U.S. Prudential Regulators Finalize Amendments to Swap Margin Rule

July 20, 2020

The U.S. Prudential Regulators[1] have finalized amendments (the "**Final Rule**")[2] to their non-cleared swap and security-based swap ("**SBS**")[3] margin regulations (the "**PR Margin Rule**").[4] Among other things, the Final Rule:

- permits prudentially regulated swap dealers and security-based swap dealers ("**SBSDs**" and, together with 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**");
- exempts covered swap entities from the requirement to collect initial margin from affiliates below a 15% Tier 1 Capital Threshold (as defined below), though variation margin is still required to be exchanged;
- adds an additional initial margin compliance period for certain smaller counterparties, and a separate interim final rule[5] extends the remaining initial margin compliance periods in light of COVID-19; and
- clarifies the point at which certain initial margin documentation must be put in place.

Each of these amendments is discussed further below. The Final Rule will be effective August 31, 2020.

Legacy Swap Amendments

Under the PR 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 PR Margin Rule's requirements, a Legacy Swap that is amended or novated on or after the applicable compliance date will generally lose its legacy status and become subject to the PR Margin Rule.[6]

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[1] The "**Prudential Regulators**" are the Office of the Comptroller of the Currency ("**OCC**"), the Board of Governors of the Federal Reserve System ("**Federal Reserve**"), the Federal Deposit Insurance Corporation ("**FDIC**"), the Farm Credit Administration, and the Federal Housing Finance Agency.

[2] Margin and Capital Requirements for Covered Swap Entities, 85 Fed. Reg. 39754 (July 1, 2020), *available at* **https://www.govinfo.gov/content/pkg/FR-2020-07-01/pdf/2020-14097.pdf**.

[3] For the remainder of this memorandum, the term "**swap**" should be read as including swaps and SBS, unless the context requires otherwise.

[4] *See* Prudential Regulators, 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.** ("**PR Margin Rule**")

[5] Margin and Capital Requirements for Covered Swap Entities, 85 Fed. Reg. 39464 (July 1, 2020), *available at* **https://www.govinfo.gov/content/pkg/FR-2020-07-01/pdf/2020-14094.pdf**.

[6] PR Margin Rule at 74850–51. The Prudential Regulators 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 (*cont.*)

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The Final Rule expands the types of amendments to Legacy Swaps that would be permitted without triggering the requirements of the Rule. The Final Rule also clarifies that the permissible amendments may be made using a variety of legal mechanisms—by method of adherence to a protocol, other amendment of a contract or confirmation, or execution of a new contract or confirmation in replacement of and immediately upon termination of an existing contract or confirmation (so-called "tear-ups").

Amendments Relating to the Replacement of an IBOR or Other Rate

As described in the Final Rule, 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 after 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 Final Rule is intended to 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 replaced or discontinued or is reasonably determined to have lost its relevance as a reliable benchmark, or any successor to such rates. Covered swap entities will also be permitted to "incorporate spreads or other adjustments to the replacement interest 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 interest 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 extended or increased "beyond what is necessary to accommodate the differences between market conventions for an outgoing interest rate and its replacement."[7] In addition, the Final Rule permits multiple amendments to a Legacy Swap under this exemption to accommodate ongoing developments toward a permanent replacement rate.[8]

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

The Final Rule provides 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 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 reference (e.g., security, currency, interest rate, or commodity), the remaining maturity or the total effective notional amount;[9]

(*cont.*)

other qualified financial contracts of global systemically important banking organizations, *see* 12 C.F.R. §§ 252.81–88 (Federal Reserve), pt. 47 (OCC), pt. 382 (FDIC)—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. The Final Rule included minor updates to both. The Final Rule relocates the provision permitting amendments to comply with the U.S. QFC Stay Rules, and the preamble notes that the United Kingdom and European Union have ratified a withdrawal agreement.

[7] The Final Rule includes a separate provision permitting covered swap entities to employ portfolio compression to effectuate amendments to Legacy Swaps for the purpose of eliminating IBORs or other covered rates. Swaps resulting from such compression exercises are subject to the same limitations on maturity and notional as other IBOR-related amendments, but are not subject to the limitations on maturity and notional that generally apply to portfolio compression exercises, which are described below.

[8] 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 Prudential Regulators explained that there would be no limit to the number of such amendments. *See* Final Rule at 39757.

[9] The Prudential Regulators also clarified that this amendment is intended to align with the no-action relief granted by in CFTC Letter No. 19-13 (June 6, 2019), *available at* **https://www.cftc.gov/csl/19-13/download**.

- **Notional reductions**—amendments reducing the notional amount of a Legacy Swap;[10] 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, provided that the swaps resulting from the portfolio compression do 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 resulting swap or (ii) exceed the longest remaining maturity of all the swaps submitted to the compression exercise.

