Client Alert | Capital Markets

US and EU Regulators Provide Relief for Compliance with Variation Margin Requirements

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The CFTC, the Federal Reserve Board and the Office of the Comptroller of the Currency have taken action to extend the period during which Swap Dealers can comply with the requirement to post and collect variation margin under the applicable margin rules with respect to certain counterparties. Full compliance must now occur by no later than 1 September 2017.

The European Supervisory Authorities also took action to grant some relief around the hard deadline by which certain Financial Counterparties and Non-Financial Counterparties that exceed the clearing threshold must have complied with the requirement to exchange variation margin under the EU margin rules.

These actions will prevent disruption to the uncleared derivatives market by permitting market participants to continue trading with their counterparties while they implement the required documentation and operational frameworks.

Background

United States

On 22 October 2015, the Prudential Regulators[1] released final rules and accompanying interpretive guidance setting out the Prudential Regulators' initial and variation margin requirements applicable to uncleared swap and security-based swap transactions (the "**PR Final Margin Rules**").[2] Subsequently, on 16 December 2015, the Commodity Futures Trading Commission (the "**CFTC**") released final rules and accompanying interpretive guidance setting forth the CFTC's initial and variation margin requirements applicable to uncleared swap

[1] The five Prudential Regulators are the Federal Deposit Insurance Corporation, the Department of the Treasury (the Office of the Comptroller of the Currency), the Board of Governors of the Federal Reserve System, the Farm Credit Administration and the Federal Housing Finance Agency.

[2] Margin and Capital Requirements for Covered Swap Entities, 80 FR 74839 (November 30, 2015), available at https://federalregister.gov/a/2015-28671.

transactions (the "**CFTC Final Margin Rules**").[3] The CFTC Final Margin Rules apply to Swap Dealers and Major Swap Participants that are not prudentially regulated, while Swap Dealers, Major Swap Participants, Security-Based Swap Dealers and Major Security-Based Swap Participants (collectively, "**Swap Entities**") that are prudentially regulated are subject to the PR Final Margin Rules. For further information, please see our client alert available here.

Compliance with the initial and variation margin requirements of both the CFTC Final Margin Rules and the PR Final Margin Rules began on 1 September 2016 for the largest swap market counterparties (i.e., those with more than USD 3 trillion in outstanding swap activity). Compliance with the initial margin requirements for the rest of the market will be phased-in between now and 1 September 2020, following which all covered Swap Entities will be required to comply with the initial margin requirements with all their counterparties. Importantly, however, from 1 March 2017 all covered Swap Entities are required to comply with the variation margin requirements with all their counterparties not previously covered (the "**US 1 March VM Requirements**").[4]

In a recognition that some market participants will likely not be in a position to fully comply with such variation margin requirements by 1 March 2017, the CFTC, the Federal Reserve Board and the Office of the Comptroller of the Currency ("**OCC**") have sought to extend the period during which Swap Dealers subject to their jurisdiction can comply with the requirement to post and collect variation margin with respect to certain counterparties, as further set out below. This extension is intended to prevent disruption to the uncleared swaps market, the occurrence of which would undermine the regulatory purpose of the margin requirements.[5]

European Union

On 4 October 2016, the European Commission adopted the draft regulatory standards submitted by the European Supervisory Authorities ("**ESAs**") relating to the mandatory exchange of collateral for non-cleared derivatives (the "**EU Margin Rules**").[6] The EU Margin Rules were published in the Official Journal of the European Union and entered into force on 4 January 2017.

From 4 February 2017, counterparties who had a group aggregate average notional amount of EUR 3 trillion for non-cleared OTC derivatives[7] were required to begin posting both initial margin and variation margin (with a phase-in then commencing on such date through to 1 September 2020). From 1 March 2017 it was planned for there to be a market "big bang" in the EU bringing all financial counterparties ("**FCs**") and non-financial counterparties who have not exceeded the clearing threshold ("**NFC+s**") within scope of the obligation to post variation margin in accordance with the EU Margin Rules (the "**EU 1 March VM Requirements**").

Following the actions of the US regulators, the ESAs likewise opted to issue a similar (although more limited) statement granting a degree of flexibility for certain parties who were required to comply with the EU 1 March VM Requirements.

3 Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 FR 635 (6 January 2016), available at https://federalregister.gov/a/2015-32320.

