



U.S. COMMODITY FUTURES TRADING COMMISSION

Three Lafayette Centre
1155 21st Street NW, Washington, DC 20581
Telephone: (202) 418-5000

Division of Swap Dealer and
Intermediary Oversight

Eileen T. Flaherty
Director

CFTC Letter No. 16-70
No-Action
September 1, 2016
Division of Swap Dealer and Intermediary Oversight

Re: Commission Regulation 23.157: Time Limited No-Action Position for Failure to Require Initial Margin to be Held by Unaffiliated Custodian

Ladies and Gentlemen:

This letter is in response to a request for a no-action position received by the Division of Swap Dealer and Intermediary Oversight (“**DSIO**”) of the Commodity Futures Trading Commission (“**Commission**”) from the International Swaps and Derivatives Association (“**ISDA**”) and the Securities Industry and Financial Markets Association (“**SIFMA**”) on behalf of their members that are swap dealers (“**SDs**”) registered with the Commission and subject to the Commission’s rules regarding margin requirements for uncleared swaps.¹

Specifically, ISDA/SIFMA asked for relief from the custodial arrangement requirements of Commission Regulation 23.157² such that any initial margin posted to, or collected from, a counterparty by an SD with respect to an uncleared swap will not be required to be held by a custodian that is not the SD, its counterparty, or a margin affiliate³ of the SD or its counterparty between September 1, 2016 and October 3, 2016.

¹ The Commission’s margin requirements for uncleared swaps apply only to SDs and major swap participants for which there is not a Prudential Regulator. *See* 7 U.S.C. 6s(e)(1)(B). SDs and major swap participants for which there is a Prudential Regulator must meet the margin requirements for uncleared swaps established by the applicable Prudential Regulator. 7 U.S.C. 6s(e)(1)(A). *See also* 7 U.S.C. 1a(39) (defining the term “Prudential Regulator” to include the Board of Governors of the Federal Reserve System; the Office of the Comptroller of the Currency; the Federal Deposit Insurance Corporation; the Farm Credit Administration; and the Federal Housing Finance Agency). The Prudential Regulators published final margin requirements in November 2015. *See* Margin and Capital Requirements for Covered Swap Entities, 80 FR 74840 (Nov. 30, 2015) (“**Prudential Regulators’ Final Margin Rule**”).

² 17 CFR § 23.157

³ “Margin affiliate” is defined in Commission Regulation 23.151, which states: “A company is a margin affiliate of another company if: (1) Either company consolidates the other on a financial statement prepared in accordance with

I. Regulatory Background

Pursuant to section 4s(e) of the Commodity Exchange Act (“CEA”)⁴, the Commission is required to promulgate margin requirements for uncleared swaps applicable to each SD for which there is no Prudential Regulator.⁵ The Commission published final margin requirements for such SDs in January 2016 (the “**Final Margin Rule**”).⁶

As part of the Final Margin Rule, the Commission promulgated Commission Regulation 23.157, which, among other things, requires SDs to ensure that initial margin posted to counterparties and collected from counterparties be held with an unaffiliated custodian.⁷ Commission Regulation 23.157(c) further provides that SDs must enter into custodial agreements meeting certain specified criteria.

The Commission notes that, pursuant to Commission Regulation 23.161, compliance dates for the Final Margin Rule are staggered such that SDs must come into compliance in a series of phases over 4 years. The first phase affects SDs with the largest outstanding notional amounts of uncleared swaps (“**Phase 1 Firms**”), which must begin complying with the Final Margin Rule on September 1, 2016.⁸

U.S. Generally Accepted Accounting Principles, the International Financial Reporting Standards, or other similar standards, (2) Both companies are consolidated with a third company on a financial statement prepared in accordance with such principles or standards, or (3) For a company that is not subject to such principles or standards, if consolidation as described in paragraph (1) or (2) of this definition would have occurred if such principles or standards had applied.”

⁴ 7 U.S.C. § 1 et. seq.

⁵ See 7 U.S.C. 6s(e)(1)(B).

⁶ See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 FR 636 (Jan. 6, 2016). The Margin Rule, which became effective April 1, 2016, is codified in part 23 of the Commission’s regulations. See §§ 23.150-159, 161. The Commission’s regulations are found in Chapter 17 of the Code of Federal Regulations, 17 CFR 1 et. seq.

⁷ See Commission Regulation 23.157(a) and (b), 17 CFR § 23.157(a) and (b), stating:

(a) *Initial margin posted by covered swap entities.* Each covered swap entity that posts initial margin with respect to an uncleared swap shall require that all funds or other property that the covered swap entity provides as initial margin be held by one or more custodians that are not the covered swap entity, the counterparty, or margin affiliates of the covered swap entity or the counterparty.

