



U.S. COMMODITY FUTURES TRADING COMMISSION

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Division of Swap Dealer and
Intermediary Oversight

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Director

CFTC Letter No. 17-13

No-Action

February 23, 2017

Division of Swap Dealer and Intermediary Oversight

Re: Commission Regulation 23.153: Time-Limited No-Action Position for the Timing of the Posting and Collection of Variation Margin from Certain Counterparties Operating in Japan

Ladies and Gentlemen:

This letter is in response to a request dated February 14, 2017, for a no-action position received by the Division of Swap Dealer and Intermediary Oversight (“**DSIO**”) of the U.S. Commodity Futures Trading Commission (“**Commission**” or “**CFTC**”) from the International Swaps and Derivatives Association (Japan) (“**ISDA Japan**”) on behalf of its members that are swap dealers (“**SDs**”)¹ registered with the Commission and subject to the Commission’s rules regarding margin requirements for uncleared swaps.²

Specifically, ISDA Japan requested relief for SDs that are subject to the uncleared swap margin requirements of both the CFTC and the Financial Services Agency of Japan (“**JFSA**”) from the CFTC’s requirement under Commission Regulation 23.153³ to post and collect variation margin

¹ Although the relief contained herein was requested by ISDA (Japan) on behalf of its members that are SDs, such relief is available to all SDs that are subject to Japan’s uncleared OTC derivative margin requirements.

² 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).

³ 17 CFR § 23.153.

from certain financial counterparties within one business day of the execution of an uncleared swap and on a daily basis thereafter.

I. Regulatory Background

A. CFTC Margin Rule

Pursuant to section 4s(e) of the Commodity Exchange Act (“CEA”), the Commission is required to promulgate margin requirements for uncleared swaps applicable to each SD and MSP for which there is no Prudential Regulator (collectively, “**Covered Swap Entities**” or “**CSEs**”). On January 6, 2016, the Commission published margin requirements for such CSEs (“**CFTC Margin Rule**”).⁴

The CFTC Margin Rule requires SDs to exchange variation margin with CFTC-registered SDs and MSPs, as well as financial end users, on or before the business day after execution of an uncleared swap with those counterparties.⁵ Further, SDs must continue to calculate and exchange variation margin on a daily basis until the swap is terminated or expires (the timing of such required exchange together with the timing of the first required exchange of variation margin after execution, “**T+1**”).⁶

B. JFSA Margin Rules

Japan’s margin requirements for over-the-counter derivatives (“**OTC derivatives**”) are governed by the Financial Instruments and Exchange Act, the Cabinet Office Ordinance on Financial Instruments Business, and various JFSA public notices (collectively, “**JFSA FIEA**”).⁷ The entities subject to the JFSA FIEA include, but are not limited to, certain types of Financial Instruments Business Operators and Registered Financial Institutions (collectively, “**JFSA Covered Enti-**

⁴ See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 FR 636 (Jan. 6, 2016) (“**CFTC Margin Rule**”). The CFTC Margin Rule 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.*

⁵ See 17 CFR § 23.153(a); see also 17 CFR § 23.150 for the definition of “financial end user.”

⁶ See 17 CFR § 23.153(b).

⁷ See Financial Instruments and Exchange Act, No. 25 of 1948, as amended; Cabinet Office Ordinance on Financial Instruments Business (Cabinet Office Ordinance No. 52 of August 6, 2007) (“**FIB Ordinance**”); JFSA Public Notification No.15 of March 31, 2016; JFSA Public Notification No.16 of March 31, 2016; and JFSA Public Notification No.17 of March 31, 2016.

ties”).⁸ Additionally, the JFSA has published supervisory guidelines that supplement the content and scope of the JFSA FIEA (“**JFSA Supervisory Guidelines**”).⁹

