and any organization operating under section 25A of the Federal Reserve Act (12 USC 611) or having an agreement with the Board under section 25 of the Federal Reserve Act (12 USC 601).

loan holding companies, foreign banking organizations, state branches and agencies of foreign banks, and Edge and agreement corporations and, therefore, these entities are respondents under the PRA. The annual burden for the 30 covered swap entities is estimated to be 8,670 hours.

## **Background and Justification**

Title VII of the Dodd-Frank Act established a comprehensive new regulatory framework for derivatives, which the Act generally characterizes as “swaps” (which are defined in section 721 of the Act to include interest rate swaps, commodity-based swaps, and broad-based credit swaps) and “security-based swaps” (which are defined in section 761 of the Dodd-Frank Act to include single-name and narrow-based credit swaps and equity-based swaps).<sup>4</sup>

The comprehensive derivatives-related provisions of title VII of the Dodd-Frank Act are intended in general to reduce risk, increase transparency, and promote market integrity within the financial system, and in particular to address a number of weaknesses in the regulation and structure of the derivatives markets that were revealed during the financial crisis experienced in 2008 and 2009. During the financial crisis, the opacity of derivatives transactions among dealer banks and between dealer banks and their counterparties created uncertainty about whether market participants were significantly exposed to the risk of a default by a swap counterparty. By imposing a regulatory margin requirement on non-cleared swaps<sup>5</sup>, the Dodd-Frank Act will reduce the uncertainty around the possible exposures arising from non-cleared swaps.

The recent financial crisis also revealed that some participants in the derivatives markets had used derivatives to take on excessive risks. By imposing a minimum margin requirement on non-cleared derivatives, sections 731 and 764 of the Dodd-Frank Act will reduce the ability of firms to take on excessive risks through swaps without sufficient financial resources to make good on their contracts. Because the Dodd-Frank Act requires that the margin requirements be based on the risks posed by the non-cleared swaps, firms that take significant risks through derivatives will face more stringent margin requirements with respect to non-cleared derivatives, while firms that take lower risks will face less stringent margin requirements.

For certain types of swap entities that are prudentially regulated by one of the Agencies, sections 731 and 764 of the Dodd-Frank Act require the Agencies to adopt rules jointly for swap entities under their respective jurisdictions imposing (i) capital requirements and (ii) initial and

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<sup>4</sup> See 7 U.S.C. § 1a(47); 15 U.S.C. § 78c(a)(68). Swaps and security-based swaps are sometimes referred to herein collectively as “derivatives.”

<sup>5</sup> A non-cleared swap is not, directly or indirectly, submitted to and cleared by a registered clearing agency. As defined by the Commodity Exchange Act a derivatives clearing agency means a clearinghouse, clearing association, clearing corporation, or similar entity, facility, system, or organization that, with respect to an agreement, contract, or transaction— (i) enables each party to the agreement, contract, or transaction to substitute, through novation or otherwise, the credit of the derivatives clearing organization for the credit of the parties; (ii) arranges or provides, on a multilateral basis, for the settlement or netting of obligations resulting from such agreements, contracts, or transactions executed by participants in the derivatives clearing organization; or (iii) otherwise provides clearing services or arrangements that mutualize or transfer among participants in the derivatives clearing organization the credit risk arising from such agreements, contracts, or transactions executed by the participants.

variation margin requirements on all non-cleared swaps.<sup>6</sup> Swap entities that are prudentially regulated by the Agencies and therefore subject to the proposed rule are referred to herein as “covered swap entities.”

