



**U.S. COMMODITY FUTURES TRADING COMMISSION**

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Division of Swap Dealer and  
Intermediary Oversight

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**Re: No-Action Position: Application of Uncleared Swap Margin Rules to Immaterial Amendments, Swaption Exercises, Partial Terminations, Partial Novations, or Multilateral Compression of Legacy Swaps**

Ladies and Gentlemen:

This letter is in response to a request for a no-action position received by the Division of Swap Dealer and Intermediary Oversight (“**DSIO**”) of the Commodity Futures Trading Commission (“**Commission**”) from the International Swaps and Derivatives Association (“**ISDA**”) on behalf of its members that are swap dealers (“**SDs**”) registered with the Commission and subject to the Commission’s rules regarding margin requirements for uncleared swaps.<sup>1</sup> For the reasons discussed below, ISDA requests a position of no-action for failure of an SD to comply with the Commission’s uncleared swap margin requirements with respect to certain amendments to Legacy Swaps.

For purposes of this letter, “**Legacy Swap**” means a swap executed prior to the applicable compliance date prescribed in Commission regulation 23.161. Where a swap is executed after the compliance date for variation margin (i.e., March 1, 2017) but before the applicable compliance date for initial margin (see *infra* for a description of initial margin compliance dates), the swap is a Legacy Swap for the initial margin requirements only.

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<sup>1</sup> The Commission’s margin requirements for uncleared swaps apply only to SDs and major swap participants for which there is not a prudential regulator. See 7 U.S.C. 6s(e)(1)(B). SDs and major swap participants for which there is a prudential regulator must meet the margin requirements for uncleared swaps established by the applicable prudential regulator. 7 U.S.C. 6s(e)(1)(A). See also 7 U.S.C. 1a(39) (defining the term “Prudential Regulator” to include the Board of Governors of the Federal Reserve System; the Office of the Comptroller of the Currency; the Federal Deposit Insurance Corporation; the Farm Credit Administration; and the Federal Housing Finance Agency). The Prudential Regulators published final margin requirements in November 2015. See Margin and Capital Requirements for Covered Swap Entities, 80 FR 74840 (Nov. 30, 2015). Although requested by ISDA on behalf of its members that are SDs, the relief provided by this letter is available to all SDs subject to the Commission’s rules regarding margin requirements for uncleared swaps.

The Commission's Office of the Chief Economist ("OCE") recently conducted an analysis to estimate, among other things, the population of uncleared swap positions that constitute Legacy Swaps.<sup>2</sup> In particular, OCE analyzed the notional of uncleared swaps outstanding as of December 2018. Focusing strictly on the entity pairs covered in phases 1 through 3 of the uncleared margin rule, the three phases implemented as of the December 2018 reference date, OCE estimated that approximately 41% of credit default swaps ("CDS"), 5% of forex products, and 40% of interest rate swaps ("IRS") were Legacy Swaps. DSIO notes that many of these Legacy Swaps will be terminated prior to maturity for a variety of reasons. Swaps executed by SDs with counterparties not yet subject to the initial margin requirements (i.e., phases 4 and 5) may become Legacy Swaps as defined above to the extent such are still in effect on the compliance dates for those phases.

ISDA seeks a no-action position for the following types of amendments to Legacy Swaps: (i) an immaterial amendment to a Legacy Swap, (ii) a swap resulting from the exercise of a swaption that is a Legacy Swap, (iii) the remaining portion of a swap resulting from a partial termination of a Legacy Swap, (iv) the remaining portion of a swap resulting from a partial novation of a Legacy Swap, and (v) new swaps resulting from a multilateral compression exercise consisting solely of Legacy Swaps. For purposes of the relief provided by this letter, "Legacy Swap" also includes any swap that results from the exercise of a swaption that is a Legacy Swap and any swap that results from an immaterial amendment, partial termination, partial novation, or multilateral compression of a Legacy Swap in accordance with the terms and conditions of this letter.

## I. Regulatory Background

Pursuant to section 4s(e) of the Commodity Exchange Act ("CEA"),<sup>3</sup> the Commission is required to promulgate margin requirements for uncleared swaps applicable to each SD for which there is no Prudential Regulator.<sup>4</sup> The Commission published final margin requirements for such SDs in January 2016 (the "**CFTC Margin Rule**").<sup>5</sup>

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<sup>2</sup> See Legacy Swaps under the CFTC's Uncleared Margin and Clearing Rules (May 22, 2019), available at: <https://www.cftc.gov/node/216426>.

