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Mandatory Margin Update: CFTC and Prudential Regulators Provide Limited Compliance Relief

At the end of last year and earlier this year, the Department of the Treasury (the "OCC"), the Federal Reserve System (the "Fed"), the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency (collectively, the "Prudential Regulators")[1] and the Commodity Futures Trading Commission (the "CFTC")[2] promulgated rules (the "Margin Rules") imposing minimum margin requirements on swap dealers, major swap participants and certain other regulated institutions (collectively, "Covered Swap Entities") in respect of their uncleared swaps and security-based swaps trading.[3] The Margin Rules' requirements regarding variation margin were scheduled to become applicable to trading relationships between a Covered Swap Entity and any financial end-user starting on March 1, 2017. On February 13, 2017, the CFTC provided time-limited no-action relief (the "CFTC NOL")[4] to swap dealers not regulated by a Prudential Regulator. Similarly, on February 23, 2017, the Fed and the OCC issued guidance (the "PR Guidance")[5] offering compliance relief to Covered Swap Entities subject to their jurisdiction. This Client Alert explores how the CFTC NOL and PR Guidance may impact clients' ongoing efforts to comply with the Margin Rules.

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1 *See* Margin and Capital Requirements for Covered Swap Entities; Final Rule, 80 Fed. Reg. 229 (November 30, 2015), *available at:* https://www.gpo.gov/fdsys/pkg/FR-2015-11-30/pdf/2015-28671.pdf.

2 *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants; Final Rule, 81 Fed. Reg. 3 (January 6, 2016), *available at:* http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2015-32320-1a.pdf.

3 The Margin Rules promulgated by the Prudential Regulators govern "swaps" and "security-based swaps" (as defined in the Commodity Exchange Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and the rules promulgated thereunder), whereas the Margin Rules promulgated by the CFTC only apply to "swaps." For more information on the distinction between swaps and security-based swaps, please *see* https://www.paulweiss.com/practices/transactional/finance/publications/sec,-cftc-finalize-definition-of-swap,-security-based-swap,-security-based-swap-agreement-and-mixed-swap,-triggering-effectiveness-of-swap-regulations.aspx?id=10966.

4 *See* CFTC Letter No. 17-11, *available at*: http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/17-11.pdf.

5 *See* SR 17-3, *available at*: https://www.federalreserve.gov/bankinforeg/srletters/sr1703.pdf; *see also* OCC Bulletin 2017-12, *available at*: https://www.occ.gov/news-issuances/bulletins/2017/bulletin-2017-12.html?source=govdelivery&utm_medium=email&utm_source=govdelivery.

I. Remind Me – What Are the Margin Rules?

Starting in 2011, the Basel Committee on Banking Supervision, the International Organization of Securities Commissions and other international regulators developed a framework for minimum initial and variation margin requirements for uncleared derivatives; this framework is the basis for the Margin Rules. Under the Margin Rules, financial institutions in the U.S. with the largest uncleared derivatives portfolios commenced exchanging initial margin and variation margin on September 1, 2016. Initial margin requirements for financial institutions with smaller derivatives portfolios and financial end-users with material swaps exposure are scheduled to be phased in over the next four years. Subject to the CFTC NOL and PR Guidance, the provisions regarding variation margin, however, are applicable to trading relationships between a Covered Swap Entity and any financial end-user from March 1, 2017 (the "Original Compliance Date"), regardless of the size of the financial end-user's uncleared derivatives portfolio. Commercial end-users and their derivatives transactions are not covered by the Margin Rules. Similar regulations are expected to come into effect on or around March 1, 2017 in other jurisdictions around the globe.

II. How Do the CFTC NOL and PR Guidance Affect the Original Compliance Date?

The CFTC NOL:

Pursuant to the CFTC NOL, the CFTC Division of Swap Dealer and Intermediary Oversight will not recommend enforcement against a swap dealer not regulated by a Prudential Regulator for failure to comply with the Margin Rules by the Original Compliance Date, so long as the swap dealer meets certain conditions, including an ongoing, good faith effort to promptly bring trading relationships into compliance with the Margin Rules. The Margin Rules still come into effect on March 1, 2017, trades booked on or after the Original Compliance Date must be margined in compliance with the Margin Rules by no later than September 1, 2017, and existing credit support arrangements must be complied with in the interim period. To be clear, the CFTC NOL represents a forbearance on enforcement and simply affords market participants more time to update their credit support documentation; it does not alter the scope of transactions subject to the Margin Rules.

The PR Guidance:

Pursuant to the PR Guidance, examiners are instructed to apply a flexible approach to reviewing compliance with the Margin Rules. Similar to the CFTC NOL, the PR Guidance does not change the March 1, 2017 effective date of the Margin Rules. However, the guidance recognizes the challenges encountered by Covered Swap Entities in coming into effective compliance with the Margin Rules. In reviewing compliance, the PR Guidance suggests that examiners will focus on the Covered Swap Entity's risk assessment systems, its program for compliance and efforts undertaken to meet the regulatory deadline. Covered Swap Entities are advised to focus their compliance efforts on those counterparties posing the greatest credit and market risk, and to make good faith efforts to implement the Margin Rules requirements with all other counterparties as soon as possible. The PR Guidance explains that there is no relief from compliance by the Original Compliance Date with respect to counterparties that "present significant exposures" – a standard not further defined in the guidance. Compliance with the margin requirements for all other counterparties must be achieved by no later than September 1, 2017. Unlike the CFTC NOL, the PR Guidance does not specifically provide that trades booked between the Original Compliance Date and September 1, 2017 be margined in accordance with the Margin Rules.

III. What About Non-US Margin Regulations?

A detailed analysis of foreign margin regulations is beyond the scope of this client alert. To the extent that clients are transacting with foreign counterparties, clients should consult with those counterparties and counsel to determine whether, despite any forbearance afforded by the CFTC NOL or PR Guidance, the Original Compliance Date may apply to trades with those counterparties as a result of foreign margin regulations.

IV. I Have not Started Amending Documentation, or I am Partway Through the Amendment Process – What Should I Do?

Given the volume of credit support documentation that must be amended prior to the September 1, 2017 long-stop date and the CFTC and Prudential Regulator's emphasis on good faith efforts to promptly comply with the Margin Rules, it is advisable to stay focused on completing the compliance process as soon as possible to avoid unnecessary disruptions to trading. As previously noted, compliance can be achieved either via (a) bilaterally negotiated amendments to existing credit support documentation (or, if no credit support documentation is currently in place, new credit support documentation) or (b) adherence to the ISDA 2016 Variation Margin Protocol.[6]

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6 For more information on the ISDA 2016 Variation Margin Protocol, please *see* https://www.paulweiss.com/practices/transactional/finance/publications/managing-mandatory-margin-isdas-2016-variation-margin-protocol.aspx?id=22885.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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