## Description of Information Collection

The Dodd-Frank Act requires the Commodities Futures Trade Commission (CFTC), the Securities and Exchange Commission (SEC)<sup>7</sup>, and the Agencies to establish and maintain, to the maximum extent practicable, capital and margin requirements that are comparable, and to consult with each other periodically (but no less than annually) regarding these requirements.<sup>8</sup>

The capital and margin standards for swap entities imposed under sections 731 and 764 of the Dodd-Frank Act are intended to offset the greater risk to the swap entity and the financial system arising from the use of swaps and security-based swaps that are not cleared.<sup>9</sup> Sections 731 and 764 of the Act require that the capital and margin requirements imposed on swap entities must, to offset such risk, (i) help ensure the safety and soundness of the swap entity and (ii) be appropriate for the greater risk associated with the non-cleared swaps and non-cleared security-based swaps held as a swap entity.<sup>10</sup> In addition, sections 731 and 764 of the Dodd-Frank Act require the Agencies, in establishing capital rules for covered swap entities, to take into account the risks associated with other types of swaps or classes of swaps or categories of swaps engaged in and the other activities conducted by that person that are not otherwise subject to regulation applicable to that person by virtue of the status of the person as a swap dealer or a major swap participant.<sup>11</sup>

The capital and margin requirements that must be established with respect to non-cleared derivatives compliment changes made elsewhere in the Act that require all sufficiently standardized swaps and security-based swaps be cleared through a derivatives clearing organization or clearing agency.<sup>12</sup> This clearing mandate reflects the consensus of the G-20 leaders: “All standardized over-the-counter derivatives contracts should be traded on exchanges

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<sup>6</sup> See 7 U.S.C. § 6s(e)(2)(A); 15 U.S.C. § 78o-8(e)(2)(A). Section 6(s)(e)(1)(A) directs registered swap dealers and major swap participants for which there is a prudential regulator to comply with margin and capital rules issued by the prudential regulators, while section 6(s)(e)(1)(B) directs registered swap dealers and major swap participants for which there is not a prudential regulator to comply with margin and capital rules issued by the CFTC and SEC.

<sup>7</sup> Sections 731 and 764 of the Act require the CFTC and SEC to separately adopt rules imposing capital and margin requirements for swap entities for which there is no prudential regulator. See 7 U.S.C. § 6s(e)(2)(B); 15 U.S.C. § 78o-8(e)(2)(B).

<sup>8</sup> See 7 U.S.C. §§ 6s(e)(2)(A); 6s(e)(3)(D); 15 U.S.C. §§ 78o-8(e)(2)(A), 78o-8(e)(3)(D).

<sup>9</sup> See 7 U.S.C. § 6s(e)(3)(A); 15 U.S.C. § 78o-8(e)(3)(A).

<sup>10</sup> See 7 U.S.C. § 6s(e)(3)(A); 15 U.S.C. § 78o-8(e)(3)(A).

<sup>11</sup> See 7 U.S.C. § 6s(e)(2)(C); 15 U.S.C. § 78o-8(e)(2)(C). In addition, the margin requirements imposed by the Agencies must permit the use of noncash collateral, as the Agencies determine to be consistent with (i) preserving the financial integrity of the markets trading swaps and security-based swaps and (ii) preserving the stability of the U.S. financial system.

<sup>12</sup> See 7 U.S.C. § 2(h); 15 U.S.C. § 78c-3. Certain types of counterparties (e.g., counterparties that are not financial entities and are using a swap or security-based swap to hedge or mitigate commercial risks) are exempt from this mandatory clearing requirement and may elect not to clear a swap or security-based swap that would otherwise be subject to the clearing requirement.

or electronic trading platforms, where appropriate, and cleared through central counterparties by end of 2012 at the latest.”<sup>13</sup>

This proposed rule sets forth proposed margin and capital requirements with respect to non-cleared swaps and non-cleared security-based swaps for covered swap entities. The information requirements are found in sections \_\_.2(t)(3), \_\_.2(t)(4), \_\_.4(e)(2)(i), \_\_.5, \_\_.6(d)(4), \_\_.8(c)(1)-(3), \_\_.8(d)(3), \_\_.8(d)(8)-(10), \_\_.8(d)(12), \_\_.8(e)(1), \_\_.8(f)(2)-(4), and \_\_.8(g).

