

February 27, 2017

## UPDATE: U.S. Prudential Regulators and EU (EMIR) Relief Guidance Issued on March 1st Variation Margin Deadline

By: [Brian Sung](#) and [Phil Lookadoo](#)

### U.S. Prudential Regulators and European Supervisory Authorities Follow CFTC in Issuing Regulatory Guidance Regarding March 1, 2017 Variation Margin Deadline, But Relief is “Risk” Based

Last week we issued an [alert](#) advising of No-Action Letter 17-11 issued on February 13, 2017 by the U.S. Commodity Futures Trading Commission (“CFTC”), providing limited relief from the March 1, 2017 deadline for covered swap entities to implement variation margin requirements (“VM Requirements”) for uncleared swaps with in-scope counterparties.<sup>1</sup> In that alert we advised that the relief granted by the CFTC might have only limited impact given that no similar relief had yet been issued by the various Prudential Regulators<sup>2</sup> who regulate many banks in the U.S. or by the European Supervisory Authorities<sup>3</sup> (“ESAs”) who regulate many banks in the European Union. On Thursday, February 23, 2017, both the U.S. Prudential Regulators and the ESAs elected to issue regulatory guidance addressing covered swap entities’ (*i.e.*, swap dealers’) compliance with the March 1, 2017 variation margin deadline. Unlike the CFTC relief, the Prudential Regulators’ and the ESAs’ relief is “risk” based, requiring covered swap entities to comply with VM Requirements with respect to counterparties that present significant exposures by March 1, 2017, focusing on a covered swap entity’s good faith efforts to comply with VM Requirements with all other counterparties as soon as possible (for the Prudential Regulators “in no case later than September 1, 2017”). Accordingly, the scope of relief granted in the new guidance is limited and market participants should review the details carefully.

While the CFTC elected to issue relief in the form of a no-action letter, indicating that, subject to certain conditions, during a transitional period until September 1, 2017, the CFTC would not recommend enforcement actions against covered swap entities failing to satisfy applicable VM Requirements, the nature of the Prudential Regulators’ and ESAs’ guidance, and the scope of relief that may be relied upon thereunder, are more limited.

On February 23, 2017, both the [Federal Reserve Board](#) and the [Office of the Comptroller of the Currency](#) issued guidance discussing their expectations regarding compliance with the March 1, 2017 variation margin deadline.<sup>4</sup> Both observed that the March 1, 2017 deadline remained in place, and did not provide for general suspension of enforcement or postponement of the deadline.

Instead, they focused on principles that examiners should focus on in examining supervised institutions’ compliance with the VM Requirements during initial exams following the implementation of the new variation margin rules, and in so doing, discussed some parameters around which regulators could exercise discretion in such examinations.

<sup>1</sup> For discussion of the March 1, 2017 variation margin requirements, and the CFTC’s no-action relief in respect thereof, please see our client alert [“CFTC Variation Margin Rule No Action Relief”](#) dated February 20, 2017.

<sup>2</sup> The five agencies constituting the Prudential Regulators include the Board of Governors of the Federal Reserve System (the “Board”), the Farm Credit Administration, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency and the Office of the Comptroller of the Currency (the “OCC”).

<sup>3</sup> The three agencies constituting the European Supervisory Authorities include the European Banking Authority, the European Securities and Markets Authority and the European Insurance and Occupational Pensions Authority.

<sup>4</sup> In the Prudential Regulators’ joint press release on February 23, 2017 regarding the [new regulatory guidance](#), they noted that, while the Farm Credit Administration, the Federal Deposit Insurance Corporation and the Federal Housing Finance Agency currently have no swap entities affected by the guidance, they did support the Board’s and the OCC’s guidance.

The Board's guidance notes that covered swap entities would be expected to:

- prioritize compliance efforts based on the "size of and risk inherent in the credit and market risk exposures presented by each counterparty";
- comply with the VM Requirements by March 1, 2017 with respect to swap entities and financial end user counterparties that present "significant exposures"; and
- with respect to other counterparties, use good faith efforts to comply with the VM Requirements as soon as possible, and in no case later than September 1, 2017.

Similarly, the OCC's guidance notes that covered swap entities would be expected to:

- make good faith efforts to comply with the VM Requirements in a timely manner;
- prioritize efforts "according to the size and risk inherent in the credit and market exposures presented by each counterparty";
- achieve full compliance with respect to swap entities and financial end users that present "significant exposures" by March 1, 2017; and
- for other counterparties, make good faith efforts to comply with the VM Requirements in a timely manner, and in no case later than September 1, 2017.

Both the Federal Reserve and the OCC will have examiners evaluate covered swap entities' underlying management and compliance systems, governance processes for assessing and managing credit exposures and market risks, and implementation plans (including documentation, policies, procedures and processes, and training programs).

