



The Federal Reserve and OCC Guidance Regarding Initial Examinations for Compliance with Variation Margin Rules for Non-Cleared Swaps and Security-Based Swaps

Last week the Board of Governors of the Federal Reserve System (the “Federal Reserve”) and the Office of the Comptroller of the Currency (the “OCC” and, collectively with the Federal Reserve, the “Banking Agencies”) released guidance (the “Examination Guidance”)¹ on the examinations of swap entities subject to their regulation (the “Fed/OCC Swap Entities”) with respect to rules requiring such entities to exchange margin with their counterparties to non-cleared swaps and security-based swaps (the “Margin Rules”).² The Examination Guidance signals that, with respect to variation margin,³ the Banking Agencies will not immediately seek to enforce strict compliance with the Margin Rules, which are scheduled to go into effect on March 1, 2017, in relation to variation margin requirements for non-cleared transactions between swap dealers and counterparties including financial end users.⁴ Instead, the Examination Guidance states the Banking Agencies’ expectation that the Fed/OCC Swap Entities will prioritize their compliance efforts, achieving full compliance by March 1 in relation to those counterparties whose transactions pose significant credit or market risks.

The Examination Guidance will likely have a significant effect on the manner in which the Fed/OCC Swap Entities implement their plans to comply with the Margin Rules and, in turn, on their counterparties, including financial end users.⁵ Together with a no-action letter⁶ issued earlier this month by the Commodity Futures Trading

¹ Board of Governors of the Federal Reserve System, SR 17-3, Initial Examinations for Compliance with Minimum Variation Margin Requirements for Non-Cleared Swaps and Non-Cleared Security Based Swaps (Feb. 22, 2017); Office of the Comptroller of the Currency, OCC Bulletin 2017-12, Initial Examinations for Compliance With Final Rule Establishing Margin Requirements for Non-Cleared Swaps and Non-Cleared Security-Based Swaps (Feb. 23, 2017).

² Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74839 (Nov. 20, 2015). The prudential banking regulators that issued the Margin Rules included not only the Federal Reserve System and the OCC but also the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency. However, many if not all of the registered swap dealers that are subject to prudential regulation are regulated by the OCC or the Federal Reserve.

³ Variation margin is intended to represent the mark-to-market value of a swap or the cumulative mark-to-market value of a set of swaps. It differs from initial margin, which is intended to provide an additional buffer for market movements during the period of time when a swap or set of swaps is being closed out. See Margin Rules.

⁴ The Margin Rules went into effect on September 1, 2016, with respect to both variation margin and initial margin for certain large dealing entities that, with their affiliates, had average daily notional amounts of relevant swaps and security-based swaps exceeding \$3 trillion. The Margin Rules provide that March 1, 2017, is the compliance date for variation margin for transactions between Fed/OCC Swap Entities and their other counterparties in non-cleared swaps or security-based swaps whose transactions are subject to the Margin Rules. See Margin Rules, 80 Fed. Reg. at 74898-99.

⁵ The Margin Rules’ definition of “financial end user” includes many types of entities that typically engage in financial activities and are not regulated as swap entities. These include, among others, a wide variety of banks and bank-like institutions, both domestic and foreign; certain entities that are state-licensed or registered as credit or lending entities or as money services businesses; a securities holding company, broker or dealer, investment adviser or registered investment company; a private fund and certain investment company-like entities; a commodity pool, a commodity pool operator, a commodity trading advisor, or futures commission merchant; many employee benefit plans; an insurance company; an entity that is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in financial assets; a foreign entity that would constitute a financial end user if it were organized under the laws of the United States or any State thereof; and any other entity that a relevant regulator determines should be treated as a financial end user. The “financial end user” definition expressly excludes from its scope, among other things, sovereign entities and multilateral development banks. Margin Rules, 80 Fed. Reg. at 74900-901.

Commission (“CFTC”) regarding its margin rules for dealers that are not subject to regulation by the Federal Reserve or OCC, the Examination Guidance provides much needed relief not only to swap dealers but also to their smaller counterparties, many of which are not expected to be fully prepared to comply with variation margin requirements by March 1.

Indeed, the March 1 deadline for variation margin has been a source of considerable controversy, with numerous market participants and industry groups, including the International Swaps and Derivatives Association (“ISDA”), warning that lack of preparation was widespread and the deadline was not realistic without significant market disruptions.⁷ By their terms, the Margin Rules require Fed/OCC Swap Entities and their financial end user counterparties by March 1 to exchange variation margin on terms that in many cases differ from the parties’ current arrangements for the exchange of collateral. In particular, by their terms the Margin Rules require the exchange of margin on a zero-threshold basis and with a prescribed minimum transfer amount, specified types of collateral and same-day transfer of collateral in many cases. Further, the market has seen confusion regarding the forms that amendments of existing contractual arrangements should take, with different parties taking different approaches to new ISDA documentation and to their arrangements for legacy transactions predating the effectiveness of the Margin Rules.

The Examination Guidance states that swap dealers should prioritize their efforts according to the size and risk inherent in the credit and market risk exposures presented by each counterparty. By March 1, swap dealers are expected to be in full compliance with respect to other swap dealers and financial end users that present significant exposures. For other counterparties, swap dealers must make good faith efforts to comply with variation margin requirements in a timely manner, and in no case later than September 1, 2017.⁸

In view of the substantial changes necessary for swap dealers to achieve full effective compliance, the Examination Guidance states that during initial examinations for compliance with the variation margin requirements, Federal Reserve and OCC examiners should evaluate a swap dealer’s management systems and program to come into compliance. Swap dealers are expected to have governance processes that assess and manage current and potential future credit exposure to counterparties to non-cleared swaps, as well as any other market risk arising from such transactions. Examiners will consider swap dealers’ implementation plans, including actions taken to update documentation, policies, procedures, and processes, as well as training of appropriate staff and handling of early technical problems or other implementation challenges.⁹

⁶ CFTC Letter No. 17-11, Commission Regulation 23.153: Time Limited No-Action Position for Failure to Collect and/or Post Variation Margin (Feb. 13, 2017). See also Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 635 (Jan. 6, 2016).

⁷ See, e.g., “Uncleared Swap Margin Requirements – Request for Forbearance from March 1, 2017 Variation Margin Implementation” a letter from numerous industry groups to numerous regulatory agencies in the G-20 group of countries (Feb. 7, 2017), available as a link from <http://isda.derivatviews.org/>.

⁸ See Examination Guidance.

⁹ See Examination Guidance.

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