Compliance with the information collections found in sections \_\_.2(t)(3) and \_\_.2(t)(4) would be mandatory for any covered swap entity wishing to take a qualifying master netting agreement into account for purposes of calculating initial margin or variation margin. Compliance with the information collections found in sections \_\_.4(e)(2)(i), \_\_.5, and \_\_.6(d)(2)(i) would be mandatory for all covered swap entities. Compliance with the information collections found in sections \_\_.8(c)(1)-(3), \_\_.8(d)(3), \_\_.8(d)(8)-(10), \_\_.8(d)(12), \_\_.8(e)(1), \_\_.8(f)(2)-(4), and \_\_.8(g) would be mandatory for all covered swap entities wishing to use an initial margin model to calculate initial margin requirements.

### **Definitions**

Section \_\_.2 defines terms used in the proposed rule, including the definition of “qualifying master netting agreement” contained in section \_\_2(t). Covered swap entities must comply with the recordkeeping requirements contained in sections \_\_.2(t)(3) and \_\_.2(t)(4). These sections provide that, with respect to a qualifying master netting agreement, a covered swap entity must (i) conduct sufficient legal review of the agreement to conclude with a well-founded basis that the agreement meets specified criteria and (ii) establish and maintain procedures for monitoring relevant changes in law.

### **Variation Margin**

Section \_\_.4 requires that on and after the date on which a covered swap entity enters into a non-cleared swap or non-cleared security-based swap, the covered swap entity shall, to the extent the variation margin amount for such swap or security-based swap is positive, collect variation margin from the counterparty to such swap or security-based swap. Covered swap entities must comply with the recordkeeping requirement contained in section \_\_.4(e)(2)(i). This section requires the covered swap entity to make the necessary efforts to attempt to collect the required variation margin, including the timely initiation and continued pursuit of formal dispute resolution mechanisms, or has otherwise demonstrated upon request to the satisfaction from the relevant Agency that it has made appropriate efforts to collect the required variation margin.

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<sup>13</sup> G-20 Leaders, June 2010 Toronto Summit Declaration, ¶ 25. The dealer community has also recognized the importance of clearing—beginning in 2009, in an effort led by the Federal Reserve Bank of New York, the dealer community agreed to increase central clearing for certain credit derivatives and interest rate derivatives. See Press Release, Federal Reserve Bank of New York, New York Fed Welcomes Further Industry Commitments on Over-the-Counter Derivatives press release (June 2, 2009), [available at www.newyorkfed.org/newsevents/news/markets/2009/ma090602.html](http://www.newyorkfed.org/newsevents/news/markets/2009/ma090602.html).

## **Documentation of Margin Matters**

Section \_\_.5 requires a covered swap entity to execute trading documentation with each counterparty that (i) includes credit support arrangements that grant the covered swap entity the contractual right to collect initial margin and variation margin in such amounts, in such form, and such circumstances as are required by the initial margin and variation margin requirements set forth in the proposed rule and (ii) meets other specified criteria.

## **Eligible Collateral**

A covered swap entity shall collect for initial margin and variation margin certain forms of eligible collateral. Section \_\_.6 establishes these forms of eligible collateral. The section further requires a covered swap entity to monitor the market value of any eligible collateral it has collected to satisfy initial margin or variation margin and, to the extent that the market value of such collateral has declined, shall collect such additional eligible collateral as is necessary to bring itself into compliance with the margin requirements of this part. Section \_\_.6(d)(2)(i) requires that the covered swap entity has made the necessary efforts to attempt to collect the required additional eligible collateral, including the timely initiation and continued pursuit of formal dispute resolution mechanisms, or has otherwise demonstrated upon request to the satisfaction from the relevant Agency that it has made appropriate efforts to collect the required additional eligible collateral.

