SULLIVAN & CROMWELL LLP

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Uncleared Swaps: Proposed Amendments to Margin Requirements

Prudential Regulators Propose Rules Amending Current Swap Margin Requirements for Covered Swap Entities

INTRODUCTION

On September 18, 2019, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency proposed rules that would amend their regulations requiring swap dealers and security-based swap dealers to post and collect margin with their counterparties for uncleared swaps. The uncleared swap margin rules were originally adopted under Sections 731 and 764 of the Dodd-Frank Act, became effective on April 1, 2016 and are being phased in over a four-year period. The proposal would make the following changes:

- Most significantly, repeal the requirement that affiliates of the dealer post initial margin to the dealer;
- Permit legacy swaps to retain legacy status in the event that amendments are made (1) in order to implement a transition away from references to interbank offered rates, or (2) in connection with certain routine life-cycle activities; and
- Extend the initial margin requirement compliance date for certain smaller counterparties and clarify the timing by which trading documentation must be completed.

The agencies request comments on all aspects of the proposal. Comments are due to the agencies within 30 days after publication of the proposal in the Federal Register.

PROPOSED CHANGES REGARDING SWAP MARGIN REQUIREMENTS[1]

A. INITIAL MARGIN EXEMPTION FOR INTER-AFFILIATE UNCLEARED SWAPS

Under the existing rules governing margin requirements for swap dealers, major swap participants, security-based swap dealers and major security-based swap dealers subject to their jurisdictions ("Covered Swap Entities") adopted in 2015 (the "Swap Margin Rules" or "Rules"), Covered Swap Entities are required to collect initial margin from their affiliated counterparties, and to collect and post variation margin with those counterparties over the life of each transaction.[2] Covered Swap Entities include swap entities that are banks, bank holding companies, foreign banks, and other similar banking entities.[3] However, Covered Swap Entities do not include affiliates of such entities that are registered as swap dealers, major swap participants, security-based swap dealers or major security-based swap participants with the Commodity Futures Trading Commission (the "CFTC") or the Securities and Exchange Commission (the "SEC").

The amendments (the "Proposed Amendments") proposed by the Office of the Comptroller of the Currency (the "OCC"), the Board of Governors of the Federal Reserve System (the "Federal Reserve"), the Federal Deposit Insurance Corporation (the "FDIC"), the Farm Credit Administration (the "FCA") and the Federal Housing Finance Agency (the "FHFA") (collectively, the "Prudential Regulators") would exempt inter-affiliate uncleared swaps from the initial margin requirement of the Rules.[4] The Prudential Regulators note in their Proposed Amendments that the main reason Covered Swap Entities enter into inter-affiliate swaps has been to manage internal risk, including the transfer of risk within a banking organization to a centralized risk management function pursuant to the "prudent risk management practice."[5] As more Covered Swap Entities have come within the scope of the Swap Margin Rules, the amount of initial margin collected by Covered Swap Entities in inter-affiliate swaps has increased, leading banking entities to borrow increasing amounts of cash to fund eligible collateral. The Prudential Regulators further note that because (i) margin requirements for inter-affiliate swaps are inconsistent across different foreign jurisdictions (and even among the various U.S. market regulators, as discussed in the next paragraph) and (ii) many Covered Swap Entities are internationally active banking organizations with operations in many jurisdictions that may exempt initial margin requirements on inter-affiliate transactions, the Swap Margin Rules' imposition of initial margin requirements for inter-affiliate swaps may have provided limited systemic risk benefits and put U.S. banking firms at a competitive disadvantage. To address these concerns, the Proposed Amendments aim to provide affected banking institutions with additional flexibility for internal allocation of collateral.

Currently, as noted above, under the Swap Margin Rules, a Covered Swap Entity is required to collect initial margin from an affiliate in connection with an uncleared swap but is not required to post initial margin to the affiliate.[6] By contrast, under the CFTC and SEC rules on margin requirements, a swap entity that is not a Covered Swap Entity (a "Non-Covered Swap Entity") is not required to collect *or* post initial margin for inter-affiliate uncleared swaps, subject to certain conditions. As a result, under the Swap Margin Rules and the CFTC rules, a Covered Swap Entity, such as a bank swap dealer, is required to collect initial margin from an affiliate with which it transacts, but a Non-Covered Swap Entity within the same corporate family, such as a non-bank swap dealer that is under common control with the bank but is not itself a Covered Swap Entity, is not required to collect initial margin from the bank. In addition, because the definition of affiliate under the Swap Margin Rules includes any consolidated subsidiary of the Covered Swap Entity, a bank that is a Covered Swap Entity is required to collect initial margin on uncleared swaps from its consolidated subsidiary. The Proposed Amendments would eliminate the initial margin requirement with respect to both consolidated subsidiaries and affiliates under common consolidation.

