

CFTC Issues No-Action Relief for Derivatives Market IBOR Transition

While not unlimited, the relief is welcome for counterparties seeking to transition to risk-free rates for legacy swaps.

The US Commodity Futures Trading Commission (CFTC) has issued no-action relief to help market participants transition away from the London Interbank Offered Rate (LIBOR) and other interbank offered rates (collectively, the IBORs).

Pursuant to the CFTC staff letters, market participants who are engaged in amending swap transactions in order to provide for fallback language to address IBOR transition or to amend IBOR-linked uncleared swaps to reference a new risk-free rate (RFR) will benefit from no-action relief with respect to:

- The swap dealer *de minimis* exception
- Uncleared swap margin requirements for non-prudentially regulated swap dealers
- Swap dealer business conduct standards
- Swap trading relationship documentation
- Portfolio reconciliation
- Trade confirmation requirements
- Eligible contract participant requirements
- The end-user exception to mandatory clearing
- Clearing and trade execution requirements

IBORs are expected to be discontinued in the coming years, and all contracts referencing IBORs will need to be amended to reference new RFRs, such as the Secured Overnight Financing Rate (SOFR). The US Dollar LIBOR interest rate benchmark alone impacts over US\$200 trillion worth of global financial contracts.

Various divisions of the CFTC granted the no-action relief in response to requests made by the Alternative Reference Rates Committee on behalf of its CFTC-regulated members. The relief is set forth in:

- No-Action Letter No. [19-26](#), issued by the Division of Swap Dealer and Intermediary Oversight (DSIO)
- No-Action Letter No. [19-27](#), issued by the Division of Market Oversight (DMO)
- No-Action Letter No. [19-28](#), issued by the Division of Clearing and Risk (DCR)

Without the no-action relief, market participants might have been reluctant to amend legacy contracts for fear of bringing such contracts (and new swap transactions created as a result of remediation of such contracts) under derivatives regulations adopted pursuant to Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Title VII DF Rules), to which such legacy contracts are not currently subject or to which such new swap transactions would otherwise be subject. While the relief is a welcome addition to the developing IBOR transition framework, it does not provide relief from all Title VII DF Rules.

DSIO Relief From Requirements Applicable to Swap Dealers

For purposes of facilitating the transition away from IBORs to RFRs, pursuant to No-Action Letter No. 19-26, DSIO will not recommend enforcement for non-compliance with certain requirements applicable to swap dealers, including:

- ***De minimis* threshold requirements** that would otherwise apply as a result of a qualifying amendment

The relief provides that entities may exclude a swap subject to a qualifying amendment from its *de minimis* calculation for purposes of determining whether it continues to fall under the *de minimis* threshold to swap dealer designation and registration under Section 1a(49)(D) of the Commodity Exchange Act, as amended (CEA), without risk that amending legacy contracts with replacement rates or fallback provisions will bring modified swaps within the *de minimis* threshold count.

- **Uncleared swap margin requirements** that would otherwise apply to legacy swaps as the result of a qualifying amendment

Uncleared swaps that were entered into prior to an applicable compliance date are not subject to the uncleared swap margin requirements for non-prudentially regulated swap dealers (CFTC Margin Rules), and as a result do not need to post regulatory variation or initial margin (as applicable). However, these legacy swaps would be brought into scope if amended with replacement rates or fallback provisions. DSIO also granted relief for counterparties that prefer to use new “basis swaps” to achieve substantially the same effect as legacy swap amendments, if the basis swap (i) references only one or more legacy swaps and (ii) does not extend the maximum maturity or increase the total notional amount of the referenced legacy swap(s).

- **Certain swap dealer business conduct standards** that would otherwise apply in their dealings with counterparties as the result of a qualifying amendment

Swaps that were entered into prior to finalization of the counterparty business conduct standards either (i) are not subject to the applicable rules or (ii) have already complied with such business

conduct standards, such as regulatory disclosures, verification, and suitability. However, these swaps would be brought into scope if amended with replacement rates or fallback provisions. The relief is not all encompassing with respect to the business conduct requirements. While it specifically exempts swap dealers from the requirement to verify a counterparty's eligible contract participant (ECP) status, it **does not** extend to non-compliance with CFTC Rule 23.431(a), which requires the disclosure of material information to counterparties of a swap's risk profile, including information on the use of new reference rates.