The JFSA FIEA requires JFSA Covered Entities to exchange variation margin with other JFSA Covered Entities that exceed a minimum trading volume threshold (“**Variation Margin Threshold**”)¹⁰ as soon as practicable after the execution of an OTC derivative.¹¹ Thereafter, JFSA Covered Entities must continue to calculate variation margin on a daily basis, and exchange variation margin as soon as practicable.¹²

However, as represented by ISDA (Japan), SDs are not required to comply with the JFSA FIEA with certain counterparties operating in Japan, such as those whose OTC derivatives activities fall below the Variation Margin Threshold or counterparties that are not JFSA Covered Entities (such entities are hereinafter referred to as “**Supervised Counterparties**”). Nevertheless, SDs entering into transactions with Supervised Counterparties are subject to the JFSA Supervisory Guidelines, which require the establishment of an appropriate risk management system in accordance with relevant margin requirements under the JFSA FIEA and BCBS/IOSCO framework except that variation margin must be calculated and exchanged “with sufficient frequency” as determined by the counterparties, rather than the more stringent “as soon as practicable” standard under the JFSA FIEA.¹³

C. Japan Comparability Determination

On September 15, 2016, the Commission published the Japan Comparability Determination, which found that, with the exception of inter-affiliate swap requirements, the JFSA FIEA is com-

⁸ Specifically, the JFSA FIEA applies to: (i) Type 1 Financial Instruments Business Operators (“**FIBOs**”); (ii) banks that are Registered Financial Institutions (“**RFIs**”); (iii) insurance companies that are RFIs; (iv) trust accounts that are either FIBOs or RFIs; (v) Shoko Chukin Bank; (vi) the Development Bank of Japan; (vii) Shinkin Central Bank; and (viii) Norinchukin Bank.

⁹ See *e.g.*, Comprehensive Guideline for Supervision of Major Banks, Comprehensive Guidelines for Supervision of Regional Financial Institutions, Comprehensive Guideline for Supervision of Cooperative Financial Institutions, Comprehensive Guideline for Supervision of Financial Instruments Business Operators, etc., Comprehensive Guidelines for Supervision of Insurance Companies, and Comprehensive Guidelines for Supervision of Trust Companies.

¹⁰ In general, a JFSA Covered Entity has exceeded the Variation Margin Threshold if the average total amount of the notional principal of its OTC derivatives for a one-year period from April two years before the year in which calculation is required (or one year if calculated in December) exceeds JPY 300 billion (approximately \$2.7 billion).

¹¹ See FIB Ordinance, Article 123(1)(xxi)-5(a)-(c). The JFSA has represented to the Commission that, as a supervisory matter, it would expect most entities subject to the JFSA FIEA to collect margin within one to two business days, with some flexibility for cross-border transactions. The JFSA also represented that Japan has committed to moving towards a T+1 settlement of financial instruments by 2018. See Comparability Determination for Japan: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 FR 63376, 63386 (Sept. 15, 2016) (“**Japan Comparability Determination**”).

¹² See FIB Ordinance, Article 123(1)(xxi)-5(a)-(c).

¹³ See JFSA Supervisory Guidelines at IV-2-4(4)(i).

parable to the CFTC Margin Rule.¹⁴ Accordingly, where a transaction is subject to the margin rules of both jurisdictions, an SD may choose to comply with the JFSA FIEA in place of the CFTC Margin Rule. Given that the Commission has not made a comparability determination for the JFSA Supervisory Guidelines, substituted compliance is not available for transactions involving Supervised Counterparties.

II. Summary of Request for Relief

In its letter dated February 14, 2017, ISDA Japan acknowledged that transactions that are subject to the JFSA Supervisory Guidelines, rather than the JFSA FIEA, only require variation margin to be calculated and exchanged with “sufficient frequency,” as determined by the counterparties. SDs in Japan are encountering regulatory compliance challenges with respect to the requirements under the CFTC Margin Rule pertaining to the timeframe in which variation margin must be collected and/or posted under § 23.153(a) and § 23.153(b).