The preamble to the Proposed Amendments notes that certain affiliate transactions remain subject to the requirements of sections 23A and 23B of the Federal Reserve Act and Regulation W,[7] and the Prudential Regulators state that those provisions are "more effective tools to address risks arising from transactions between affiliates."[8] The Prudential Regulators note that, "[t]he Board continues to consider how inter-affiliate non-cleared swaps can be addressed under Regulation W."[9] Sections 23A and 23B and Regulation W generally apply to transactions between a bank and its commonly controlled affiliates and not to transactions between the bank and its subsidiaries. As a result, the impact of the elimination of the inter-affiliate initial margin requirement in the Proposed Amendments may differ as between uncleared swap transactions between a Covered Swap Entity and its subsidiaries as opposed to between a Covered Swap Entity and its Regulation W affiliates.

The Proposed Amendments would not alter the requirement for Covered Swap Entities to post and collect variation margin with their affiliates, which has become routine in recent years for Covered Swap Entities and contributes to safety and soundness of the Covered Swap Entity and the overall banking organization.[10]

The Proposed Amendments would also supplement the current accounting-based consolidation definition of affiliate under the Swap Margin Rules, solely for the purposes of the inter-affiliate swap provisions, by introducing banking law concepts of controlling influence to the definition. This amendment has been included in order to avoid a situation in which a Covered Swap Entity would be required to exchange initial margin with an unconsolidated entity that is treated as an affiliate of the Covered Swap Entity for other legal or regulatory purposes.

B. INTERBANK OFFERED RATES

As currently structured, the Swap Margin Rules generally do not apply to swaps that have been entered into before the applicable compliance date. However, the Rules do require a Covered Swap Entity to treat an existing swap that is amended or novated after the compliance date as a new transaction, resulting in the imposition of initial and variation margin requirements to a transaction that was previously exempt from these requirements. The Proposed Amendments would provide a safe harbor permitting a Covered Swap Entity to make amendments to a legacy swap (*i.e.*, swaps entered into prior to an applicable compliance date) in order to replace an interbank offered rate ("IBOR") or another discontinued reference rate with an alternative reference rate or rates and permit necessary follow-on amendments, without converting the legacy swap into one that becomes subject to the Swap Margin Rules.

An IBOR is a benchmark interest rate at which banks lend and borrow from one another.[11] IBORs have been used as the benchmark interest rate for a large volume of existing financial products. However, with the increased concerns about the reliability of IBORs and the expected discontinuance of the use of LIBOR by the end of 2021, it is expected that many Covered Swap Entities with swap agreements based on LIBOR and other IBORs may need to amend existing swap agreements to replace an IBOR before the IBOR becomes discontinued, and regulators have urged market participants to replace the IBORs with other reference rates as quickly as possible.[12] Such replacements may also require follow-on amendments necessary to maintain the economics of the contract.

The specific IBORs that may be replaced, and that are addressed by the safe harbor under the Proposed Amendments, are LIBOR, TIBOR, BBSW, SIBOR, CDOR, EURIBOR, and HIBOR, but the rule also applies to amendments to replace any other interest rate that a Covered Swap Entity reasonably expects to be discontinued or reasonably determines has lost its relevance as a reliable benchmark due to a significant impairment, and to any rate that succeeds either category of rate. The Proposed Amendments contemplate that a rate could be changed multiple times as market practices develop. Follow-on contractual changes that would be permitted by the Proposed Amendments include changes that incorporate spreads and other adjustments necessary to maintain consistency between the original rate and the replacement rate as well as more administrative and technical changes, such as changes to determination dates, calculation agents and payment dates. However, the safe harbor would permit amendments to the legacy uncleared swaps solely to accommodate the replacement of a qualifying reference rate. The safe harbor would be unavailable if, for instance, amendments extended maturity or increased the total effective notional amount of the legacy uncleared swap.