- **Swap confirmation requirements** regarding timing and papering that would otherwise apply to swap transactions as the result of a qualifying amendment, provided such market participants amend and confirm via a multilateral protocol

The relief provides certainty that adherence to a multilateral protocol will not bring such trades out of compliance with respect to a swap dealer's swap confirmation requirements, since adherence via a multilateral protocol will amend and confirm contracts simultaneously without further action by the parties.

- **Swap trading relationship documentation and reconciliation requirements** that would otherwise apply as the result of a qualifying amendment

Uncleared swaps that were entered into prior to the compliance date of the swap trading relationship documentation rules are not subject to the applicable rules. Absent relief, these legacy swaps would be brought into scope if amended with replacement rates or fallback provisions.

- **Certain other eligibility requirements applicable to commercial end-user counterparties** that would otherwise apply as the result of a qualifying amendment

Swaps that are used to hedge or mitigate commercial risk and benefit from an exception or exemption from the swap clearing requirement or CFTC Margin Rules may maintain their exempt or excepted status provided that the swap qualified for the exemption at the time of execution, and such swap qualifies again as a swap used to hedge or mitigate commercial risk pursuant to CFTC regulations prior to December 31, 2021. End-user status as an ECP, which is based on a swap's purpose to manage the risk associated with the end-user's asset or liability, may also be maintained for swaps amended with replacement rates or fallback provisions if there is a temporary mismatch with regard to the underlying asset or liability provided the foregoing is satisfied.

While the no-action relief is not time-limited, general limitations and caveats include:

- Market participants may not rely on the relief to renegotiate economic terms or engage in price-forming activity.
- A qualifying amendment for purposes of the no-action relief is an amendment that includes new fallback provisions for an alternative reference rate triggered only by permanent discontinuation of an IBOR or other reference rate that is phased out or becomes impaired (collectively, Impaired Reference Rates) or determination by an administrator or relevant authority that such Impaired Reference Rate is no longer representative of the benchmark. While DSIO recognizes that amendments during the IBOR transition will require various changes to trade terms, including payment dates, reset dates, day count fraction, and notional amounts, a qualifying amendment does not include amendments that do either of the following:

- Extend the maximum maturity of a swap or swap portfolio
- Increase the total notional amount of a swap or the aggregate total effective notional amount of a swap portfolio, beyond what is necessary to accommodate the operational differences between the IBOR and its replacement RFR

DMO Relief From the Trade Execution Requirement

The trade execution requirement mandates that all swap transactions approved for clearing must be traded on a valid exchange — such as a designated contract market, a registered swap execution facility (SEF), or a SEF that is exempt from registration — and executed according to specific rules and principles under the CEA.

For purposes of facilitating the transition away from IBORs to RFRs, pursuant to No-Action Letter No. 19-27, DMO will not recommend enforcement for non-compliance with the trade execution requirement that would have otherwise applied under Section 2(h)(8) of the CEA, as the result of a qualifying amendment to a legacy swap or a new RFR swap created for the same purpose. The relief applies if an amendment is made via an IBOR transition mechanism being developed for (and in consultation with) market participants by the International Swaps and Derivatives Association, Inc. (ISDA). DMO will not recommend enforcement for non-compliance with trade execution requirements with respect to swaps that are either (i) amended to incorporate a recognized and accepted RFR or (ii) created by an IBOR transition mechanism to reference such RFRs.

- This no-action relief is time-limited through December 31, 2021.

DCR Relief From the Mandatory Swap Clearing Requirement

The swap clearing requirement mandates that parties centrally clear all interest rate swaps (IRS) created or amended by counterparties after the rule's compliance date. Legacy swaps transacted before the compliance date, however, are not required to be centrally cleared.

For purposes of facilitating the transition away from IBORs to RFRs, No-Action Letter No. 19-28 provides relief from the swap clearing requirement that would otherwise have applied under Section 2(h)(1)(A) of the CEA and CFTC Rule 50.4(a) as the result of a qualifying amendment to a legacy swap. The relief applies if an amendment is created via bilateral negotiations or by using a multilateral protocol being developed for (and in consultation with) market participants by ISDA. DCR will not recommend enforcement for non-compliance with swap clearing requirement with respect to qualified uncleared legacy IRS that are amended to incorporate fallback provisions with a recognized and accepted RFR.