Specifically, as mentioned in the Japan Comparability Determination, transactions in Japanese Government Bonds (“**JGBs**”) currently settle in 2 or 3 business days. While the timing of margin collection and posting is expected to naturally shorten over a relatively brief period of time and become T+1 for JGBs by 2018, smaller institutions and funds may need additional time to become capable of settling JGBs on a T+1 basis due to operational or other infrastructure constraints. If JGBs become ineligible for use as collateral by Supervised Counterparties whenever the CFTC Margin Rule is applicable, the market will lose a safe and highly liquid form of eligible collateral, perhaps increasing certain types of risk.

ISDA Japan further noted that dual SDs/JFSA Covered Entities act as primary liquidity providers for non-JPY instruments in the Japanese market. ISDA Japan also represented that some Supervised Counterparties may find it operationally difficult to calculate and exchange variation margin on a daily basis. Accordingly, ISDA Japan stated that, absent a no-action position from DSIO, dual SDs/JFSA Covered Entities may have to discontinue trading with Supervised Counterparties, potentially leading to substantial losses for such counterparties.

When the Commission adopted the CFTC Margin Rule, it stated that “the daily exchange of variation margin is an important risk mitigant” that is also reflective of current market practices.¹⁵ DSIO acknowledges, however, that daily variation margin exchange does not reflect the current market practices in Japan for all transactions involving Supervised Counterparties.

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 an SD that is a dual SD/JFSA Covered Entity for failure to comply with the variation margin posting and collection

¹⁴ See Japan Comparability Determination, 81 FR at 63386.

¹⁵ See CFTC Margin Rule at 665.

timing requirements of Commission Regulation 23.153(a) and (b) with respect to an uncleared swap with a Supervised Counterparty, subject to the following conditions:

- (1) Subject to any minimum transfer amount not exceeding the amount permitted under Commission Regulation 23.153(c),¹⁶ the SD posts or collects any variation margin amount required pursuant to Commission Regulation 23.153(a),¹⁷ within three business days of the execution of the uncleared swap (“**T+3**”);
- (2) Subject to any minimum transfer amount not exceeding the amount permitted under Commission Regulation 23.153(c), the SD posts or collects any variation margin amount required pursuant to Commission Regulation 23.153(b)¹⁸ at least T+3 until the uncleared swap is terminated or expires;
- (3) The SD uses its best efforts to comply with the T+1 requirement of Commission Regulation 23.153(a) and (b) for transactions with Supervised Counterparties as soon as possible; and
- (4) No later than March 1, 2020, the SD complies with the T+1 requirement of Commission Regulation 23.153(a) and (b) for all transactions with Supervised Counterparties.

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

¹⁶ See 17 CFR § 23.153(c), stating:

Minimum transfer amount. A covered swap entity is not required to collect or to post variation margin pursuant to §§ 23.150 through 23.161 with respect to a particular counterparty unless and until the combined amount of initial margin and variation margin that is required pursuant to §§ 23.150 through 23.161 to be collected or posted and that has not been collected or posted with respect to the counterparty is greater than \$500,000.

¹⁷ See 17 CFR § 23.153(a), stating:

Initial obligation. On or before the business day after the day of execution of an uncleared swap between a covered swap entity and a counterparty that is a swap entity or a financial end user, the covered swap entity shall collect the variation margin amount from the counterparty when the amount is positive, or post the variation margin amount with the counterparty when the amount is negative as calculated pursuant to § 23.155 and in a form that complies with § 23.156.

¹⁸ See 17 CFR § 23.153(b), stating:

Continuing obligation. The covered swap entity shall continue to collect the variation margin amount from, or to post the variation margin amount with, the counterparty as calculated each business day pursuant to § 23.155 and in a form that complies with § 23.156 each business day until such uncleared swap is terminated or expires.

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 divisions. 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 do not hesitate to contact me at (202) 418-5326 or Frank Fisanich, Chief Counsel, at (202) 418-5949.

Very Truly Yours,

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