

# Derivatives Alert

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## Non-Cleared Swap Variation Margin Requirements to Spark Credit Support Annex Amendments for Financial End Users

On March 1, 2017, new rules<sup>1</sup> adopted by U.S. Prudential Regulators<sup>2</sup> and the Commodity Futures Trading Commission (CFTC) will require registered swap dealers to post and collect daily variation margin for over-the-counter, non-cleared swaps entered into with private funds, securitization vehicles, pension plans, insurance companies, registered investment companies, business development companies and other “financial end users.”<sup>3</sup>

The new U.S. rules make various adjustments to current margining practices, such as requiring daily mark-to-market margining, shortening the timeframes for margin transfers, establishing a \$500,000 cap on the minimum transfer amount (applicable collectively to initial margin and variation margin), restricting the kinds of collateral permitted to be posted and specifying required valuation haircuts depending on the types of collateral posted.<sup>4</sup> As typical credit support documentation addresses all of these issues, swap dealers and financial end-user counterparties already are starting to revise credit support documentation to comply with the new variation margin requirements. The variation margin requirements are already in effect for registered swap dealers with respect to swaps with counterparties where both the swap dealer and the counterparty’s aggregate notional amount of covered swaps has exceeded \$3 trillion.<sup>5</sup>

The International Swaps and Derivatives Association, Inc. (ISDA) has introduced a protocol process (VM Protocol) that provides different avenues for implementing the changes that will be required by the new rules.<sup>6</sup> The VM Protocol introduces three avenues for parties to amend their existing ISDA agreements to comply with the rules:

1. **The Amend Method:** Parties may use this VM Protocol method to amend their current Credit Support Annex (CSA) to comply with the new variation margin requirements. Under this method, trades entered into by the parties prior to March 1, 2017 (legacy trades), which are not required to be subject to the new rules, as well as trades entered into on or after the effective date (new trades), will be subject to the new variation margin requirements.
2. **The Replicate and Amend Method:** Parties may use this VM Protocol method to replicate their current CSA and amend the replica CSA to conform with the new variation margin requirements. This results in the parties having two CSAs: the original CSA, which will govern all of the parties’ legacy trades not subject to the new variation margin requirements, and the replica CSA, which will govern all new trades.

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3. **The New Method:** Parties who do not have a CSA, or want to replace an existing CSA, may use this VM Protocol method to enter into a new, rule-compliant CSA that will govern trades.<sup>7</sup>

The VM Protocol is complex and includes four components: (1) an adherence letter, (2) a questionnaire, (3) the protocol agreement and (4) sets of substantive amendments or new credit support annexes governed by New York, English or Japanese law.

As an alternative to the VM Protocol, some swap dealers and financial end-user counterparties are finding it less cumbersome to negotiate their own variation margin changes to their CSAs through bilateral amendments instead of adhering to the VM Protocol. This bilateral approach can be especially efficient where there are existing CSAs with customized provisions that are difficult to replicate through the VM Protocol, or where a financial end user uses only a small number of swap dealers.

Whether via the VM Protocol or bilaterally, the new rules are presenting swap dealers and their financial end-user counterparties with issues regarding how existing margin posting practices will meet the rules' stricter transfer timing, how minimum transfer amounts will apply across multiple accounts and how existing swap positions could be affected by the new rules. There are also many cross-border issues regarding which jurisdiction's rules apply, to whom they apply and which kinds of derivatives are covered.<sup>8</sup>

With only three months until the compliance date, financial end users that do not soon engage with their swap dealers on the new variation margin rules may find themselves with insufficient time to tailor credit support amendments to their preferences and circumstances.

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## Endnotes

<sup>1</sup> See Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74,840 (November 30, 2015) (PR Rule); *see also* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 636 (January 6, 2016) (CFTC Rule). The PR Rule also applies to security-based swaps. As of the time of this article, the U.S. Securities and Exchange Commission has not yet finalized margin requirements. *See* Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, 77 Fed. Reg. 70,214 (Nov. 23, 2012).

<sup>2</sup> The Prudential Regulators are the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Federal Housing Finance Agency and the Farm Credit Administration.

<sup>3</sup> Under the Final Rules, the term "financial end user" includes: nonbank financial institutions supervised by the Board of Governors of the Federal Reserve System, depository institutions, foreign banks, state-licensed or registered credit or lending entities (but excluding entities registered or licensed solely on account of financing the entity's direct sales of goods or services to customers), broker-dealers, floor brokers, floor traders, introducing brokers, registered investment companies, business development companies, private funds, securitization vehicles, commodity pools, commodity pool operators, employee benefit plans, insurance companies, cooperatives that are financial institutions, U.S. intermediate holding companies established or designated for purposes of compliance with Regulation YY of the Board of Governors of the Federal Reserve System and entities that are or would be a financial end user or swap entity if they were organized under the laws of the U.S. or any state. *See* PR Rule at 74,900; *see also* CFTC Rule at 696.

<sup>4</sup> For more details on the U.S. variation margin requirements set out in the PR and CFTC Rules, *see* our November 2, 2015, [Client Alert](#).

<sup>5</sup> *See* PR Rule at 74,850; *see* CFTC Rule at 676.

<sup>6</sup> *See* "[Open Protocols](#)," ISDA, (last visited November 30, 2016) and "[ISDA 2016 Variation Margin Protocol](#)," ISDA, (last visited November 30, 2016).

<sup>7</sup> The VM Protocol calls on the parties to elect, through various questions in the protocol process, whether or not to subject pre-March 1, 2017, swaps to the variation margin requirements.

<sup>8</sup> *See* PR Rule at 74,907-908; *see also* Margin Requirements for Uncleared Swap Dealers and Major Swap Participants — Cross-Border Application of the Margin Requirements, 81 Fed. Reg. 34,818 (May 31, 2016). *See e.g.*, Comparability Determination for Japan: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 63,376, 63,393 (September 15, 2016) (concluding that the Japanese margin rules are substantially comparable to the U.S. margin requirements, with the exception of the treatment of interaffiliate uncleared swaps transactions). When these requirements become effective on March 1, 2017, similar kinds of regulations in the EU and other countries also will become effective. *See e.g.*, Final Draft Regulatory Technical Standards on Risk Mitigation Techniques for OTC-Derivative Contracts Not Cleared By A CCP Under Article 11(15) of Regulation (EU) No 648/2012, available [here](#); Office of the Superintendent of Financial Institutions Canada Guideline E-22 Margin Requirements for Non-Centrally Cleared Derivatives, available [here](#); Articles 110 and 111 of the Swiss Federal Act on Financial Market Infrastructures and Market Conduct in Securities and Derivatives Trading of 19 June 2015, *and* Articles 100 through 107 of the Swiss Federal Ordinance on Financial Market Infrastructures and Market Conduct in Securities and Derivatives Trading of 25 November 2015.