Inter-Affiliate Exemption for Initial Margin

The Final Rule eliminates the requirement in the PR Margin Rules that a covered swap entity collect initial margin from an affiliate,[11] subject to a 15% Tier 1 Capital Threshold (as defined below). Covered swap entities were already exempted from the requirement to post initial margin to affiliates. Inter-affiliate swaps are still subject to variation margin requirements. This approach is a step closer to the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions ("**BCBS/IOSCO**") policy framework on margin requirements for non-cleared derivatives (the "**BCBS/IOSCO Framework**"),[12] as well as the CFTC's uncleared swap margin rule and the SEC's uncleared SBS margin rule, each of which exempt non-prudentially regulated swap dealers and SBSDs from the requirement to collect initial margin from affiliates.

The Prudential Regulators explained in the preamble to the Final Rule that their views of inter-affiliate swaps have developed "with the benefit of hindsight in the time since the [PR Margin Rule] was finalized."[13] For example, with respect to swap booking practices, the Prudential Regulators observe that internationally active covered swap entities often establish places of business (either a local branch or a locally incorporated affiliate) both in the locations of their customers and in the marketplaces where trading is heavily concentrated for key types of derivatives—e.g., the United Kingdom as the primary marketplace for sterling interest rate swaps. If a customer in the United States wants to enter into a swap that is primarily traded in the United Kingdom, a U.S. covered swap entity may first book a swap with the customer in the United States. It may then hedge the swap by transferring the risk through an inter-affiliate swap to its U.K. affiliate and entering into an offsetting swap between the U.K. affiliate and another market participant (including another dealer) in the United Kingdom. This allows the covered swap entity to centralize its risk for a certain type of product within one legal entity, generally the entity that can receive the most advantageous terms such as the best pricing and widest range of maturities. The Prudential Regulators recognize that centralizing the risk in this was is a "better risk management practice" than managing market-facing risk in the jurisdiction of each customer, where markets are less

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[10] For this purpose, 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* Final Rule at 39767.

[11] The Final Rule supplements the definition of "affiliate" for purposes of the limited inter-affiliate exemption by adding a "catch-all" legal standard for affiliates that covers 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. This change aligns the affiliate definition under this provision of the PR Margin Rule with the full scope of entities treated as affiliates under the Bank Holding Company Act and banking regulations that apply to covered swap entities that are banking organizations. It is not clear, however, from the Final Rule whether the Prudential Regulators will interpret the new catch-all control prong of the affiliate definition consistent with the U.S. banking agencies' interpretation of the similar Bank Holding Company Act definition.

[12] BCBS/IOSCO, Margin Requirements for Non-Centrally Cleared Derivatives (revised March 2015), *available at* **https://www.bis.org/bcbs/publ/d317.pdf**.

[13] Final Rule at 39761.

liquid or local personnel need to enter into trades with foreign dealers.[14] The exemption from the requirement to collect initial margin for inter-affiliate swaps is consistent with that view.

The preamble also explains that collecting initial margin on the inter-affiliate swap is not the only method to protect a covered swap entity from the risk of the trade. Covered swap entities are subject to prudential regulation and must employ market and credit risk limits, and the local entities that enter into the customer- and market-facing swaps will collect initial margin to the extent required pursuant to the PR Margin Rule or other applicable U.S. and foreign swap margin rules (continuing the example above, because the U.S. covered swap entity would be subject to the PR Margin Rule, it would collect initial margin from the customer as required under the PR Margin Rule, and the U.K. affiliate would collect initial margin from its counterparty in the U.K. as required under the U.K. margin rules). In addition, the Final Rule includes a new provision clarifying that all inter-affiliate swaps are subject to PR Margin Rule section __.3(d), which provides that even where initial margin is not strictly required under the Rule, a covered swap entity must still collect initial margin from a counterparty "at such times and in such forms and such amounts (if any), that the covered swap entity determines appropriately addresses the credit risk posed by the counterparty and the risks of the" underlying non-cleared swaps.[15]

Moreover, the Prudential Regulators argued that initial margin for inter-affiliate swaps is not loss absorbing in the same way that equity capital is and therefore does not provide the same protection to the covered swap entity. An affiliate posting initial margin to a covered swap entity is, in the Prudential Regulators' experience since adopting the PR Margin Rule, likely to fund the initial margin payment by issuing debt, not equity.[16] In a stress scenario, when the affiliate's claim to the initial margin may be subordinated to the covered swap entity's claim, this can "plac[e] additional stress on the banking organization's access to funding."[17]

15% Tier 1 Capital Threshold.

While the Final Rule generally removes the requirement for a covered swap entity to collect margin from its affiliates, the Final Rule includes a threshold above which initial margin is required. Specifically, a covered swap entity must calculate on each business day the amount of initial margin that it would have been required to collect from each affiliate under the PR Margin Rule (an "**initial margin collection amount**"). On each business day that the aggregate of all initial margin collection amounts for all affiliates is *greater than* 15% of the covered swap entity's CET1 capital plus additional tier 1 capital, as determined under applicable U.S. Basel III capital rules and reported on the most recent call report (the "**15% Tier 1 Capital Threshold**"), the covered swap entity must collect initial margin for each new non-cleared swap with an affiliate, to the extent required under the PR Margin Rule—i.e., where the affiliate is a covered swap entity or financial end user with material swaps exposure. Initial margin must be collected for each new swap on a daily basis starting on the day after execution and ending on the earlier of the termination date or the business day on which the aggregate initial margin collection amounts for all affiliates falls *below* the 15% Tier 1 Capital Threshold.