On February 23, 2017, the ESAs issued a [statement](#) discussing their expectations regarding compliance with the VM Requirements. The ESAs' statement noted that "neither the ESAs nor [member jurisdictions' national] competent authorities ("CAs") possess any formal power to disapply directly applicable EU legal text", such as the VM Requirements under the European Market Infrastructure Regulation ("EMIR"), but that the ESAs expected the national competent authorities<sup>5</sup> ("CAs") in each relevant EU jurisdiction to apply their risk-based supervisory powers in day-to-day enforcement of the VM Requirements, particularly with respect to smaller counterparties. The ESAs noted that they were not proposing "a general forbearance, but a case-by-case assessment from the CAs on the degree of compliance and progress" and that, "[i]n any case, the ESAs and

---

<sup>5</sup> The Financial Conduct Authority, the competent authority for financial services firms in the UK, also released a [statement](#) in response to the ESAs' statement, confirming that:

"In our supervision of firms' progress, we will take a risk-based approach and use judgment as to the adequacy of progress, taking into account the position of particular firms and the credibility of the plans they have made. Where a firm has not been able to comply fully, we 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. We will expect detailed and realistic plans to be in place, which we may request to see at any time. We expect firms to have come into compliance within the coming few months."

CAs expect that the difficulties will be solved in the coming few months and that transactions concluded on or after 1 March 2017 remain subject to the obligation to exchange variation margin.”

The ESAs’ statement further notes that, in examinations of covered swap entities:

- CAs can take into account size of exposure to a counterparty and its default risk;
- participants must document steps taken toward full compliance; and
- participants must put in place alternative arrangements to contain risk of non-compliance, such as using existing Credit Support Annexes to exchange variation margin.

Given the lack of any explicit suspension or postponement of the VM Requirements under the Prudential Regulators’ and the ESAs’ regulatory guidance, and the explicit statements that covered swap entities are expected to continue to work towards full compliance, market participants may find the new guidance does not significantly change their target of aiming for full compliance by (or as close as possible to) the original deadline, although it may provide some comfort as to regulators’ intentions to the extent they are unable, in good faith, to comply.

## Haynes and Boone’s Analysis

The risk for affected counterparties (*i.e.*, counterparties that are not eligible for an exemption from the VM Requirements) that have existing swap documentation, but have not yet revised that documentation to comply with the rules, is that, as of March 1, 2017, the swap dealer will have to stop entering into new swaps with relevant affected counterparties. So, if an affected counterparty has an active swaps hedging or investing program/strategy that requires putting on a substantial number of new swap transactions, or as little as one new swap transaction with a high notional value, over the next few months, then that counterparty needs to raise the internal awareness of this issue within the company and expedite getting its documents revised and in effect quickly, so that its ability to enter into new swap trades will not be adversely affected. The risk for a swap dealer is either (i) having to tell one of its best customers that she/he can no longer enter into new swap trades as of March 1, 2017, or (ii) having to explain to regulators why diligently pursuing its regulatory compliance requirements fell short of the deadline, maintain records and documentation of its continued implementation efforts and hope no penalties for non-compliance will be imposed.

Swap dealers and their counterparties (customers) should consider the following actions: (i) examining their anticipated requirements for new swap transactions and prioritize getting new or revised swap documents in place expeditiously with those swap counterparties that have the potential for high-value, or a high number of, new swaps, (ii) coming up with innovative ways to make compliance easier for all other swap counterparties, and (iii) performing the necessary accounting analysis to be financially ready to begin posting and collecting Variation Margin on March 1, 2017, or shortly thereafter.



If you have any questions, please contact one of the lawyers listed below.

<p><u>Brian Sung</u> +1 212.659.4964 <a href="mailto:brian.sung@haynesboone.com">brian.sung@haynesboone.com</a></p>	<p><u>Phil Lookadoo</u> +1 202.654.4510 <a href="mailto:phil.lookadoo@haynesboone.com">phil.lookadoo@haynesboone.com</a></p>
<p><u>Kirsten Polyansky</u> +1 713.547.2069 <a href="mailto:kirsten.polyansky@haynesboone.com">kirsten.polyansky@haynesboone.com</a></p>	<p><u>Chad Mills</u> +1 713.547.2900 <a href="mailto:chad.mills@haynesboone.com">chad.mills@haynesboone.com</a></p>
<p><u>Katy Shurin</u> +1 713.547.2280 <a href="mailto:kathryn.shurin@haynesboone.com">kathryn.shurin@haynesboone.com</a></p>	<p><u>Kim Mai</u> +1 713.547.2029 <a href="mailto:kim.mai@haynesboone.com">kim.mai@haynesboone.com</a></p>

**About the Commodities Group:**

Haynes and Boone's Commodities Group serves clients from key global energy and financial hubs, including Houston, Denver, London, Mexico City, New York, and Washington, DC. We have a team of more than 20 commodities lawyers covering a broad spectrum of commodities business, which we divide into the following four distinct sub-specialty areas of (1) Trading and Derivatives, (2) Trade and Commodity Finance, (3) Structured Transactions and (4) Regulatory Authorization and Compliance. [Learn more.](#)