Hogan Lovells

U.S. federal regulators propose amendments to swap margin regulations to clarify treatment of certain amendments to legacy swaps

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The Dodd-Frank Act requires entities that engage in swap activities to either submit their swaps for clearing with a central clearinghouse or to collect and post collateral (margin) based on the daily mark-to-market exposure under the swaps, subject to certain exemptions, notably for non-financial entities that enter into swaps for the purposes of hedging or mitigating commercial risk. Financial institutions, funds, and other entities that are not eligible for an exemption are now, or will in the coming years become, subject to mandatory margin rules for uncleared swaps. In other words, swaps entered into between such entities that are not submitted for clearing must have arrangements in place for the collection and posting of margin, with staggered compliance dates being rolled out through September 1, 2020. "Legacy" swaps, i.e. swaps that were executed prior to the effective date of the margin regulations, are (unless modified later) generally "grandfathered" from the margin regulations. If, however, the material economic terms of a swap are subsequently modified or amended this could bring the swap within the scope of the margin regulations even though the swap was initially entered before the margin regulations were effective. The Dodd-Frank Act regulations on margin, which were finalized in 2015, are intricate and complex and cover topics such as eligibility of collateral, valuation of collateral, frequency of margin transfers, and use of master netting agreements. The regulations were summarized in detail in a previous Hogan Lovells memorandum.

In order to address recently enacted federal banking rules (the QFC Rules) related to the orderly resolution of troubled financial institutions and amendments to documentation proposed by banks to comply with the QFC Rules, the Commodity Futures Trading Commission (the CFTC), the U.S. derivatives regulator, released proposed rules on May 18 that seek to amend the previously issued margin regulations in order to clarify that changes to swap documentation resulting from the QFC Rules would not trigger the margin rules for legacy swaps initially entered into prior to the effectiveness of the margin regulations.

The CFTC margin rules apply to entities that are not regulated by one of the U.S. federal "prudential regulators", such as the Federal Reserve, the Federal Deposit Insurance Corporation (the FDIC), and the Office of the Comptroller of the Currency (the OCC). The prudential regulators published substantively identical proposed amendments to their own margin regulations in February 2018. While non-financial end users may be asked by their bank counterparties to amend their existing derivatives contracts (including ISDA Master Agreements) for purposes of complying with the QFC Rules, the CFTC rules proposed on May 18 are not expected to affect such end users as they are generally not subject to mandatory clearing or margin under Dodd-Frank Act regulations.

By way of background, the federal margin regulations allow for the use of master netting agreements, which are agreements that create a single legal obligation for multiple individual transactions upon an event of default, such as the bankruptcy of a counterparty, and as a result allow the non-defaulting counterparty to accelerate, terminate, and close-out on a net basis all transactions under the agreement and to promptly liquidate or set off collateral posted by the defaulting party. Furthermore, the regulations allow a master netting agreement to have multiple "netting portfolios", with each netting portfolio containing an insulated group of transactions that may be netted against each other but not against any transactions outside the portfolio. Uncleared swap transactions entered into prior to the applicable margin compliance rule (so-called legacy swaps) are not subject to mandatory margin, but legacy swaps become subject to margin once they are amended or novated.

In 2017, the Federal Reserve, the FDIC, and the OCC adopted the QFC Rules, which are intended to enhance the resolvability and resilience of U.S. global systemically important banking institutions (GSIBs). These rules require U.S. GSIBs and their subsidiaries to ensure that their covered Qualified Financial Contracts (such as swap agreements) include specified contractual provisions limiting their counterparties' default rights in certain circumstances during the administrative resolution of a U.S. GSIB. This new regime effectively requires the U.S. GSIBs to amend their Qualified Financial Contracts. Accordingly, to the extent any such Qualified Financial Contracts cover legacy swaps, the legacy swaps may be deemed to become subject to margin once their governing agreements are amended. To resolve questions about the effect of QFC Rules-driven amendments on the applicability of margin rules, the CFTC amendments proposed on May 18 provide that a master netting agreement that is amended in order to comply with the QFC Rules continues to be an eligible master netting agreement for purposes of CFTC margin rules and that an uncleared legacy swap will not become subject to mandatory margin solely due to such an amendment.

The CFTC's proposed rule is currently subject to a public comment period that expires on July 23, after which the CFTC is expected to finalize the rule.

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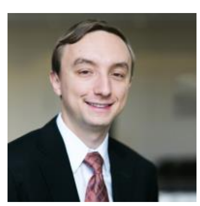

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