(b) *Initial margin collected by covered swap entities.* Each covered swap entity that collects initial margin required by § 23.152 with respect to an uncleared swap shall require that such initial margin be held by one or more custodians that are not the covered swap entity, the counterparty, or margin affiliates of the covered swap entity or the counterparty.

⁸ See Commission Regulation 23.161(a)(1), 17 CFR § 23.161(a)(1).

II. Summary of Request for No-Action Position

ISDA/SIFMA have completed a comprehensive survey of the readiness of Phase 1 Firms to comply with the Final Margin Rule as of September 1, 2016. As represented by ISDA/SIFMA, the survey shows that Phase 1 Firms have not completed all documentation required to comply with the custodial requirements of Commission Regulation 23.157 due to the high volume of custodial agreements that must be completed (including control agreements that provide a perfected security interest to a counterparty receiving initial margin). In addition, ISDA/SIFMA have represented that many Phase 1 Firms that have completed custodial agreements are concerned that they have not had sufficient time to test the new custodial infrastructure requirement under the CFTC's margin requirements.

For these and other reasons, ISDA/SIFMA state that many Phase 1 Firms will not be able to implement the Final Margin Rule by September 1, 2016 without causing disruptions to the uncleared swap market. Specifically, Phase 1 Firms may be required to stop trading with some counterparties, which could reduce access to liquidity and the ability to hedge positions for other counterparties, including other SDs and their affiliates.

III. DSIO No-Action Position

Based on the foregoing, DSIO believes that a time limited no-action position is warranted. Accordingly, DSIO will not recommend an enforcement action against a Phase 1 Firm that, acting in good faith, has not completed required custodial agreements or requires additional time to test a new custodial infrastructure based solely on such firm failing to comply with Commission Regulation 23.157 prior to October 3, 2016 by:

- (a) Not requiring that initial margin amounts collected from, or posted to, a counterparty be held by a custodian in accordance with 23.157(a) or (b); or
- (b) Not having entered into an agreement with a custodian holding such initial margin amounts in accordance with 23.157(c).

The no-action position above is subject to the following conditions:

- (1) The Phase 1 Firm collects and posts initial and variation margin amounts calculated in accordance with the Commission's uncleared swap margin rules;
- (2) The Phase 1 Firm holds initial margin collected from other Phase 1 Firms in accordance with arrangements existing and documented as of the date of this letter;⁹

⁹ DSIO notes that this condition would not permit a Phase 1 Firm to initiate new custodial or other arrangements for the period of the no-action position. Rather, a Phase 1 Firm must use whatever existing arrangements it has in place with its Phase 1 Firm counterparties regarding the manner in which a Phase 1 Firm will hold collateral posted by such counterparty.

- (3) The Phase 1 Firm must comply with the restrictions set forth in Commission Regulation 23.157(c)(1) with respect to the initial margin amounts collected from other Phase 1 Firms;¹⁰ and
- (4) The Phase 1 Firm immediately complies with 23.157 with respect to a counterparty for which the Phase 1 Firm has completed required custodial agreements and its testing of the custodial infrastructure relevant to such counterparty.¹¹

This letter, and the positions taken herein, represent the views of DSIO and do not necessarily represent the positions or views of the Commission or of any other office or division of the Commission. The relief issued by this letter does not excuse persons relying on it from compliance with any other applicable requirements contained in the CEA or in the Regulations issued thereunder. This letter does not create or confer any rights or obligations on any person or persons subject to compliance with the CEA that bind the Commission or any of its other offices or division. As with all no-action letters, DSIO retains the authority to condition further, modify, suspend, terminate, or otherwise restrict the terms of the no-action relief provided herein, at its discretion.

Should you have any questions, please contact me at (202) 418-5326 or Frank Fisanich, Chief Counsel, at (202) 418-5949.

Very truly yours,

Eileen T. Flaherty
Director
Division of Swap Dealer and Intermediary Oversight

Cc: Regina Thoele, Compliance
National Futures Association, Chicago

Jamila A. Piracci, OTC Derivatives
National Futures Association, New York

¹⁰ Commission Regulation 23.157(c)(1) prohibits a custodian from “rehypothecating, repledging, reusing, or otherwise transferring (through securities lending, securities borrowing, repurchase agreement, reverse repurchase agreement or other means) the collateral held by the custodian except that cash collateral may be held in a general deposit account with the custodian if the funds in the account are used to purchase an asset described in asset is held in compliance with this section, and such purchase takes place within a time period reasonably necessary to consummate such purchase after the cash collateral is posted as initial margin.”

¹¹ DSIO notes that this condition requires initial margin received from a Phase 1 Firm counterparty during the period of the no-action position to be immediately transferred to the custodian agreed between the parties upon completion of the custodial arrangements required by Commission Regulation 23.157 and testing of the relevant custodial infrastructure.