Hogan Lovells

Documentation changes may be required for commercial end users, funds, and other financial end users

February 5, 2020

The new year is here and with it two important developments in the derivatives markets for non-swap dealer clients to consider. The first development is the market response to the looming discontinuation of U.S. dollar LIBOR (and its equivalents in other currencies). The second development relates to the documentation requirements under the U.S. margin rules for uncleared swaps.

Do you have swaps that reference LIBOR?

If you have existing interest rate swaps or other types of derivatives that are linked to LIBOR, then you may be required by your dealer banks to update your documentation in 2020. As you may be aware, global regulators have set a target date of the end of 2021 in order to transition from LIBOR to alternative reference rates. Industry groups around the globe have been working with regulators for some time to plan for this transition and adopt recommended alternative reference rates. In the United States, the applicable working groups have recommended the use of the Secured Overnight Financing Rate (SOFR) published by the New York Federal Reserve Bank. However, agreement on using SOFR to replace LIBOR is just the beginning of the transition as SOFR and LIBOR have different underlying assumptions, LIBOR being an unsecured term rate determined in arrears, with SOFR, a secured overnight rate. In order to bridge the gap between these rates and minimize disruption, the International Swaps and Derivatives Association (ISDA) has been working on amending the 2006 ISDA Definitions to incorporate SOFR and finalizing the approaches to bridging SOFR and LIBOR, as there may be several methods to interpolate between LIBOR and SOFR.

Similar efforts are currently underway in other jurisdictions where LIBOR or other reference rates are being discontinued. For example, in the sterling market the Sterling Overnight Index Average (SONIA) is being adopted as the risk-free alternative reference rate to the British pound sterling LIBOR. For any given calculation period, this will be determined on a compounding basis in arrears and the market conventions around this are currently being established. The 2006 ISDA Definitions will also be amended to cater for such developments.

Particularly challenging, however, will be how to treat legacy trades as the approaches used to bridge LIBOR and SOFR (and other new reference rates) can have economic consequences depending upon which methodology is chosen. Over the past year, ISDA has engaged in

consultations with its members and the market in order to select the preferred methodologies for the transition. Based on these consultations, ISDA is planning to publish a protocol with a target publication date not later than the end of the first quarter 2020. It is expected that this protocol will have certain default transition methodologies incorporated in amendments to the 2006 ISDA Definitions, in the event that the parties do not specify a particular transition methodology. The process for protocol adherence will be similar to the adherence process that you may be familiar with respect to the Dodd-Frank regulations.

As with the other ISDA protocols, commercial end users and financial end users will likely receive an email from their dealer requesting adherence to this protocol and explaining this process. While there should be no regulatory requirement on non-swap dealers to adhere to this protocol and your dealers cannot "force" you to adhere, they may choose not enter into new trades with counterparties that do not adhere and there may be disputes as to the determination of amounts due under existing transactions if the issue is not addressed either through the protocol or bilaterally once LIBOR ceases to be published or ceases to be a representative rate. Whether you should adhere to the uniform protocol or seek a bilateral solution may depend upon the extent to which you have swaps referencing LIBOR and how the transition methodologies selected by your dealer will affect you. In addition, if your LIBOR referenced derivatives are linked to, or are fixing a floating rate loan or other debt instrument, then you will have additional considerations as, for example, the loan market is considering other approaches and you may wish to adopt a consistent approach to your swaps and loans.

Once the protocol is published, we will send a more detailed client alert explaining the issues.

U.S. initial margin rules for uncleared swaps[1]

If you are a financial end user that trades derivatives that are not cleared at a central counterparty clearing house, then you may be contacted by your dealer banks regarding their obligation to post and collect initial margin with you as of September 1, 2020. A "financial end user" is defined to include securities broker-dealers, certain hedge funds, investment advisers, and other financial institutions, whether organized in the United States or abroad.[2] The term "financial end user" does not include commercial end users.

As of September 1, 2020, U.S. swap dealers will be required to collect and post initial margin with in-scope financial end users when the amount of initial margin amount exceeds US$50 million. Financial end users will be in scope for compliance as of September 1, 2020 if their average daily aggregate notional amount of uncleared swaps and certain other financial products (AANA) is between US$50 billion and US$750 billion during March, April, and May 2020.[3] Initial margin requirements are in addition to the variation margin requirements that already apply to all financial end users – irrespective of AANA – that trade uncleared derivatives with U.S. swap dealers.

If they have not done so already, U.S. swap dealers may contact you in the first instance to discuss your expected AANA. If based on your AANA you are expected to be in scope for the September 1, 2020 compliance date, then the U.S. swap dealer may request that you begin negotiating initial margin trading documentation, which will likely take place within the next several months if they have not already done so.

[1] Note that there are similar but not identical initial margin requirements that are applicable when trading with non-U.S. dealers.
[2] See Commodity Futures Trading Commission (CFTC) Rule 23.151 for the complete "financial end user" definition.
[3] The compliance date applicable to financial end users having an AANA exceeding US$8 billion but less than US$50 billion would be September 1, 2021. Neither the CFTC nor the prudential regulators has finalized this revised compliance timetable, but each is expected to do so in the first half of 2020.

