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Practice Groups:

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Global Government Solutions

Regulators Provide Guidance on Variation Margin for Uncleared Swaps; CFTC Also Delays Compliance Date for Filing Notices to Disaggregate Positions

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Introduction

Global regulators adopted regulations to govern the posting and collection of margin on uncleared swaps.[1] These regulations are set to take effect in stages over a four-year period. The initial compliance date was September 1, 2016, which required the posting and collection of initial and variation margin between the very largest swap dealers ("SD") where all parties to a swap and their respective affiliates had an average daily aggregate notional amount of swaps for March, April, and May of 2016 that exceeded $3 trillion. The next compliance date was set for March 1, 2017, when any SDs would have been required to post and collect variation margin with and from other SDs or "financial end users," a term that encompasses entities such as registered investment companies, insurance companies or pension plans. The regulators have now provided some relief and guidance regarding compliance with the March 1, 2017 date.

Variation Margin Relief

Although the regulators took pains to say that they were not postponing the March 1, 2017 compliance date, they have provided guidance so that SDs will have a six-month grace period during which to implement the variation margin requirements using a risk-based approach.[2] The CFTC conditioned its relief for SDs on (1) an inability, despite good faith efforts, to complete necessary documentation or implement operational processes; (2) using their best efforts to continue to implement compliance without delay with each counterparty; (3) continuing to collect and post variation margin under existing arrangements with a counterparty; and (4) back-loading by no later than September 1, 2017, so that compliance with the variation margin requirements is completed by that date for all uncleared swaps entered into on or after March 1, 2017.

On February 22, 2017, the Board of Governors of the Federal Reserve System ("Federal Reserve" or "FRB") provided guidance to institutions under its supervision regarding initial examinations with respect to compliance with variation margin requirements.[3] This guidance is likely of even greater significance than the CFTC relief, because the Federal Reserve and

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[1] *See, e.g.*, 80 Fed. Reg. 74839 (November 30, 2015) (U.S. banking regulators); Commission Delegated Regulation (European Union ("EU")) 2016/2251 of 4 October 2016 supplementing regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives central counterparties and trade repositories with regard to regulatory technical standards for risk mitigation techniques for OTC derivative contracts not cleared by a central counterparty (December 15, 2016), http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R2251&from=EN (EU); 81 Fed. Reg. 635 (January 6, 2016) (U.S. Commodity Futures Trading Commission ("CFTC")).

[2] The relief is set forth in CFTC Staff Letter 17-11 (February 13, 2017), which is available by clicking here.

[3] The guidance is set forth in FRB Supervisory Letter SR 17-3 (February 22, 2017), which is available by clicking here.

the other banking regulator that supervises SDs — the Office of the Comptroller of the Currency ("OCC") — are the regulators of the largest SDs. The guidance states that priority should be given to compliance efforts by SDs based on the size of and risk presented by each counterparty. SDs are expected to comply with the variation margin requirements with respect to other SDs and to those financial end user counterparties that present significant exposures as of March 1, 2017. With respect to other counterparties, SDs are expected to make good-faith efforts to comply with the variation margin requirements as soon as possible and in no case later than September 1, 2017. Federal Reserve and OCC examiners will evaluate an SD's (1) management systems and program for compliance; (2) governance processes that assess and manage its current and potential future credit exposure to uncleared swap counterparties, as well as any other market risk arising from such transactions; and (3) 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.

Global regulators have also reacted to industry requests for more time. On February 23, 2017, the European Supervisory Authorities ("ESA"), which include the European Securities and Markets Authority, the European Banking Authority, and the European Insurance and Occupational Pensions Authority, issued their response.[4] While expressing disappointment "that the financial industry has not managed to prepare for the implementation" and stating that legally neither the ESAs nor national regulators have any formal power to disapply directly applicable EU legal text such as by issuing no-action letters, like the CFTC, the ESA's statement was nevertheless similar to that of the Federal Reserve. The ESAs expect national authorities generally to enforce variation margin requirements using a risk-based approach, taking into account the size of the exposure to the counterparty plus its default risk, and indicated that market participants must document the steps taken toward full compliance and put in place alternative arrangements to ensure that the risk of noncompliance is contained, such as using existing credit support annexes to exchange variation margin. Regulators in Australia, Hong Kong, and Singapore had previously provided a six-month transitional period, and the Japanese Financial Services Agency is taking an approach similar to that of the Federal Reserve. Accordingly, global regulators have now established September 1, 2017, as the date by which all SDs must be in compliance with the new variation margin requirements for uncleared swaps with respect to all counterparties, including all financial end-users.