<sup>3</sup> 7 U.S.C. § 1 et. seq.

<sup>4</sup> See 7 U.S.C. § 6s(e)(1)(B).

<sup>5</sup> See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 FR 636 (Jan. 6, 2016). The CFTC Margin Rule, which became effective April 1, 2016, is codified in part 23 of the Commission's regulations. See §§ 23.150-159, 161.

The CFTC Margin Rule applies only to swaps of SDs executed after the applicable compliance date set forth in Commission regulation 23.161.<sup>6</sup> Pursuant to Commission regulation 23.161, compliance dates for the CFTC Margin Rule are staggered such that SDs must come into compliance in a series of phases over four years with counterparties depending on the aggregate outstanding notional amounts of uncleared swaps and certain other financial products. The first phase began on September 1, 2016, and required SDs to comply with both the initial and variation margin requirements with counterparties that have the largest aggregate outstanding notional amounts. The second phase began March 1, 2017, and required SDs to comply with the variation margin requirements of Commission regulation 23.153 with all relevant counterparties not covered in the first phase. The third phase began on September 1, 2018, with the fourth and fifth phases beginning on Sept 1, 2019 and 2020 respectively. Each phase requires SDs to begin complying with the initial margin requirements with counterparties with successively lesser outstanding notional amounts.<sup>7</sup>

Generally, pursuant to the CFTC Margin Rule, amendments to Legacy Swaps following the compliance date applicable to an SD and its counterparty would cause such swaps to be brought into scope and require compliance with the CFTC Margin Rule.<sup>8</sup> However, subsequent to implementation of the rule, DSIO has become aware of discrepancies in the treatment by SDs of amendments that have an economic impact and those that reduce risk or are administrative in nature. In addition, other major swap trading centers have made the distinction between economically significant amendments and risk reducing or administrative amendments.<sup>9</sup>

## **II. Summary of Request for No-Action Position**

### **A. Immaterial Amendments to Legacy Swaps.**

ISDA argues that immaterial amendments to Legacy Swaps should not require such swaps to be deemed “new” swaps subject to the CFTC Margin Rule. For example, changing the contact information for an SD’s counterparty or the account number under the SD’s payment instructions do not materially alter the economic rights or obligations

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<sup>6</sup> See Commission regulation 23.150(a), 17 CFR § 23.150(a).

<sup>7</sup> See Commission regulation 23.161, 17 CFR § 23.161.

<sup>8</sup> See CFTC Margin Rule, 81 FR at 675.

<sup>9</sup> See, e.g., Australia Prudential Regulation Authority, Prudential Standard CPS 226 recognizing swaps resulting from compression of Legacy Swaps as not subject to margin requirements; Hong Kong Monetary Authority, Margin and other Risk Mitigation Standards, recognizing that only material amendments require recognition of a new transaction; Office of the Superintendent of Financial Institutions Canada, Margin Requirements for Non-Centrally Cleared Derivatives, recognizing that novations of grandfathered trades as well as trades resulting from compression of grandfathered trades do not qualify as a new derivatives contract.

of the parties to the swap and thus should not require the swap to be brought into scope for purposes the CFTC Margin Rule.

DSIO recognizes that certain amendments are often not a choice of swap counterparties. For example, administrative changes within firms unconnected to the economics of a swap portfolio will inevitably occur and will necessitate amendments in order to maintain operational processes. Accordingly, DSIO does not believe SDs should be concerned that such changes will bring Legacy Swaps into scope of the CFTC Margin Rule. With respect to defining what would constitute an “immaterial amendment,” DSIO notes that the Commission has recently updated a definition of the “material terms” of a swap in connection with its portfolio reconciliation rule, Commission regulation 23.502.<sup>10</sup> For purposes of that rule, the Commission permitted the exclusion of a number of data fields<sup>11</sup> that the Commission determined were not relevant to the mutual obligations and valuation of swaps.<sup>12</sup> In keeping with this rationale, DSIO believes that a no-action position for amendments to Legacy Swaps that do not amend any term that would affect the economic obligations of the parties to the swaps or the valuation of the swaps should allay concerns that SDs would use the exception to evade the margin requirements of the CFTC Margin Rule.