C. PORTFOLIO COMPRESSION EXERCISE AND OTHER AMENDMENTS

The Proposed Amendments would also amend the Swap Margin Rules to permit legacy swaps to retain their legacy status (*i.e.*, not trigger margin requirements) if they are amended due to certain routine life-cycle activities, such as technical amendments, notional reductions or portfolio compression exercises.

The Prudential Regulators indicate that the Proposed Amendments are meant to address industry concerns that certain non-material amendments, such as amendments to technical, operational or administrative provisions, or to reduce operational or counterparty risk, would trigger the margin requirements under the Swap Margin Rules. The Proposed Amendments would permit the following amendments without jeopardizing legacy status (in addition to the IBOR amendments noted above):

- ***As part of certain portfolio compression exercises used as a risk management tool, whether on a bilateral or multilateral basis***. Covered Swap Entities execute compression exercises to reduce the size of their gross derivatives exposures and reduce the frequency of payments between parties (*i.e.*, to maintain and reduce the overall risk profile of their portfolios). In a bilateral compression between two counterparties, offsetting positions between the two counterparties are simply cancelled and only the net amount remains, without any change to the overall net market exposures. The resulting net position is documented by amending one of the original swaps, and cancelling the others. In a multilateral compression, the trades across multiple counterparties are offset, reducing the risk in each relationship among the various counterparties involved. The resulting net position is usually documented by creating a replacement swap between each pair of parties reflecting the net position. Under the Proposed Amendments, an amended swap resulting from compression cannot extend the remaining maturity of the amended uncleared swap or increase the total effective notional amount of the uncleared swap, and a replacement swap cannot extend the longest remaining maturity of all of the swaps in the compression exercise or have a total effective notional amount that exceeds the total effective notional amount of that longest remaining maturity swap. This aspect of the Proposed Amendments would permit Covered Swap Entities to perform portfolio compression exercises in legacy swaps without triggering margin requirements.

- ***Reduction in notional amount.*** Amendments to reduce notional amounts without altering other terms of the original uncleared swap agreement would also be permitted. A reduction in notional amount may be achieved by (i) partially terminating the original uncleared swap, with the remaining non-terminated uncleared swap being able to retain its legacy status, or (ii) novating a portion of the original uncleared swap's notional amount to a third party, with the remaining (non-novated) portion of the original uncleared swap being able to retain legacy status (although the novated portion would not retain legacy status, if the third party is subject to the Rules or the corresponding rules of the CFTC or the SEC).

- ***Technical changes.*** Technical changes that are necessary to reflect changes in a counterparty's circumstances, such as a change in address, would be permitted. Such changes must not alter the uncleared swaps' underlying asset or indicator.

The Proposed Amendments expressly state that these permitted amendments, as well as those relating to the replacement of reference rates as discussed above and those permitted under prior amendments to the Rules, may be executed by any appropriate means, including by means of bilateral amendment, adherence to a protocol, or execution of a replacement transaction immediately upon termination of an existing legacy contract.

D. COMPLIANCE DATE FOR INITIAL MARGIN REQUIREMENTS

The Proposed Amendments extend the compliance date for initial margin requirements for certain smaller counterparties. Under the Swap Margin Rule, the implementation of both initial and variation margin requirements began on September 1, 2016. The variation margin requirements were completely phased in for all Covered Swap Entities and counterparties by March 1, 2017. With regard to initial margin, compliance dates ranged from September 1, 2016 to September 1, 2020, implemented in five phases based on the size of the Covered Swap Entity's and the counterparty's portfolios of uncleared swaps, measured by their respective average daily aggregate notional amount of non-cleared swaps, non-cleared security-based swaps, foreign exchange forwards and foreign exchange swaps ("AANA"). Under the Swap Margin Rules, the fifth and final phase of compliance, scheduled for September 1, 2020, includes all remaining entities within the scope of the initial margin requirements, which includes Covered Swap Entities and counterparties with AANAs ranging from $8 billion up to $750 billion.[13]

In response to industry concerns about the operational hurdles associated with beginning to exchange initial margin with the large number of smaller counterparties included in the fifth phase by the September 1, 2020 compliance date, the Prudential Regulators propose to amend the fifth phase to include only those counterparties with AANAs ranging from $50 billion to $750 billion. The Proposed Amendments would add an additional compliance date (a sixth phase), proposed to be September 1, 2021, for the smallest entities subject to the Rules, with AANAs ranging from $8 billion to $50 billion.

