

# Derivatives Alert

## Contacts

### Mark D. Young

Washington, D.C.  
202.371.7680  
mark.d.young@skadden.com

### Maureen A. Donley

Washington, D.C.  
202.371.7570  
maureen.donley@skadden.com

### Daniel B. O'Connell

Washington, D.C.  
202.371.7003  
daniel.oconnell@skadden.com

### Shekida A. Smith

Washington, D.C.  
202.371.7382  
shekida.smith@skadden.com

This memorandum is provided by Skadden, Arps, Slate, Meagher & Flom LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum is considered advertising under applicable state laws.

Four Times Square  
New York, NY 10036  
212.735.3000

1440 New York Avenue, N.W.  
Washington, D.C. 20005  
202.371.7000

## Regulators Provide Some Flexibility on the Swaps Variation Margin Compliance Deadline

On February 23, 2017, U.S. federal banking regulators (Prudential Regulators), European regulators and the International Organization of Securities Commissions (IOSCO) issued statements clarifying their expectations on compliance with the March 1, 2017, variation margin (VM) requirements for uncleared swaps.<sup>1</sup> This guidance follows a U.S. Commodity Futures Trading Commission (CFTC) announcement on February 13, 2017, that provides time-limited no-action relief to swap dealers subject to CFTC VM requirements.<sup>2</sup> Under the VM requirements, covered counterparties must exchange margin with respect to non-cleared swaps (defined below) entered into on or after the requirements' effective date, absent an exception. The VM requirements are already effective for the largest swap counterparties and become effective for all remaining counterparties<sup>3</sup> on March 1, 2017.

Various market participant groups had asked for extensions of the March 1 deadline because of the challenges swap entities and their counterparties face in implementing the documentation and underlying operational processes needed to comply with the VM requirements.<sup>4</sup> While most U.S. and European regulators declined to postpone the March 1 date, their statements and guidance expressed the regulators' understanding that documentation and operational processes may not be completed by the deadline. Faced with this reality, the regulators expressed an intention to prioritize the exercise of their supervisory authority in accordance with the risks of counterparties and to take into

<sup>1</sup> See, e.g., statements from the [Prudential Regulators](#), [European Securities and Markets Authority](#), [International Organization of Securities Commissions](#) and [Financial Conduct Authority](#).

<sup>2</sup> See press release "[CFTC's Division of Swap Dealer and Intermediary Oversight Issues Time-Limited No-Action Transition for March 1, 2017 Compliance Date for Variation Margin and No-Action Relief from Minimum Transfer Amount Provisions](#)," CFTC (Feb. 13, 2017); see also [CFTC Letter 17-11](#).

<sup>3</sup> The September 1, 2016, effective date for the VM rules applied only to covered swap entities with more than \$3 trillion in outstanding swap activity.

<sup>4</sup> See, e.g., Securities Industry and Financial Markets Association letter regarding uncleared swap margin requirements, "[Request for Relief from March 1, 2017 Variation Margin Implementation](#)" (Dec. 16, 2016). Industry associations estimate that only around 15 percent of credit support annexes have been amended so far. See Philip Stafford, "[Global Regulators Allow Wriggle Room on New Derivatives Rules](#)," *Financial Times* (Feb. 23, 2017); see also Robert Mackenzie Smith & Nazneen Sherif, "[Regulators Relent Ahead of VM Big Bang](#)," *Risk* (Feb. 24, 2017).

# Derivatives Alert

account good faith efforts by covered entities to comply with the VM requirements.<sup>5</sup>

**U.S. VM Requirements and Guidance.** In November 2015, the Prudential Regulators finalized rules for initial and VM requirements for certain swaps and security-based swaps that are not centrally cleared through a registered derivatives clearing organization or a registered clearing agency (non-cleared swaps). The CFTC finalized its substantially similar rulemaking in January 2016.<sup>6</sup> The VM rules necessitate that all covered swap entities review and, if needed, amend their current swap documentation to comply with the VM requirements. Such requirements limit certain aspects of non-cleared swap agreements, such as the types of collateral that may be posted as margin, valuation percentages that must be applied to posted collateral and minimum transfer amounts. The VM requirements also call for operational changes, as the requirements dictate timelines for making margin transfers.