- This no-action relief is time-limited through December 31, 2021.
- Market participants may not rely on the no-action relief from mandatory clearing to renegotiate economic terms or engage in price-forming activity.
- A qualifying fallback amendment for purposes of the no-action relief does not include amendments that do either of the following:
 - Extend the maximum maturity of an uncleared legacy IRS
 - Increase the total notional amount of an uncleared legacy IRS

- The no-action relief applies only if amended legacy IRS maintain the same counterparties, maximum maturity, average weighted maturity, and total effective notional amount as the original swap.
- The no-action relief does not apply to legacy IRS that have been voluntarily submitted for clearing to a derivatives clearing organization.
- The no-action relief does not apply to IRS currently subject to the trade execution requirements.
- IRS that are used to hedge or mitigate commercial risk and benefit from an exception or exemption from the swap clearing requirement or documentation requirements may maintain their status under specific conditions if amended with replacement rates or floating rate fallback provisions.

Considerations

However, the relief is not free from consideration. Notably, while the relief for ECPs is welcome, it is not complete. The CFTC does not holistically address the ECP requirement for swap transactions under Section 2(e) of the CEA, and thus a question remains as to whether the relief from a swap dealer's obligation to verify its counterparties' ECP status will provide enough comfort in the market to counterparties that no longer satisfy the ECP requirement at the time of amendment. Separately, disclosure requirements applicable under the business conduct rules regarding the new RFR swaps and amended swaps will still apply, and material information concerning the risks of the trade must be provided to the counterparty prior to entering into the amended swap. Swap dealers will need to be mindful of disclosures and timing, given that transition itself is a moving target, and they will want to formulate proper counterparty disclosures well in advance of transition. Finally, the relief provided to end-users is not complete. No relief is provided for other financial entities that benefit from a clearing exemption (e.g., captive finance vehicles, small banks), and for their potential failure to qualify for such exemption at the time of a qualifying amendment.

Further, uncertainty remains regarding the application of US uncleared swap margin regulations to pre-IBOR transition swaps. Like No-Action Letter No. 19-26 (which applies to the CFTC Margin Rules), [proposed amendments](#) to the uncleared swap margin rules for prudentially regulated swap dealers (PR Margin Rules) would permit pre-compliance date swaps to retain their legacy status under the PR Margin Rules if amendments are made solely for the purpose of addressing IBOR transition. However, it is not clear whether (and for how long) post-compliance date swaps would continue to qualify for the [hedging exemption for end-users](#) under the PR Margin Rules if the non-swap dealer counterparty qualifies for such end-user exemption upon execution of the existing swap, but no longer qualified upon an IBOR-related amendment thereto. As noted above, No-Action Letter No. 19-28 is time-limited through December 31, 2021. Furthermore, because the end-user exemption under the PR Margin Rules for swaps entered into for hedging purposes tees off of the counterparty qualifying for an exception to mandatory clearing under CFTC regulations, and does not specifically incorporate recognition of relief, whether the CFTC staff no-action relief would satisfy such requirement is unclear.

Conclusion

Notwithstanding these concerns, the no-action relief should provide much-needed certainty that will allow large parts of the affected derivatives market to move ahead with transition planning, scoping, execution, and risk management. Regulators in both the United States and abroad have signaled increased supervisory focus related to the transition away from IBORs, and may demand evidence of progress throughout 2020 and beyond.

CFTC Chairman Heath P. Tarbert has emphasized (most recently in a December 11, 2019, [speech](#) before the Market Risk Advisory Committee) that transitioning away from IBORs is a critical global issue that market participants must address sooner rather than later, or else risk serious harm to one's firm, in addition to wider systemic risk. The global shift away from IBORs presents a complex, time-sensitive, multifaceted set of challenges and tasks for most financial services institutions. The CFTC's no-action relief is a significant step by the US derivatives regulator toward providing the market with legal and operational certainty, and clearing the way for hesitant counterparties to amend legacy swaps with accepted RFRs and fallback provisions.

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