Swaps Regulation under Dodd-Frank’s Title VII: Recent Developments

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Presented By
Anna Pinedo, Morrison & Foerster
James Schwartz, Morrison & Foerster
Michael Sefton, Baker & McKenzie
Overview of Presentation

• Will review areas in which rulemaking is largely completed:
  • Swap Dealer and MSP registration
  • Recordkeeping
  • Swap data reporting
  • Business conduct standards
  • Mandatory swap clearing
  • Swap execution facilities
  • Volcker Rule

• Will review major areas in which the state of play is less final:
  • Extraterritoriality (final for CFTC but not SEC)
  • OTC margin requirements
  • Position limits
  • SEC Title VII implementation
  • Related areas: CFTC Enforcement, Exchange Developments, Lincoln Amendment
Swap Dealer/MSP Registration

• First wave of registrations occurred on December 31, 2012
  • Close to 70 swap dealers provisionally registered, no MSPs
• At last count, there were 89 provisionally registered swap dealers and two provisionally registered MSPs
• For potential swap dealers, application of de minimis threshold remains an important issue
  • Middle market US banks: many have attempted to structure their IRS and FX businesses to stay within de minimis threshold
  • Foreign banks: many have structured their business to stay within de minimis threshold or have struggled with whether to register or curtail activities
  • For entities engaged in FX business, focus has been on limiting scope of activities to FX swaps and FX forwards covered by the Treasury exemption
Recordkeeping

• Recordkeeping requirements are in effect for all market participants

• Recordkeeping requirements are more extensive for registered entities than for other market participants

• However, even non-registered end-users should appreciate that they are subject to recordkeeping requirements and should accordingly keep full, complete and systematic records for all new swaps
Swap Data Reporting

• Reporting obligations are now generally in effect
• The CFTC’s rules impose far greater obligations on dealers and MSPs than on other market participants
• Each of the three sets of CFTC rules contains a hierarchy under which swap dealers bear the most responsibility for reporting
  • Part 43 – Real-time Public Reporting (publicly disseminated, but not counterparty names)
  • Part 45 – Swap Data Reporting for new swaps
  • Part 46 – Swap Data Reporting for historical swaps
Swap Data Reporting (cont’d)

• It is not clear what use the CFTC is making, or is currently capable of making, of the data that is reported
• Early this year the CFTC announced the formation of an interdivisional staff working group to review certain swaps transaction data reporting and recordkeeping provisions
• Working group is expected to formulate and recommend questions for public comment relating to reporting rules and related provisions
Business Conduct Standards

• External and Internal Business Conduct Standards have gone into effect
  • These are applicable to, and create compliance burdens for, swap dealers and MSPs
  • External Business Conduct Standards
    • Cover verification of counterparty status, KYC and institutional suitability requirements, disclosure obligations relating to material risks, characteristics and conflicts of interest, daily mark-to-market values, clearing disclosures
    • Additional standards apply to interactions with Special Entities
  • Swap dealers have addressed the EBC requirements in several ways
    • ISDA Protocols
    • Bi-lateral documentation based on or incorporating portions of the ISDA Protocol
    • Standalone bi-lateral onboarding documentation
Business Conduct Standards (cont’d)

• Internal business conduct standards address such matters (in addition to reporting and recordkeeping)
  • conflicts of interest related to research and clearing activities;
  • chief compliance officer and duties; and
  • risk management requirements
Mandatory Clearing

• In general:
  • Section 2(h)(1)(A) of the CEA makes it unlawful to engage in any swap that the CFTC requires to be cleared, unless it is submitted to a registered clearing organization for clearing or an exception is available
  • The CFTC subjects classes or types of swaps to mandatory clearing by describing them in a clearing determination. To date, there has been only one final clearing determination
  • Once a final clearing determination has been issued, the related swap types are subject to mandatory clearing on a phased-in timeline based on type of entity
    • (T+90, T+180, T+270)
  • Section 2(h)(7)(A) of the CEA provides an exception to the clearing requirement (the “end-user exception”)
  • The CFTC has also provided an exception to mandatory clearing for trades between affiliated entities
Mandatory Clearing (cont’d)

• Pursuant to the CFTC’s first mandatory clearing determination, which is now in effect, subject to applicability of the end-user exception (or any other applicable exception), mandatory clearing of standard IRS and certain index CDS products is now required for all market participants.
Mandatory Clearing (cont’d)

• First set of clearing determinations covered only plain vanilla IRS and index CDS
  • These instruments were already being cleared in many cases, thus did not present a challenge to the market