On February 13, 2017, the CFTC responded to industry concerns about meeting the March 1 deadline by issuing two forms of relief,<sup>7</sup> including time-limited, transitional no-action relief from enforcement recommendations for non-compliance with the VM requirements until September 1, 2017.<sup>8</sup>

<sup>5</sup> Japan also issued a statement taking a similar stance to the Federal Reserve and the European regulators. “JFSA’s Views on Margin Requirements for Non-Centrally Cleared OTC Derivatives,” Japan Financial Services Agency (Feb. 23, 2017) (reference translation). In contrast, regulators in Australia, Hong Kong and Singapore have elected to delay the broader VM requirements’ effective date until September 2017. See press release “[APRA Announces Timetable for Margining and Risk Mitigation Requirements](#),” Australian Prudential Regulation Authority (Dec. 6, 2016); “[Implementation of Margin and Risk Mitigation Standards for Non-Centrally Cleared OTC Derivatives](#),” Hong Kong Monetary Authority (Dec. 6, 2016); “[Response to Feedback Received – Policy Consultation on Margin Requirements for Non-Centrally Cleared OTC Derivatives Contracts](#),” Monetary Authority of Singapore (Dec. 2016).

<sup>6</sup> For more information on the final rules, see Skadden’s November 2, 2015, [client alert](#). The final rules were adopted pursuant to Sections 731 and 764 of the Dodd-Frank Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

<sup>7</sup> The CFTC also issued a no-action letter stating that its Division of Swap Dealer and Intermediary Oversight would not recommend enforcement against a swap dealer that does not comply with the VM minimum transfer amount requirements, under certain conditions. See [CFTC Letter 17-12](#).

<sup>8</sup> Transitional relief is available in circumstances where:

- (1) the swap dealer does not comply with the March 1 VM requirements with respect to a particular counterparty solely because it has not 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 VM in accordance with the March 1 VM requirements with such counterparty;
- (2) the swap dealer uses its best efforts to comply with the March 1 VM requirements with each counterparty as soon as possible following the deadline;
- (3) to the extent the swap dealer has existing VM arrangements with a counterparty, it must continue to post and collect VM with such counterparty in accordance with such arrangements until such time as the swap dealer is able to comply with the March 1 VM requirements with respect to that counterparty; and
- (4) no later than September 1, 2017, the swap dealer complies with the March 1 VM requirements with respect to all swaps to which the March 1 VM requirements are applicable entered on or after March 1, 2017

The Prudential Regulators do not provide relief as extensive as that provided by the CFTC. However, the Prudential Regulators acknowledged the scope and scale of the changes that entities covered by the VM requirements are required to make to comply with the March 1, 2017, effective date<sup>9</sup> and indicated that they would take a risk-based approach when examining for compliance. Seemingly acknowledging that swap dealers would not be able to modify every affected swap agreement before March 1, the Federal Reserve and the Office of the Comptroller of the Currency (OCC)<sup>10</sup> recommended prioritizing compliance efforts based on the size and risk of credit and market risk exposures presented by each counterparty.<sup>11</sup> The joint statement noted that the Prudential Regulators expect swap dealers to comply with the VM requirements with respect to non-cleared swaps with “counterparties that present significant credit and market risk exposures” by the March 1 date.<sup>12</sup> Swap dealers are expected to make good faith efforts to comply with the VM requirements in a timely manner with respect to their non-cleared swaps with all other counterparties, but they must fully comply with the VM requirements no later than September 1, 2017.<sup>13</sup> The guidance also stated that Federal Reserve examiners would be expected to evaluate management systems and compliance programs; assess governance processes that assess and manage current and potential future credit exposure to non-cleared swap counterparties and related market risk; and consider covered swap entities’ implementation plans, such as steps taken to update documentation, policies, procedures, processes and training on a case-by-case basis during initial examinations for compliance with the VM requirements.<sup>14</sup>

<sup>9</sup> See, e.g., joint press release “[Agencies Release Swap Margin Guidance, Board of Governors of the Federal Reserve System](#)” (Feb. 23, 2017) (hereinafter Joint Press Release).