## **Approved Initial Margin Matters**

Section \_\_.8 establishes standards for initial margin models. These standards include reporting and recordkeeping requirements that the covered swap entity must:

- receive prior approval from the relevant Agency based on demonstration that the initial margin model meets specific requirements (sections \_\_.8(c)(1) and \_\_.8(c)(2));
- notify the relevant Agency in writing before extending use of the model to additional product types, making certain changes to the initial margin model, or making material changes to modeling assumptions (section \_\_.8(c)(3));
- validate (using a variety of quantitative requirements) and demonstrate the reasonableness of its process for modeling and measuring hedging benefits, demonstrate to the satisfaction of the relevant Agency that the omission of any risk factor from the calculation of its initial margin is appropriate, demonstrate to the satisfaction of the relevant Agency that any conversion of initial margin calculated using a different holding period is appropriate, periodically review and, as necessary, revise the data used to calibrate the initial margin model to ensure that the data incorporate an appropriate period of significant financial stress (sections \_\_.8(d)(3), \_\_.8(d)(8), \_\_.8(d)(9), \_\_.8(d)(10), \_\_.8(d)(12));
- review its initial margin model annually ( section \_\_.8(e));
- validate its initial margin model initially and on an ongoing basis, describe to the relevant Agency any remedial actions being taken, and report internal audit findings regarding the effectiveness of the initial margin model to the covered swap entity's

- board of directors or a committee thereof (section \_\_.8(f)(2), \_\_.8(f)(3), and \_\_.8(f)(4)); and
- document, adequately, all material aspects of its initial margin model (\_\_8(g)).

### **Time Schedule for Information Collection**

Sections 731 and 764 become effective not less than 60 days after publication of the final rule or regulation implementing these sections.<sup>14</sup> The information collection pursuant to these recordkeeping and reporting requirements is event-generated. The recordkeeping must be maintained on sight and the reporting must be provided to the relevant Agency within the time periods established by the law and regulation.

### **Consultation Outside of the Agency**

On May 11, 2011 a joint notice of proposed rulemaking was published in the *Federal Register* (76 FR 27564) requesting comment on the implementation of the recordkeeping and reporting requirements for the *Margin and Capital Requirements for Covered Swap Entities*. The comment period expires on June 24, 2011.

### **Sensitive Questions**

This information collection contains no questions of a sensitive nature, as defined by OMB guidelines.

### **Legal Status**

The Board's Legal Division determined that sections 731 and 764 of the Dodd-Frank Act expressly authorize "prudential regulators" such as the Board to adopt rules for swap entities under their respective jurisdictions by imposing (i) capital requirements and (ii) initial and variation margin requirements on all non-cleared swaps.<sup>15</sup> Section 721(a)(39) of the Act<sup>16</sup> defines the Board as the "prudential regulator" for the covered swap entities set forth in footnote 3, above.

The obligation to comply with the recordkeeping and reporting requirements is (1) with respect to the Qualifying Master Netting Agreement provisions (§ \_\_.2(t)(3) and \_\_.2(t)(4)), required in order to obtain the benefit of calculating the initial or variation margin by taking account of that agreement; (2) with respect to the Variation Margin, Documentation of Margin Matters, and Eligible Collateral provisions (§§ \_\_.4(e)(2)(i), \_\_.5, and \_\_.6(d)(2)(i)), mandatory for all covered swap entities; and (3) with respect to the Approved Internal Margin Model

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<sup>14</sup> See Dodd Frank Act § 754, § 774.

<sup>15</sup> 124 Stat. 1703-1712 (Section 731), 1784-1796 (Section 764) (2010) *to be codified at* 7 U.S.C. 6s, 15 U.S.C. 78o-8, respectively.

<sup>16</sup> 124 Stat. 1664-1665, *to be codified at* 7 U.S.C. 1a(39).

provisions (§§ \_\_.8(c), (d), (e), (f), and (g)), required to obtain the benefit of using an initial margin model to calculate initial margin requirements.

The Qualifying Master Netting Agreement, Variation Margin, Documentation of Margin Matters, and Eligible Collateral requirements reflect records maintained at the entities so issues of confidentiality normally would not arise. Should such information be obtained by the Board in the course of an examination, it would be exempt from disclosure under exemption 8 of the Freedom of Information Act (FOIA), 5 U.S.C. § 552(b)(8). In addition, some if not all of such information may be highly sensitive “commercial or financial” information protected from disclosure under exemption 4 of FOIA.