## **B. Swaps Resulting from Exercise of Swaptions that are Legacy Swaps**

In the most basic terms, a “swaption” is an option to enter into a specified swap upon exercise of the option. The exercise of a swaption involves one party exercising its right to require the other party to enter into a swap on pre-agreed terms.

ISDA argues that although the swap resulting from the exercise of a swaption is processed in the same way as a new swap, the economic effect of the exercise is determined by the terms of the swaption transaction, which are agreed by the parties when they entered into the swaption, not when the swaption is exercised. ISDA argues that because the terms of the swap that results from the exercise of a swaption that is a Legacy Swap were set prior to the compliance date for the requirements of the CFTC Margin Rule, such terms would not have “priced in” such requirements and thus such swap should be treated as a Legacy Swap for purposes of the CFTC Margin Rule. The

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<sup>10</sup> See Definitions of “Portfolio Reconciliation” and “Material Terms” for Purposes of Swap Portfolio Reconciliation, 81 FR 27309 (May 6, 2016) (hereinafter, “**Material Terms in Portfolio Reconciliation**”).

<sup>11</sup> See Commission regulation 23.500(g), 17 CFR § 23.500(g).

<sup>12</sup> See Material Terms in Portfolio Reconciliation, 81 FR at 27311, where the Commission determined that such excluded terms:

*(i) pertain to static items about entering into the swap; (ii) pertain to static data fields about a party’s status; (iii) are only relevant to cleared transactions; (iv) are data which is not agreed, exchanged, or confirmed between the parties; or (v) are not relevant to the swap’s daily valuation.*

Commission previously recognized the logic of this position in the context of the clearing mandate.<sup>13</sup>

### **C. Partial Terminations and Partial Novations of Legacy Swaps**

ISDA explains that when the original counterparties to a swap wish to novate or terminate an original swap in part, they may agree to an amendment that reduces the notional amount of the swap by terminating a portion of the swap (a “partial termination”) or by novating a portion of the swap to another counterparty (a “partial novation”). The remaining portion of the swap between the original counterparties after such reduction by a partial novation or partial termination is referred to as the “stub.” ISDA represents that the terms of an original swap, including the terms that define the remaining cash flows, continue to govern the stub (apart from the reduction in the notional amount of that swap).

Under a partial termination, all terms of the stub, apart from the reduction of the notional amount, remain the same. The original counterparties remain the same and no third parties are involved in the transaction. Under a partial novation, one of the two original counterparties novates part of the original swap to a third party (the “novated swap”). As with partial terminations, for the remainder of the original swap (*i.e.*, the stub), all terms, apart from the reduction of the notional amount, remain the same.

According to ISDA, where the original swap is a Legacy Swap, imposing margin requirements pursuant to the CFTC Margin Rule on the stub, under either a partial novation or a partial termination, would create distorted incentives for risk and investment management decisions. For example, an SD that seeks to reduce its exposure under a swap with a partial termination (*i.e.*, a reduction in notional amount, which reduces both market and credit risk) may be incentivized not to do so if the stub loses its status as a Legacy Swap and becomes subject to the additional costs and operational burdens associated with compliance with the CFTC Margin Rule.

ISDA states that it does not request relief from DSIO for circumstances where the original counterparties enter into and book a new swap that fully or partially offsets the risk of a Legacy Swap and thereby achieves a similar economic result to a partial termination. ISDA further acknowledges that in the context of partial novations, the novated swap, which was executed between one of the original counterparties and a

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<sup>13</sup> “The Commission agrees that the cost of clearing may not be reflected in the pricing of the swaption or extendible swap if the clearing requirement for the underlying swap or the extendible swap arises after the execution of the swaption or extendible swap. The Commission is thus clarifying that the clearing requirement only applies to swaps resulting from the exercise of a swaption or extendible swap extension if the clearing requirement would have been applicable to the underlying swap or the extended swap at the time the counterparties executed the swaption or extendible swap.” *See* “Clearing Requirement Determination Under Section 2(h) of the CEA; Final Rule,” 77 FR 74284, 74316 (Dec. 13, 2012).

third party, may be subject to the CFTC Margin Rule.<sup>14</sup> ISDA does not seek relief for such novated swap.