4 These requirements are set out in CFTC Rule 23.153 (17 CFR § 23.153) and CFTC Rule 23.161(a)(2) (17 CFR § 23.161).

5 See also, International Organization of Securities Commissioners "Statement on Variation Margin Requirements" (23 February 2017), available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD556.pdf, and International Swaps and Derivatives Association, Inc., the Global Financial Markets Association, the Investment Association, the Financial Services Roundtable, the ABA Securities Association and the American Council of Life Insurers, Re: Uncleared Swap Margin Requirements – Request for Forbearance from March 1, 2017 Variation Margin Implementation, available at http://assets.isda.org/media/f253b540-153/43121ac6-pdf/.

6 Commission Delegated Regulation (EU) 2016/2251, available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R2251&from=EN.

7 Calculated on the basis of (a) the average of total gross notional amount recorded as of the last business day of each testing month then an average of the three (3) numbers is taken (b) including all entities that consolidate accounts (c) including all non-centrally cleared OTC derivative contracts of that group (including intra-group but counted only once) and (d) assessed on an annual basis in March, April and May with requirements applied the same year.

United States

Federal Reserve Board and Office of the Comptroller of the Currency Guidance

The Federal Reserve Board in SR 17-3 and the OCC in OCC Bulletin 2017-12 have each released substantially similar guidance in which they state that, in exercising their supervisory discretion, they will prioritise compliance efforts by registered Swap Dealers subject to their jurisdiction based on the size of and risk inherent in the credit and market risk exposure presented by each counterparty. Each such Swap Dealer is expected to comply with the US 1 March VM Requirements:

- on **1 March 2017** (as scheduled) with respect to its counterparties that present significant exposures as at such time; and

- as soon as possible, and in no case later than **1 September 2017**, with respect to its other counterparties, provided the Swap Dealer is using good faith efforts to comply with the variation margin requirements by such date.

The guidance also sets out the following additional principles to be used by the Federal Reserve Board and the OCC when examining a Swap Dealer's compliance with the variation margin requirements:

- the Swap Dealer's management systems and program for compliance given the scope and scale of changes necessary to achieve effective compliance for each of its uncleared swap transactions;

- the expectation that the Swap Dealer has governance processes that assess and manage its current and potential future credit exposure to its counterparties, as well as any other market risk arising from such transactions; and

- the Swap Dealer's implementation plan, including actions taken to update documentation, policies, procedures, and processes, as well as its training program for staff on how to handle technical problems or other implementation challenges.

The other Prudential Regulators (the Farm Credit Administration, the Federal Deposit Insurance Corporation, and the Federal Housing Finance Agency) are not a part of this guidance as they do not currently have any Swap Dealers subject to their jurisdiction that would be affected.

It does not appear that this guidance is intended to apply to market participants that were required to comply with the variation margin requirements on 1 September 2016.

CFTC No-Action Relief

In CFTC No-Action Letter 17-11, the CFTC's Division of Swap Dealer and Intermediary Oversight ("**DSIO**") noted that it had received requests for no-action relief from various industry associations representing both Swap Dealers and end-users. The requests indicated that, notwithstanding the efforts undertaken by the industry to develop new documentation and execution processes to fully comply with the US 1 March VM Requirements, these efforts have only been partially effective as, due to the complex nature of many trading relationships, Swap Dealers are often unable to utilize multilateral solutions (e.g., the ISDA 2016 Variation Margin Protocol) and are therefore required to negotiate and implement bilateral solutions with their counterparties. This has presented significant operational challenges for Swap Dealers.

Given that Swap Dealers will not be able to implement the US 1 March VM Requirements without causing substantial disruption to the uncleared swaps market (namely, due to the fact that Swap Dealers would be forced to stop trading with a significant number of counterparties resulting in a reduction in liquidity and the ability to hedge positions), the DSIO stated that specific and limited no-action relief was warranted to help avoid any such disruption.