Whether you are requested to negotiate such documentation will depend on the exposures that your uncleared derivatives generate (as calculated by the U.S. swap dealer). U.S. regulators have clarified that U.S. swap dealers must post and collect initial margin – and thus have the requisite documentation in place – only when the amount of initial margin exceeds US$50 million. Despite this regulatory guidance, however, U.S. swap dealers may ask you to begin negotiating well in advance of exceeding the US$50 million initial margin threshold amount. The approach taken may vary among your swap dealer counterparties.

The initial margin requirements differ substantially from the variation margin requirements, the chief difference being the requirement to post initial margin to a segregated account at an unaffiliated custodian. Relationships subject to the initial margin requirements are documented under (1) a form of ISDA credit support annex for initial margin, (2) the account control agreement, and (3) any other documentation required by the third-party custodian.

If applicable, reviewing and executing these agreements ahead of the September 1, 2020 compliance date is a time-intensive process. Custodial documentation, in particular, can take several months to finalize. While there is no direct regulatory requirement on financial end users to comply with the initial margin requirements, failure to negotiate and execute trading documentation may lead the U.S. swap dealer to cease entering into new uncleared derivatives trades with you as of September 1, 2020.

Will I have to post initial margin for trades that are amended to replace LIBOR?

Fortunately, efforts to comply with the first development – LIBOR transition – should not complicate efforts related to the second development – the September 1, 2020 compliance date for initial margin. Amendments made to existing transactions that solely reflect a new reference rate replacing LIBOR will not make such transactions in-scope for the initial margin requirements, even if such amendment is made after September 1, 2020.[4]

What is happening in the European Union?

The equivalent requirement for in-scope entities[5], which are established in the European Union, to post initial margin[6] has been phased in gradually, with the first, most systemically important, counterparties being required to post initial margin from February 4, 2017 and with this phase-in due to be completed by September 1, 2020. On December 19, 2019, the European Supervisory Authorities (ESAs)[7] published a final report in which certain amendments to the margin Regulatory Technical Standards (RTS) were proposed by way of a new draft RTS, which has amended this timeline and given some breathing space to smaller market participants.

As in the United States, the new RTS seeks to extend the expected final phase-in date for the implementation of the initial margin rules in relation to in-scope entities with an AANA of uncleared over-the-counter derivatives above €8 billion but less than €50 billion by one year so they will take effect from September 1, 2021. For those in-scope entities with an AANA of over €50 billion but less than €750 billion, the existing phase-in date for posting regulatory initial margin of September 1, 2020 will continue to apply. These proposed extensions would give

[4] See e.g., CFTC No-Action Letter 19-26, which clarifies that certain amendments (such as benchmark replacement) will not trigger the application of certain regulatory requirements if such swaps were entered into prior to the compliance date of the particular regulatory requirement, in this case the September 1, 2020 initial margin compliance date.

[5] The margining requirements apply to financial counterparties (i.e., credit institutions, investment firms, pension funds, insurance companies, alternative investment funds, and Undertakings for the Collective Investment in Transferable Securities funds) and non-financial counterparties (i.e., any entity that is not a financial counterparty) exceeding certain clearing thresholds as set out in European Market Infrastructure Regulation (EMIR).

[6] As set out in Article 11(15) of Regulation (EU) No 648/2012 (EMIR) and Commission Delegated Regulation (EU) 2016/2251 (the Margin RTS) (as amended by Regulation (EU) 2019/834).

[7] The ESAs consist of the European Banking Authority, European Insurance and Occupational Pensions Authority, and the European Securities and Markets Authority.

additional time to in-scope entities to ensure they set up the necessary systems to comply with the initial margining rules prior to the new phase-in dates.

What should we be doing now?

Do an inventory of your swaps and loans that reference LIBOR – when do the transactions expire/terminate? Do you have exposure post-2021?

If you are a financial end user under the U.S. margin regulations or a financial counterparty or otherwise exceed certain clearing thresholds under the EU margin regulations, be prepared to calculate your AANA to see whether you are in scope for the initial margin requirements as of September 1, 2020. If you anticipate that your AANA will exceed US$50 billion or €50 billion, as applicable, engage your dealer banks to see whether they will require initial margin documentation to continue to trade uncleared swaps with you.

Contacts

Evan Koster
Partner, New York
T +1 212 918 8260
evan.koster@hoganlovells.com

Adam Lapidus
Senior Associate, New York
T +1 212 918 3246
adam.lapidus@hoganlovells.com

www.hoganlovells.com

"Hogan Lovells" or the "firm" is an international legal practice that includes Hogan Lovells International LLP, Hogan Lovells US LLP and their affiliated businesses.
The word "partner" is used to describe a partner or member of Hogan Lovells International LLP, Hogan Lovells US LLP or any of their affiliated entities or any employee or consultant with equivalent standing. Certain individuals, who are designated as partners, but who are not members of Hogan Lovells International LLP, do not hold qualifications equivalent to members.
For more information about Hogan Lovells, the partners and their qualifications, see www. hoganlovells.com.
Where case studies are included, results achieved do not guarantee similar outcomes for other clients. Attorney advertising. Images of people may feature current or former lawyers and employees at Hogan Lovells or models not connected with the firm.
© Hogan Lovells 2020. All rights reserved.