ISDA notes that the Commission's Division of Clearing and Risk provided relief from the clearing requirement under section 2(h)(1)(A) of the CEA for partial termination and partial novations of swaps entered into prior to implementation of the Commission's clearing requirement.<sup>15</sup> ISDA therefore requests that DSIO take a similar no-action position, subject to the same conditions, such that Legacy Swaps do not lose their legacy status solely due to a reduction of notional amount by way of partial termination or partial novation of such swaps.

#### **D. Multilateral Compression of Legacy Swaps**

Multilateral portfolio compression allows swap market participants to decrease the number of outstanding swaps or the aggregate notional value of such swaps, thereby reducing operational risk and, in some instances, reducing counterparty credit risk. For purposes of this letter, the term "multilateral portfolio compression exercise" has the meaning given to the term in Commission regulation § 23.500(h).<sup>16</sup> Commission regulation § 23.500(h) defines the term to mean "an exercise in which multiple swap counterparties wholly terminate or change the notional value of some or all of the swaps submitted by the counterparties for inclusion in the portfolio compression exercise and, depending on the methodology employed, replace the terminated swaps with other swaps whose combined notional value (or some other measure of risk) is less than the combined notional value (or some other measure of risk) of the terminated swaps in the compression exercise."

In a multilateral portfolio compression exercise for uncleared swaps, the compression service provider analyzes the uncleared swap portfolios of multiple swap market participants and publishes the optimal solution for the compression cycle based on one of two methods. Under the first method, the outstanding notional value of the original swap between two counterparties is reduced by amending the original swap. This "amended swap" method is the predominant method used in compressions of uncleared interest rate swaps. Under the second method, one or more existing swaps are

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<sup>14</sup> The part of the Legacy Swap novated to a third party would be a new swap for the third party, and, depending on the status of the new counterparty (i.e., an SD, a financial end user, or a non-financial end user) and the applicable compliance date under Commission regulation 23.161, ISDA acknowledges that such swap may be subject to the variation and/or initial margin requirements of the CFTC Margin Rule.

<sup>15</sup> See No-Action Relief from Required Clearing for Partial Novation and Partial Termination of Swaps, CFTC Letter No. 13-02 (March 20, 2013), available on the Commission's website [www.cftc.gov](http://www.cftc.gov).

<sup>16</sup> See Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 77 FR 55904, 55960 (Sept. 11, 2012).

terminated and replaced by new swaps that reflect a netting down of existing notional exposure between the counterparties.<sup>17</sup> This “replacement swap” method is predominantly used in compression exercises for uncleared credit default swaps, but it can also be used for interest rate swap compression exercises. Counterparties have the option of electing either of the two methods of compression.

Under the rules of the compression exercise, for either method of compression — amended swap or replacement swap — the counterparties to the original swap do not change. In addition, the reference entity and the maximum maturity do not change. Finally, the overall market risk of the portfolios of the market participants in the compression exercise does not change or is reduced.

ISDA notes that the Commission’s Division of Clearing and Risk provided relief from the clearing requirement under section 2(h)(1)(A) of the CEA for amended and replacement swaps resulting from multilateral compression exercises consisting only of swaps entered into prior to implementation of the Commission’s clearing requirement.<sup>18</sup> ISDA therefore requests that DSIO take a similar no-action position, subject to the same conditions, such that the amended and replacement swaps of SDs, where the original swap was a Legacy Swap at the time of execution but that is subsequently amended or replaced in connection with a multilateral portfolio compression exercise after the applicable compliance date for the CFTC Margin Rule set forth in Commission regulation 23.161, do not lose their status as Legacy Swaps solely by virtue of being amended or replaced through a multilateral portfolio compression exercise.

ISDA represents that requiring amended swaps or replacement swaps resulting from a multilateral compression exercise consisting of Legacy Swaps to be subject to the CFTC Margin Rule would alter the credit risk profile for those participating in the compression exercise because counterparties to the amended or replacement swaps may be required to comply with the variation and initial margin requirements of the CFTC Margin Rule with respect to such swaps. Further, ISDA represents that because participants would not know in advance which swaps may be subject to an amendment or replacement, or the notional amount to be amended or replaced, market participants likely would reconsider their participation in these industry-wide risk reduction exercises. As a result, ISDA represents that changing the legacy status of the Legacy Swaps would discourage participation in compression exercises and inhibit the risk reduction benefits that such exercises provide.