E. DOCUMENTATION REQUIREMENTS

The Swap Margin Rules impose documentation requirements on Covered Swap Entities for uncleared swaps entered into by the Covered Swap Entities with swap entities (whether or not Covered Swap Entities) and financial end users.[14] Under the existing Rules, the required trading documentation must be completed no later than the time the Covered Swap Entity is required to collect or post initial margin requirements pursuant to § __.3. However, in order to avoid confusion regarding timing, the Proposed Amendments amend § __.10 to state expressly that a Covered Swap Entity is not required to execute initial margin trading documentation with a counterparty prior to the time that it is required to collect or post initial margin pursuant to § __.3.

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ENDNOTES

1 For a summary of the Swap Margin Rules *see* S&C publication "Margin Requirements for Uncleared Swaps", dated January 7, 2016, *available at* https://www.sullcrom.com/margin-requirements-for-uncleared-swaps.

2 The Covered Swap Entity is not required to provide initial margin to its affiliated counterparties, but is required to collect and post variation margin with respect to its inter-affiliate transactions. *See* § __.11(b), (c).

3 *See* 12 C.F.R. § 45.2, 12 C.F.R. § 237.2 and 12 C.F.R. § 349.2.

4 Phase-one firms have collected nearly $40 million in initial margin for inter-affiliate uncleared swaps as of the end of 2018. *See* International Swaps and Derivatives Association Margin Survey Year-End 2018, *available at* https://www.isda.org/a/nIeME/ISDA-Margin-Survey-Year-End-2018.pdf. The proposed repeal could make available up to $40 million for these phase-one firms, representing a significant regulatory relief.

5 *See* p. 34 of the preamble to the Prudential Regulators' Proposed Amendments.

6 Affected affiliates include other bank swap entities and financial end user affiliates.

7 As a general matter, Section 23A and Regulation W limit the aggregate amount of covered transactions (which include the purchase of assets by a bank from an affiliate, the extension of credit by a bank to an affiliate, and certain other transactions) between a bank and its affiliates and subject such transactions to collateral requirements. Section 23B requires that most transactions between a bank and its affiliates be on market terms.

8 *See* pg. 36 of the preamble to the Prudential Regulators' Proposed Amendments.

9 *See* n. 4 above.

10 *See* p. 35 of the preamble to the Prudential Regulators' Proposed Amendments.

11 IBORs include the London Interbank Offered Rate ("LIBOR"), the Tokyo Interbank Offered Rate ("TIBOR"), the Bank Bill Swap Rate ("BBSW"), the Singapore Interbank Offered Rate ("SIBOR"), the Canadian Dollar Offered Rate ("CDOR"), the Euro Interbank Offered Rate ("EURIBOR"), and the Hong Kong Interbank Offered Rate ("HIBOR ").

12 *See* LIBOR: The Clock is Ticking, speech by John C. Williams, President and Chief Executive Officer of the Federal Reserve Bank of New York, September 23, 2019 ("The clock is ticking, LIBOR's days are numbered, and we all need to play our part in preparing the industry for January 1, 2022."), *available at* https://www.newyorkfed.org/newsevents/speeches/2019/wil190923.

13 The Rule does not require exchange of initial margin with any counterparty whose AANA is less than $8 billion as of the previous June, July and August. *See* §§ __.1 and __.3.

14 *See* § __.10 of the Swap Margin Rule for a complete outline of required trading documentation.

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CONTACTS

New York		
David J. Gilberg	+1-212-558-4680	gilbergd@sullcrom.com
Kenneth M. Raisler	+1-212-558-4675	raislerk@sullcrom.com
Rebecca J. Simmons	+1-212-558-3175	simmonsr@sullcrom.com
Ryne V. Miller	+1-212-558-3268	millerry@sullcrom.com
Daniel M. Wolf	+1-212-558-4815	wolfd@sullcrom.com

Washington D.C.		
Andrea R. Tokheim	+1-202-956-7015	tokheima@sullcrom.com