Although the margin regulations are phrased in terms of obligations imposed upon SDs, their impact obviously flows through to the buy-side counterparties. The result of the regulatory pronouncements discussed above is that many investment advisers and particularly the smaller financial end users should have some breathing room over the next six months to implement the necessary operational procedures required by the variation margin requirements, such as the types of collateral permitted, haircuts required on collateral, and timing requirements. Counterparties will face increasing urgency and pressure from SDs to come into compliance depending upon the extent of their swaps' exposure, so buy-side firms should proceed to continue with their review of current practices and procedures and implement any required changes as expeditiously as practicable.

[4] The response is available by clicking here.

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Minimum Transfer Amount

At the same time that the CFTC established a grace period for posting and collecting variation margin, the CFTC also provided no-action relief so that investment advisers to large institutions such as registered investment companies or pension plans will be subject to a minimum transfer amount ("MTA") of variation margin based upon the separately managed account ("SMA") that the adviser is responsible for, rather than having to calculate the MTA across all accounts of the investor.[5] This relief is not time limited and provides that the CFTC's Division of Swap Dealer and Intermediary Oversight will not recommend an enforcement action against an SD that does not comply with the MTA requirements in the CFTC's regulations with respect to one or more swaps with any legal entity that is the owner of more than one SMA, subject to the following conditions: (1) any such swaps are entered into with the SD by an asset manager on behalf of an SMA owned by the legal entity pursuant to authority granted under an investment management agreement; (2) the swaps of such SMA are subject to a master netting agreement that does not permit netting of initial or variation margin obligations across SMAs of the legal entity that have swaps outstanding with the SD; and (3) the SD applies an MTA no greater than $50,000 to the initial and variation margin collection and posting obligations required of such SMA.[6]

Aggregation of Positions

Turning to a completely separate topic, the CFTC provided no-action relief for a six-month period ending August 14, 2017, from the provision of the CFTC's new aggregation regulations requiring the filing of notices to claim exemption from aggregation of positions with related entities to determine compliance with position limits.[7] This relief will be useful for investment advisers that want to continue using the exemption for "independent account controllers" ("IAC") and for principals and affiliates of commodity pool operators. The CFTC stated that persons may choose voluntarily to submit the notice filings prior to the new compliance date.[8] Currently, the CFTC only has position limits for a few agricultural commodities, but it has proposed to adopt limits with respect to 25 additional physical commodities and to include economically equivalent swaps. Interested parties are also reminded that the designated contract markets have their own position limits and position accountability levels for several commodities in addition to those of the CFTC and that CME requires a notice filing to claim the IAC exemption, but ICE Futures U.S. does not.

For those persons with an owned entity that also trades, such as an operating company with a subsidiary, the new exemption from aggregation also requires filing of a notice. The CFTC no-action letter provides similar relief from the notice filing, but no relief is provided to these traders from the provisions of the exemption designed to assure independent trading by related entities, which became effective on February 14, 2017. Such provisions require the person and the owned entity to have and enforce written procedures to preclude each from having knowledge of, gaining access to, or receiving data about, trades of the other, and require that they trade pursuant to separately developed and independent trading systems. They are also precluded from sharing employees that control trading decisions and from

[5] The relief is set forth in CFTC Staff Letter 17-12 (February 13, 2017), which is available by clicking here.

[6] The CFTC's variation margin requirements in issue are set forth in CFTC Regulations 23.152(b)(3) and 23.153(c) and generally have an MTA of $500,000.

[7] The relief is set forth in CFTC Staff Letter 17-06 (February 6, 2017), which is available by clicking here.

[8] The notice filing is to be made electronically using the CFTC form.

having risk management systems that permit sharing trades or trading strategy with employees that control the trading decisions of the other. Traders claiming the owned entity and IAC exemptions will generally be subject to similar conditions. Both CME and ICE Futures U.S. require a notice filing to claim this exemption.

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