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Brexit: U.S. Agencies Facilitate Legacy Swap Transfers

Under Interim Final Rule, Legacy Swaps Currently Exempt from the Swap Margin Rule Would Maintain Legacy Status If Transferred from U.K. Financial Entities as a Result of a “No-deal” Brexit

SUMMARY

Faced with the possibility that the United Kingdom may exit the European Union without reaching an agreement with the European Union pursuant to Article 50(3) of the Treaty on European Union, 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 issued an interim final rule to allow non-cleared swaps and non-cleared security-based swaps that are “grandfathered” under the agencies’ swap margin rule to be transferred from a United Kingdom financial entity without losing grandfathered status. The interim final rule was issued without prior notice and opportunity for public comment in view of the imminent official date for the U.K. withdrawal (also referred to as “Brexit”).

Because the agencies’ swap margin rule treats a transfer of a swap as a new transaction, swaps entered into prior to the compliance date could become subject to the requirements of the rule if they are transferred to an affiliate to address the Brexit issue. In order to address this concern, this interim final rule applies to swaps that were entered into before the applicable compliance date under the swap margin rule, and would ensure that any such swap that is currently exempt from the swap margin rule will not become subject to that rule if the swap is amended solely for the purpose of transferring it to an affiliate outside the United Kingdom as a result of a no-deal U.K. withdrawal from the European Union.

The interim final rule was effective immediately, on March 13, 2019. The agencies will accept comments for 30 days after publication in the Federal Register.

BACKGROUND OF THE SWAP MARGIN RULE

Scope

In accordance with a mandate of the Dodd-Frank Wall Street Reform and Consumer Protection Act, in 2015, 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 (collectively, the “Agencies”) adopted a set of regulations to establish the minimum margin and capital requirements (the “Swap Margin Rule”) for swaps and security-based swaps that are not cleared by a registered derivatives clearing organization or a registered clearing agency (referred to collectively as “non-cleared swaps”) and are entered into by registered swap dealers or security-based swap dealers that are prudentially regulated by the Agencies (the “Covered Swap Entities”).¹

The Swap Margin Rule became effective as of April 1, 2016 with a phased-in compliance schedule for initial and variation margin requirements, based on the average daily aggregate notional amount of non-cleared swaps, foreign exchange forwards and foreign exchange swaps of the Covered Swap Entity and its counterparty. The phase-in is scheduled to be completed by September 1, 2020.

The Swap Margin Rule’s margin requirements generally apply only to non-cleared swaps entered into on or after the applicable compliance date. Swaps entered into prior to the applicable compliance date (“Legacy Swaps”) are “grandfathered”; that is, they generally are not subject to the margin requirements of the Swap Margin Rule. However, Legacy Swaps amended or novated on or after the applicable compliance date would become subject to the margin requirements.²

Jurisdictional Reach

Non-cleared swaps entered into by foreign banks and foreign banking organizations, certain entities established abroad by U.S. banks and certain foreign branches of U.S. banks are subject to the Swap Margin Rule if such entities are Covered Swap Entities. However, for a Covered Swap Entity that is organized under foreign law and is not a subsidiary or branch of a U.S. entity, its non-cleared swaps are exempted from the Swap Margin Rule, unless the counterparty to such foreign Covered Swap Entity, or a guarantor on either side of the non-cleared swap, is a U.S. entity or a subsidiary or branch of a U.S. entity.

Generally, under the current E.U. “passporting” regulatory regime, U.K. swap dealers can be authorized to provide financial services to customers across the European Union. However, if the United Kingdom leaves the European Union without reaching a withdrawal agreement, this privilege will no longer be available. Facing such uncertainty regarding the applicable regulatory framework after the U.K. withdrawal, financial entities, including Covered Swap Entities, operating in the United Kingdom, as well as counterparties of those Covered Swap Entities operating in the United Kingdom, may be planning to transfer their U.K. operations, including derivatives, to a different location outside the United Kingdom.

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The interim final rule seeks to provide guidance to Covered Swap Entities and their counterparties looking to transfer non-cleared swaps in response to a no-deal Brexit so that their Legacy Swaps will not become subject to the margin requirements of the Swap Margin Rule as a result of the transfer.