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<sup>17</sup> In the vast majority of compression exercises there is a reduction in the notional exposures due to netting. However, in some exercises there is merely an aggregation of outstanding gross exposures arising from multiple swaps into one replacement swap with no net reduction in notional exposures.

<sup>18</sup> See No-Action Relief from Required Clearing of Swaps Resulting from Multilateral Compression Exercises, CFTC Letter No. 13-01 (March 18, 2013), available on the Commission’s website [www.cftc.gov](http://www.cftc.gov).

### **III. DSIO No-Action Position**

Based on the foregoing, DSIO believes that a no-action position is warranted, subject to the conditions set forth below.

#### **A. Immaterial Amendments, Partial Terminations, and Partial Novations of Legacy Swaps**

DSIO will not recommend that the Commission take an enforcement action against an SD for a failure to comply with the CFTC Margin Rule with respect to a Legacy Swap that is:

1. Amended, provided that no term is amended that would affect the economic obligations of the parties or the valuation of the Legacy Swap;<sup>19</sup> or
2. Partially terminated or partially novated by such SD, subject to the following conditions:
  - a. The records of the Legacy Swap that exist in the trading and/or recordkeeping systems of the SD are amended solely to reflect the reduced notional amount of the Legacy Swap;
  - b. The stated portion of the Legacy Swap that is terminated or novated by such SD is fully terminated between the SD and its original counterparty, apart from the stated portion that is the stub; and
  - c. All other material terms (as such term is defined in Commission regulation 23.500(g)) of the stub remain the same as the terms of the Legacy Swap.

#### **B. Swaps Resulting from Exercise of Swaptions that are Legacy Swaps**

DSIO will not recommend that the Commission take an enforcement action against an SD for a failure to comply with the CFTC Margin Rule with respect to swaps resulting from the exercise of swaptions, provided that the swaption is a Legacy Swap as defined in this letter and all terms of the swap were established upon execution of the swaption.<sup>20</sup>

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<sup>19</sup> For the avoidance of doubt, DSIO believes that an extension of the maturity date, expiration date, or termination date of a Legacy Swap will always affect the economic obligations of the parties and the valuation of the swap.

<sup>20</sup> This relief for swaptions in particular and the remaining relief more generally is not available for market participants who may seek to use the relief to enter into large volumes of swaps or swaptions prior to the applicable initial margin compliance date with only the intention to evade the uncleared swap margin requirements.



### **C. Swaps Resulting from Multilateral Portfolio Compression Exercises**

DSIO will not recommend that the Commission take an enforcement action against an SD for a failure to comply with the CFTC Margin Rule with respect to an amended swap or a replacement swap that is generated as part of a multilateral portfolio compression exercise, subject to the following conditions:

1. The “multilateral portfolio compression exercise” generating the amended and replacement swaps must meet the definition set forth in Commission regulation 23.500(h) and must involve more than two market participants;
2. All swaps submitted by market participants as part of the “multilateral portfolio compression exercise” generating the amended and replacement swaps must be Legacy Swaps as defined in this letter;
3. The amended or replacement swaps generated by the multilateral portfolio compression exercise must:
  - a. Be generated in accordance with a multilateral portfolio compression service provider’s established rules and parameters for multilateral portfolio compression exercises;
  - b. Be entered into between the same counterparties as the Legacy Swaps that are amended or replaced;
  - c. With the exception of reducing the notional amount, have the same material terms (as such term is defined in Commission regulation 23.500(g)) as the Legacy Swaps that are amended or replaced; and
  - d. Be entered into for the sole purpose of reducing operational or counterparty credit risk; and
4. Once the Legacy Swaps have been selected and submitted by market participants as part of the multilateral portfolio compression exercise, the multilateral portfolio compression methodology does not permit participants to specify which swaps may be amended or replaced.

This letter, and the positions taken herein, represent the views of DSIO only, and do not necessarily represent the position or view of the Commission or of any other office or division of the Commission. The relief issued by this letter does not excuse persons relying on it from compliance with any other applicable requirements contained in the CEA or in Commission Regulations. Further, this letter, and the positions taken herein, is based upon the representations made to DSIO. Any different, changed, or omitted material facts or circumstances might render this no-action position void.

Questions concerning this letter may be directed to me at (202) 418-5213; or Frank Fisanich, Chief Counsel, at (202) 418-5949.

Very truly yours,

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