If any **subsidiary** of a covered swap entity executes non-cleared swaps with affiliates, the covered swap entity parent must treat the subsidiary's non-cleared swaps as if they were the covered swap entity's own

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[14] Final Rule at 39761.

[15] Final Rule § __.11(c); PR Margin Rule § __.3(d).

[16] The Prudential Regulators explain that in their "supervisory and policy-making experience for internationally-active banks," affiliates do not raise additional equity or retain earnings to fund initial margin payments because "public policy and competitiveness concerns serve to establish and maintain capital requirements that must address not only adequacy, but regime equivalency." Final Rule at 39762 n.27.

[17] Final Rule at 39762.

for purposes of calculating the aggregate initial margin collection amount calculation. If the covered swap entity's 15% Tier 1 Capital Threshold is breached, the covered swap entity must collect initial margin from the affiliate on behalf of the subsidiary.

Any non-cash collateral collected from an affiliate may be held by the covered swap entity or an affiliate, though the other requirements of section __.7 of the PR Margin Rule, including limits on rehypothecation, still apply.

Exemption for Non-U.S. Non-Guaranteed Covered Swap Entities

The Final Rule amends section __.9 of the PR Margin Rule, which provides for substituted compliance for certain Non-U.S. Non-Guaranteed Covered Swap Entities, as defined in the sidebar.

A Non-U.S. Non-Guaranteed Covered Swap Entity is not required to collect initial margin from affiliates, regardless of the initial margin calculation amount and even where a substituted compliance determination has not been made that applies to the Non-U.S. Non-Guaranteed Covered Swap Entity, unless it is a subsidiary of a U.S. covered swap entity, in which case the subsidiary rule described above would apply.

This exemption for non-U.S. covered swap entities reflects that the safety and soundness and financial system risk concerns for U.S. insured depository institutions that motivated the 15% Tier 1 Capital Threshold do not apply to Non-U.S. Non-Guaranteed Covered Swap Entities. Absent the exemption, the Final Rule could have the perverse effect of requiring U.S. insured depository institutions to post initial margin to non-U.S. affiliates.

Non-U.S. Non-Guaranteed Covered Swap Entity

Section __.9 of the PR Margin Rules establishes rules for "**Non-U.S. Non-Guaranteed Covered Swap Entities**." A Non-U.S. Non-Guaranteed Covered Swap Entity is a covered swap entity that both:

(i) is:

- a foreign covered swap entity;
- a U.S. branch or agency of a foreign bank; or
- a subsidiary of a depository institution, Edge corporation or agreement corporation that is not organized under the laws of the United States or any State; and

(ii) does not have its obligations under the relevant non-cleared swap guaranteed by:

- an entity organized under the laws of the United States or any State, unless it is a U.S. branch or agency of a foreign bank;
- a natural person who is a resident of the United States; or
- a branch or office of an entity organized under the laws of the United States or any State.

Additional Initial Margin Compliance Date and Extended Compliance Dates

The PR Margin Rule originally implemented initial margin requirements in five phases, with the final phase scheduled for September 1, 2020. Phase five would have covered 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 PR Margin 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, and, in July 2019, BCBS/IOSCO revised their Framework to create an additional phase for smaller counterparties. In response to these concerns and consistent with the BCBS/IOSCO Framework, the Final Rule establishes a sixth phase that extends the initial margin compliance deadline for counterparties with AANAs of $8 billion up to $50 billion to September 1, 2021. Counterparties with AANAs of $50 billion to $750 billion remain within phase five.

At the same time as adopting the Final Rule, the Prudential Regulators issued a separate interim final rule and request for comment that extends the phase five compliance date to September 1, 2021 and the

phase six compliance date to September 1, 2022 in light of the ongoing efforts to address challenges caused by COVID-19, which is also consistent with the approach taken by BCBS/IOSCO.

Clarification Regarding Initial Margin Documentation Requirements

Section __.10 of the PR Margin Rule requires covered swap entities to enter into initial margin trading documentation. The Final Rule amends § __.10 of the PR Margin 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 PR Margin Rule (e.g., when it calculates an initial margin amount that, after subtracting the initial margin threshold amount, exceeds zero). The Prudential Regulators noted that they 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."[18]

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Annette L. Nazareth	202 962 7075	**annette.nazareth@davispolk.com**
Jai R. Massari	202 962 7062	**jai.massari@davispolk.com**
Gabriel D. Rosenberg	212 450 4537	**gabriel.rosenberg@davispolk.com**
Zachary J. Zweihorn	202 962 7136	**zachary.zweihorn@davispolk.com**
Mark A. Sater	212 450 3142	**mark.sater@davispolk.com**
Tyler X. Senackerib	212 450 3419	**tyler.senackerib@davispolk.com**
Greg Swanson	212 450 3374	**greg.swanson@davispolk.com**

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[18] *See* Final Rule at 39766.