In accordance with the no-action relief, the DSIO will not recommend enforcement action against a Swap Dealer that does not comply with the US 1 March VM Requirements **prior to 1 September 2017**, subject to the following requirements:

- the Swap Dealer does not comply with the US 1 March VM Requirements with respect to a particular counterparty solely because it has not, despite good faith efforts, completed necessary credit support documentation (including custodial segregation documentation, if any) with such counterparty or, acting in good faith, requires additional time to implement operational processes to settle variation margin in accordance with the US 1 March VM Requirements with such counterparty;

- the Swap Dealer uses its best efforts to continue to implement compliance with the US 1 March VM Requirements without delay with each counterparty following 1 March 2017;

- to the extent the Swap Dealer has existing variation margin arrangements with a counterparty, it must continue to post and collect variation margin with such counterparty in accordance with such arrangements until such time as the Swap Dealer is able to comply with the US 1 March VM Requirements with respect to that counterparty; and

- no later than 1 September 2017, the Swap Dealer complies with the US 1 March VM Requirements with respect to all swaps to which the US 1 March VM Requirements are applicable entered on or after 1 March 2017.

The DSIO noted that, during this no-action period, it intends to monitor the progress of Swap Dealers who rely on this no-action relief, and expects Swap Dealers to make continual, consistent, and quantifiable progress toward compliance with the US 1 March VM Requirements with all counterparties on a rolling basis during this period. It is the DSIO's expectation that all Swap Dealers should be in compliance with the US 1 March VM Requirements with all counterparties, as applicable, by 1 September 2017.

This no-action relief does not apply to market participants that were required to comply with the variation margin requirements on 1 September 2016.

European Union

European Supervisory Authorities

On 23 February 2017, the ESAs issued a statement explaining that, unlike in other jurisdictions (such as the US), the ESAs lack the power to issue no-action letters or formally disapply (on a temporary or permanent basis) any directly applicable EU legislative text. However, it was noted that the implementation of the EU 1 March VM Requirements was an issue for the industry and appeared to "*mainly pose a challenge for smaller counterparties*" (i.e. smaller FCs on the buy-side of the market and NFC+s). Taking this into account, it noted that, although the ESAs still expect Competent Authorities (being the relevant regulator in each EU member state) to generally apply their risk-based supervisory powers to enforce applicable legislation, in this context they may take into account:

- the size of the exposure to the counterparty in question and its default risk;

- the steps the parties have taken to document progress towards full compliance;

- the availability of alternative arrangements to ensure that any non-compliance is contained (such as using existing credit support documentation that may not be compliant with the EU Margin Rules (e.g. in respect of timing, collateral stated to be eligible for posting, etc.)).

The ESAs noted that the statement was not intended to entail general forbearance from the EU 1 March VM Requirements. Rather, Competent Authorities should, on a case-by-case basis, assess the degree of compliance and progress by parties subject to the EU 1 March VM Requirements.

While the ESAs did not state a hard deadline by which this flexibility around enforcement will end, it is noted that they expect "the difficulties to be solved in the coming few months and [in any case] that transactions concluded after 1 March 2017 remain subject to the obligation to exchange variation margin".

UK Financial Conduct Authority

Following the ESAs statement, the UK Financial Conduct Authority ("**FCA**"), being the Competent Authority in the UK, issued a press release, welcoming the statement from the ESAs and confirming that it will look to take a "*risk-based approach and use judgement as to the adequacy of progress, taking into account the position of particular firms and the credibility of the plans they have made*". It is noted that, where full compliance has not been achieved, the FCA expects a demonstration of how:

- the relevant parties subject to the EU 1 March VM Requirements have made "best efforts" to achieve full compliance; and

- the parties will achieve compliance in as short a time as practicable for all transactions that are in-scope for the purposes of the EU Margin Rules.

The FCA also noted that it will expect full compliance within "*a few months*".

Impact for Market Participants

While less formal than the relief granted by other regulators globally, the statement by the ESAs is nevertheless helpful in mitigating concerns for larger FCs/dealer banks operating in Europe (and, in respect of the FCA statement, in London in particular) around trading with counterparties where they do not yet have documentation in place that is compliant with the EU Margin Rules. Given that the ESA statement and the FCA press release note that assessment of compliance (and any subsequent enforcement action) will be carried out on a case-by-case basis, parties should work to ensure that they have in place a detailed internal roadmap to full compliance, clear, documented steps showing progress for each counterparty with that roadmap, and evidence that any existing credit support arrangements are being utilised. This should assist with the Competent Authorities being in a position to exercise their discretion appropriately where smaller FCs and NFC+s are concerned.

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