

U.S. Prudential Regulators Expected to Propose Amendments to Swap Margin Rule

October 8, 2019

On September 17, 2019, the Federal Deposit Insurance Corporation (the “**FDIC**”) **published** proposed amendments (the “**Proposal**”) to the U.S. prudential regulators’ (the “**Agencies**”) ¹ non-cleared swap and security-based swap ² margin regulations (the “**Swap Margin Rule**” or the “**Rule**”). ³ Each of the Agencies is expected to issue the Proposal as published by the FDIC. Among other things, the Proposal would:

- permit prudentially regulated swap dealers and security-based swap dealers (“**covered swap entities**”) to make certain amendments to Legacy Swaps (as defined below) without bringing them into scope for purposes of the Rule, including amendments made to replace an interbank offer rate (“**IBOR**”), such as the London Interbank Offered Rate (“**LIBOR**”);
- repeal the Swap Margin Rule’s requirement that a covered swap entity collect initial margin from its affiliates (although variation margin would still be required);
- add an additional initial margin compliance period for certain smaller counterparties; and
- clarify the point at which certain initial margin documentation must be put in place.

Each of these proposed amendments is discussed further below. Comments on the Proposal will be due by 30 days after publication in the Federal Register, which has not yet occurred.

Legacy Swap Amendments

Under the Swap Margin Rule, swaps entered into before the applicable compliance date (“**Legacy Swaps**”) are grandfathered from the Rule’s requirements until they expire according to their terms. However, to prevent evasion of the Swap Margin Rule’s requirements, a Legacy Swap that is amended or novated on or after the applicable compliance date will lose its legacy status and become subject to the Rule, ⁴ subject to two limited exceptions. ⁵

The Proposal would expand the types of amendments to Legacy Swaps that would be permitted without triggering the requirements of the Rule. The Proposal would also clarify that the permissible amendments may be made using a variety of legal mechanisms—by method of adherence to a protocol, contractual amendment of an agreement or confirmation, or execution of a new contract in replacement of and immediately upon termination of an existing contract.

¹ The U.S. prudential regulators include the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the FDIC, the Farm Credit Administration, and the Federal Housing Finance Agency.

² For the remainder of this memorandum, the term “swap” should be read as including swaps and security-based swaps, unless the context requires otherwise.

³ See Agencies, Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74840 (Nov. 30, 2015), *available at* <https://www.govinfo.gov/content/pkg/FR-2015-11-30/pdf/2015-28671.pdf>.

⁴ *Id.* at 74850-51

⁵ The Agencies previously amended the Rule to provide relief for amendments to Legacy Swaps made: (i) to achieve compliance with the “U.S. QFC stay rules”—rules imposing restrictions on non-cleared swaps and other qualified financial contracts of global systemically important banking organizations—and (ii) to facilitate the transfer of a Legacy Swap to an affiliate located outside of the United Kingdom in the event that the United Kingdom withdraws from the European Union without a withdrawal agreement.

Amendments Relating to the Replacement of an IBOR or Other Rate

As described in the Proposal, regulators and market participants globally have engaged in efforts to transition away from IBORs, such as LIBOR, in response to the discovery of market manipulation and false reporting of many IBORs, as well as a decline in liquidity in interbank unsecured funding markets. For example, the U.K. Financial Conduct Authority, which regulates the administrator of LIBOR, has stated that it will not compel contributions to LIBOR following the end of 2021. As a result, swaps that reference LIBOR and other IBORs will need to be amended to include alternative reference rates.

The Proposal would facilitate these efforts by permitting a covered swap entity to amend a Legacy Swap in order to replace an IBOR, any other interest rate that is reasonably expected to be discontinued or is reasonably determined to have lost its relevance as a reliable benchmark, or any successor to such rates. Covered swap entities would also be permitted to “incorporate spreads or other adjustments to the replacement rate” in order to maintain the economics of the swap and “make other necessary technical changes to operationalize the determination of payments or other exchanges of economic value using the replacement rate, including changes to determination dates, calculation agents, and payment dates,” provided that neither the maturity nor the total effective notional amount of the Legacy Swap is increased. In addition, the Proposal would permit multiple amendments to a Legacy Swap under this exemption to accommodate ongoing developments toward a permanent replacement rate.⁶

Amendments Due to Technical Changes and Other Routine Life-Cycle Activities

The Proposal would also clarify that amendments to Legacy Swaps arising from certain routine industry practices over the life-cycle of a non-cleared swap that are carried out for logistical or risk-management purposes will not affect Legacy Swap status. Specifically, such permissible amendments would include:

- **Technical changes** - amendments reflecting technical changes (e.g., addresses or identities of the parties for delivery of formal notices); provided that the changes do not alter the Legacy Swap’s underlying asset or indicator (e.g., security, currency, interest rate, or commodity), the remaining maturity or the total effective notional amount;
- **Notional reductions** - amendments reducing the notional amount of a Legacy Swap⁷; and
- **Portfolio compressions** - amendments made solely to reduce risk or remain risk-neutral through portfolio compression between or among covered swap entities and their counterparties, subject to limitations on the maturity and effective notional amount of any swap amended or entered into as a replacement as part of the compression exercise.⁸

The Agencies explained that these types of amendments would not raise concerns that the covered swap entity is seeking to evade or otherwise delay the application of margin requirements for non-cleared swaps.

⁶ For example, an IBOR may first be replaced with a temporary fallback provision, which may subsequently be replaced with a permanent alternative reference rate. The Agencies explained that there would be no limit to the number of such amendments. See Proposal at p. 29.

⁷ For these purposes, a reduction in notional amount could be achieved through a partial termination of the original swap or by novating a portion of the original swap to a third party. In the latter case, the original swap with a lower notional amount would retain legacy status, but the novated portion would be subject to applicable Swap Margin Rule requirements. See *id* at p. 42.

⁸ Specifically, if the portfolio compression amendments are made pursuant to a modification of an existing swap, any such amendments must not extend the remaining maturity or increase the total effective notional amount of the swap. If the amendments are made pursuant to a new swap that is entered into as a replacement to reflect the outcome of the compression exercise, the replacement swap must not (i) exceed the sum of the total effective notional amounts of all of the swaps that were submitted to the compression exercise that had the same or longer remaining maturity as the replacement swap or (ii) exceed the longest remaining maturity of all the swaps submitted to the compression exercise.

Inter-Affiliate Exemption for Initial Margin

When entering into an inter-affiliate⁹ swap, a covered swap entity is currently required to collect (subject to a \$20 million initial margin threshold), but is not required to post, initial margin. This contrasts with the uncleared swap margin rules adopted by the U.S. Commodity Futures Trading Commission (“**CFTC**”) and the Securities and Exchange Commission (“**SEC**”). The CFTC generally does not require swap dealers covered by the rule to collect or post initial margin when entering into swaps with affiliates, provided that the inter-affiliate swaps are subject to a centralized risk management program. The SEC does not require security-based swap dealers to likewise collect or post initial margin. The Proposal would align the Swap Margin Rule more closely with the CFTC and SEC rules by providing an exemption from collecting and posting initial margin for inter-affiliate swaps, although, consistent with the CFTC and SEC swap margin rules, inter-affiliate swaps would continue to be subject to variation margin requirements.

Additional Initial Margin Compliance Date

The Swap Margin Rule implements initial margin requirements in five phases, with phase five currently scheduled for September 1, 2020—phase five covers swap entities and counterparties with swap portfolios ranging from \$8 billion to \$750 billion in average daily aggregate notional amounts (“**AANAs**”), as calculated under the Rule. However, the industry has expressed concerns about operational and other difficulties associated with beginning to exchange initial margin with the large number of relatively small phase five counterparties. In response to these concerns, the Proposal would extend the compliance deadline for counterparties with AANAs of \$8 billion up to \$50 billion to September 1, 2021 (the compliance date for counterparties with AANAs of \$50 billion to \$750 billion would remain September 1, 2020).

Clarification Regarding Initial Margin Documentation Requirements

Section __.10 of the Swap Margin Rule requires covered swap entities to enter into initial margin trading documentation that satisfies certain specified requirements. The Proposal would amend § __.10 of the Rule to explicitly state that a covered swap entity is not required to execute such trading documentation with a counterparty until it is required to collect or post initial margin pursuant to the Rule (e.g., when it calculates an initial margin amount that, after subtracting the initial margin threshold amount, exceeds zero). The Agencies noted that they would expect covered swap entities to “closely monitor their exposures and take appropriate steps to ensure that trading documentation is in place at such time as initial margin is required to be exchanged.”¹⁰

⁹ The Proposal would also supplement the existing definition of affiliate for purposes of the proposed inter-affiliate exemption for initial margin by adding a “catch-all” legal standard for affiliates that would cover any company that controls, is controlled by, or is under common control with the covered swap entity through the direct or indirect exercise of controlling influence over the management or policies of the controlled entity.

¹⁰ See Proposal at p. 40.

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