THE INTERIM FINAL RULE

The Agencies are amending the Swap Margin Rule to preserve the status quo for Legacy Swaps in the event of a “no-deal” Brexit.³ The Agencies intend the rule to be flexible and broad enough to encompass different scenarios under which the margin requirements of the Swap Margin Rule may be triggered. Under the conditions discussed below, a transfer of Legacy Swaps held at a U.K. financial entity or a financial entity’s U.K. branch to another branch or affiliate of the financial entity outside the United Kingdom will not trigger the Swap Margin Rule whether the transferor is a Covered Swap Entity or its counterparty. The availability of the exemption does not depend on whether the transferor is a U.K. entity or a branch or office of a non-U.K. firm, nor on the manner in which Legacy Swaps were held at the U.K. transferor. Furthermore, the relocation of Legacy Swaps may be effected through any of the methods typically employed, such as industry protocols, contractual amendments, contractual tear-up and replacement or judicially supervised transfers of businesses. However, the transferee must be a branch or affiliate of the transferor located in the European Union or the United States.

To benefit from interim final rule, the arrangements for amendment must be solely for the purpose of transferring non-cleared swaps to an affiliate, branch or other related establishment located in the European Union or in the United States, in connection with the applicable U.K. entity’s planning for, or response to, the possibility of a no-deal Brexit. If the transferor is a counterparty to a Covered Swap Entity, the counterparty must represent to the Covered Swap Entity that certain requirements of the interim final rule have been met.

The relief provided by the interim final rule would not be available if the amendment changed the economic substance of a Legacy Swap, such as terms related to payment calculations, maturity date or notional amount; those types of changes independently result in the characterization of the amendment as a new transaction. Furthermore, the amendments must cause the transfer to take place after the date on which the law of the European Union ceases to apply in the United Kingdom due to the absence of an agreement between the United Kingdom and the European Union pursuant to Article 50(3) of the Treaty on European Union (the “Transfer Triggering Event”), and before the first anniversary of that date. However, because the European supervisory authorities have proposed similar novation amendments to their margin rules to facilitate such transfers, to the extent the final approval of these amendments is delayed, the time period specified in the interim final rule will also be extended to accommodate those entities that must comply with both regulatory regimes.⁴

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To summarize, the interim final rule allows Legacy Swaps to retain their legacy status, without compliance with the Swap Margin Rule, while being amended to transfer out of the United Kingdom so long as the following conditions are met:⁵

- The non-cleared swap was originally entered into before the relevant compliance date and one party to the swap held it at a branch or other entity located in the United Kingdom;
- The U.K. entity subsequently arranged to amend the swap solely for the purpose of transferring it to an affiliate, branch or other establishment located in any E.U. member state or the United States in response to the Transfer Triggering Event;
- The transferee is a Covered Swap Entity or a Covered Swap Entity's counterparty that represents to the Covered Swap Entity that it performed the transfer in compliance with the Agencies' interim rule;
- The Transfer Triggering Event takes place;
- The amendments do not modify the payment amount calculation methods, the maturity date or the notional amount of the Legacy Swap; and
- The amendments take effect on or after the date of the Transfer Triggering Event and before the later of (i) the date that is one year after the Transfer Triggering Event or (ii) such other date permitted by transitional provisions under Article 35 of Commission Delegated Regulation (E.U.) No. 2016/2251, as amended.

PUBLIC COMMENT

The Agencies have requested comment on all aspects of the rule, and specifically: (1) whether further clarification should be provided as to the types of amendments that are permissible; (2) whether any relief should be considered for swaps that are transferred from the European Union to the United Kingdom; and (3) whether there are financial entities that could not effect a necessary transfer unless they are permitted to transfer the Legacy Swaps to an unrelated entity outside the United Kingdom and, as a result, would not be covered by the interim final rule. The public comment period will be open for 30 days after publication of the interim final rule in the Federal Register on March 19.

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ENDNOTES

¹ 80 Fed. Reg. 74840 (Nov. 30, 2015), available at <https://www.govinfo.gov/content/pkg/FR-2015-11-30/pdf/2015-28671.pdf>.

² *Id.* at 74850-51.

³ 84 Fed. Reg. 9940 (Mar. 19, 2019), available at <https://www.govinfo.gov/content/pkg/FR-2019-03-19/pdf/2019-05012.pdf>.

⁴ *Id.* at 9945.

⁵ *Id.* at 9948-50.

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