The recordkeeping and reporting requirements for the Approved Initial Margin Model would consist of confidential, highly sensitive proprietary modeling information submitted by the covered swap entity to the Board for its approval, in order that the entity may engage in covered swap transactions. Such information also is subject to withholding under FOIA exemption 4.

### **Estimate of Respondent Burden**

The estimated total annual burden for the recordkeeping and reporting requirements of this information collection is 8,670 hours, as shown in the table below. In estimating the number of covered swap entities to which Regulation KK applies, the Federal Reserve reviewed the FBOs and top-tier bank in each of the top 40 bank holding companies and from there, conservatively estimated that the Federal Reserve could require 30 covered swap entities to comply with Regulation KK.

The Federal Reserve estimates that each 30 covered swap entities would take, on average, 5 hours to comply with the recordkeeping requirements contained in §\_\_.2(t)(3) and (t)(4), §\_\_.5, and §\_\_.8(g). The one-time implementation burden would take a total of 150 hours. The Federal Reserve estimates that each 30 covered swap entities would take, on average, 4 hours (half a business day) to comply with the recordkeeping requirements contained in §\_\_.4(e)(2)(i) and §\_\_.6(d). This continuous burden would take a total of 120 hours. The Federal Reserve estimates that each 30 covered swap entities would take, on average, 240 hours (6 business weeks) to comply with the reporting requirements contained in §\_\_.8(c) and (d). These on-going reporting requirements would take a total of 7,200 hours. The Federal Reserve estimates that each 30 covered swap entities would take, on average, 40 hours (1 business week) to comply with the recordkeeping requirements contained in §\_\_.8(e) and (f). This continuous burden would take a total of 1,200 hours.

The Regulation KK recordkeeping and reporting requirements represent less than 1 percent of total Federal Reserve System paperwork burden. The total cost to the public is estimated to be \$369,776.<sup>17</sup>

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<sup>17</sup> Total cost to the public was estimated using the following formula: percent of staff time, multiplied by annual burden hours, multiplied by hourly rate (30% Office & Administrative Support @ \$16, 45% Financial Managers @ \$49, 15% Legal Counsel @ \$54, and 10% Chief Executives @ \$77). Hourly rate for each occupational group are the median hourly wages (rounded up) from the Bureau of Labor and Statistics (BLS), *Occupational Employment*

	<i>Number of respondents<sup>18</sup></i>	<i>Estimated annual frequency</i>	<i>Estimated average hours per response</i>	<i>Estimated annual burden hours</i>
<b>§__.2(t)(3) and (4), Qualifying master netting agreements</b>				
<b>§__.5, Documentation of margin matters</b>				
<b>§__.8(g), Documentation</b>				
Recordkeeping	30	1	5	150
<b>§__.4(e)(2)(i), Variation margin</b>				
<b>§__.6(d), Eligible collateral</b>				
Recordkeeping	30	1	4	120
<b>§__.8(c) and (d), Initial margin model</b>				
Reporting	30	1	240	7,200
<b>§__.8(e), Periodic review</b>				
<b>§__.8(f), Control, oversight, and validation mechanisms</b>				
Recordkeeping	30	1	40	1,200
<i>Total</i>				8,670

### **Estimate of Cost to the Federal Reserve System**

Since Regulation KK only requires the Federal Reserve to collect paper-based information from a small number of covered swap entities, the cost to the System is negligible.

and Wages 2009, [www.bls.gov/news.release/ocwage.nr0.htm](http://www.bls.gov/news.release/ocwage.nr0.htm). Occupations are defined using the BLS Occupational Classification System, [www.bls.gov/soc/](http://www.bls.gov/soc/).

<sup>18</sup> Of the 30 covered swap entities required to comply with the recordkeeping and reporting requirement contained in Regulation KK none are small entities as defined by the Small Business Administration (i.e., entities with less than \$175 million in total assets) [www.sba.gov/contractingopportunities/officials/size/table/index.html](http://www.sba.gov/contractingopportunities/officials/size/table/index.html).