<sup>10</sup> The Federal Reserve and OCC noted that, although they also administer the VM requirements, the Farm Credit Administration, Federal Deposit Insurance Corporation and Federal Housing Finance Agency currently have no swap entities affected by the Federal Reserve and OCC guidance, although they each support the guidance. See Joint Press Release. The Financial Conduct Authority (FCA) has also stated that it will take a “risk-based approach” and take into account “the position of particular firms and the credibility of the plans they have made” in supervising compliance with the March 1, 2017, deadline for compliance with the European VM requirements. See “[FCA Statement on EMIR 1 March 2017 Variation Margin Deadline](#),” FCA (Feb. 23, 2017) (hereinafter FCA Statement).

<sup>11</sup> See Supervision & Regulation Letter 17-3, “[Initial Examinations for Compliance with Minimum Variation Margin Requirements for Non-Cleared Swaps and Non-Cleared Security-Based Swaps](#),” Board of Governors of the Federal Reserve System (Feb. 22, 2017) (hereinafter SR 17-3); see also OCC Bulletin 2017-12, “[Initial Examinations for Compliance With Final Rule Establishing Margin Requirements for Non-Cleared Swaps and Non-Cleared Security-Based Swaps](#),” OCC (Feb. 23, 2017) (hereinafter OCC Bulletin 2017-12).

<sup>12</sup> See Joint Press Release.

<sup>13</sup> See *id.*

<sup>14</sup> See SR 17-3; see also OCC Bulletin 2017-12.

# Derivatives Alert

**European Margin Requirements and Guidance.** In a similar approach to the U.S. Prudential Regulators, the European Supervisory Authorities (ESAs) issued a guidance statement but declined to postpone the March 1 effective date for the European VM requirements. The ESAs statement noted that ESAs have no formal power to disapply the European VM requirements, which were established by EU law,<sup>15</sup> through mechanisms like no-action letters. Consequently, the ESAs also declined to set a hard deadline of September 1, 2017, for full compliance with the VM requirements. The ESAs, however, acknowledged that they “have been made aware of operational challenges in meeting the [VM] deadline.”<sup>16</sup> The ESA guidance explained that the ESAs expect competent authorities to evaluate compliance in a risk-based fashion, taking into account the size of a counterparty’s exposure, plus its default risk as well as covered entities’ documentation of the steps taken toward compliance with the European VM requirements (*e.g.*, putting in place alternative arrangements, such as using existing credit support annexes to exchange VMs).

---

<sup>15</sup>The European VM requirements, “Regulatory Technical Standards on risk mitigation techniques for OTC derivatives not cleared by a central counterparty,” were based on Article 11(15) of Regulation (EU) No 648/2012, or EMIR.

<sup>16</sup> See “[Variation Margin Exchange under the EMIR RTS on OTC Derivatives](#),” ESMA (Feb. 23, 2017).

The U.K.’s primary regulator, the Financial Conduct Authority (FCA), also issued a statement that it intends to take a similar approach, explaining that “[w]here a firm has not been able to comply fully, [the FCA] will expect it to be able to demonstrate that it has made best efforts to achieve full compliance, and be ready to explain how it will achieve compliance in as short a time as practicable for all in-scope transactions entered into from 1 March 2017.”<sup>17</sup>

**International Organizations Guidance.** In its statement on VM implementation, IOSCO addressed operational challenges faced by swap dealers and market participants in the context of IOSCO’s interest in creating consistent standards of regulation across jurisdictions. IOSCO did not recommend that its members delay the upcoming VM effective date, stating that it expects all covered entities to make every effort to comply with the VM requirements by the March 1 effective date. However, IOSCO said that to the extent legally permitted, IOSCO members should consider taking appropriate measures available to them to ensure fair and orderly markets during the introduction and application of VM requirements.<sup>18</sup>

---

<sup>17</sup> See FCA Statement.

<sup>18</sup> See “[Statement on Variation Margin Implementation](#),” IOSCO (Feb. 23, 2017).