• Regarding future clearing determinations, many questions arise:
  • Will the CFTC, together with the cooperation of CCPs, move to designate more complex and potentially less liquid IRS and CDS for clearing
  • Will the CFTC and CCPs next focus on commodity swaps and in doing so first focus on plain vanilla highly liquid instruments
  • To what extent if any will the CFTC seek to mandate clearing of FX swaps, which is strongly disfavored by much of the international banking community
  • What, if any, mandatory clearing determinations will the SEC eventually decide upon
Mandatory Clearing (cont’d)

• Establishing a clearing relationship
  • As swap clearing becomes a reality, additional or modified documentation will be required by some non-registered entity types (although true end-users may never need to use them)
  • Clearing firms currently are proposing the following three types of documents:
    • Futures Account Agreement (“FAA”)
      • Customer agreement for setting up a futures account between an FCM and a customer
    • Cleared OTC Derivatives Addendum to FAA
      • Necessary because FAAs do not address swaps or close-out rights in relation to cleared swaps
    • Execution Agreement
      • Addresses consequences if a transaction that is expected to clear is not accepted for clearing
Mandatory Clearing/End-User Exception

• Clearing exception for end-users
  • An end-user may be eligible for an exception from the clearing and trade execution requirements under CEA Section 2(h)(7) and CFTC Rule 50.50 (formerly Rule 39.6)
  • In order to qualify for the end-user exception, an end-user:
    • Cannot be a “financial entity”;
    • Must use swap to “hedge or mitigate commercial risk”; and
    • Must fulfill certain reporting obligations
Mandatory Clearing/End-User Exception (cont’d)

• A financial entity includes:
  • SDs, MSPs;
  • Commodity pool operators;
  • Private funds;
  • ERISA plans; or
  • Persons “predominantly engaged” in activities that are in the business of banking, or in activities that are “financial in nature” (defined under Section 4(k) of the Bank Holding Company Act), including securities underwriting and dealing, investment advisory activities, insurance agency or brokerage, and extending credit
To qualify for the end-user exception, a swap must be used to hedge or mitigate commercial risk, which requires that a swap:

- qualifies as a bona fide hedging under the CEA position limit rules, or
- qualifies for hedging treatment under FASB, or
- be “economically appropriate” to reduce, in the ordinary course of business, risks arising from a change in: the value of assets that the entity owns, produces, manufactures, processes or merchandises; the value of liabilities due to fluctuations in interest, currency or foreign exchange rates, or the interest, currency or foreign exchange rate exposures arising from a person’s assets, services or liabilities; and
- not be used for a purpose that is in the nature of speculation, investing or trading and not be used to hedge or mitigate the risk of another swap, unless that other swap itself is used to hedge or mitigate commercial risk
In addition, end users seeking to make use of the end-user exception must also report annually (or, if it chooses, on a trade-by-trade basis) to an SDR (or the CFTC) information including the following:

- whether it is a financial entity or a finance affiliate;
- whether the swap hedges or mitigates commercial risk;
- whether it is an SEC reporting company, and, if so, whether the appropriate committee of its board of directors has reviewed and approved the decision to enter into swaps that are exempt from clearing; and
- how it generally meets its financial obligations in relation to uncleared swaps.
The CFTC released its affiliate exception to mandatory clearing in April, 2013.

The exception is expected to be used primarily for transactions between affiliated financial entities (ineligible for the end-user exception).

The rule is complex and includes, among others, the following requirements:

- Only majority-owned affiliates are eligible for exemption.
- Both counterparties must elect not to clear the swap.
- Swap trading relationship documentation is required between the parties.
- Swap must be subject to a centralized risk management program within the group of affiliated entities that is reasonably designed to monitor and manage the risks associated with inter-affiliate swaps.
Mandatory Clearing/Securitizations

- In May, 2013, the American Securitization Forum (ASF) submitted a no-action request to the CFTC seeking an explicit exemption for securitization swaps from mandatory clearing requirements
  - ASF stated that the relief it is seeking is confirmation that “swaps used in securitizations that include special provisions to support their legal structures and/or credit ratings are NOT subject to the clearing mandate if no derivatives clearing organization clears swaps with such provisions.”
  - Once OTC Margin rules are finalized, would expect follow on no-action request to exempt securitization vehicles from such rules
  - Viability of securitization market will be affected by how CFTC responds to such requests
- The CFTC has not responded in writing to the ASF’s request, but is said to have stated orally that a swap with bespoke features not contemplated by a clearinghouse is not required to be cleared
  - Securitization swaps typically incorporate bespoke features such as non-petition clauses and limited recourse provisions
Swap Execution Facilities

• To promote pre-trade price transparency, the Dodd-Frank Act requires that all swaps that are required to be cleared be executed on a designated contract market (DCM) or a swap execution facility (SEF), unless the swap is not available to trade on any DCM/SEF or another clearing exception applies.

• CFTC approved final rules for SEFs in May, 2013, but has provided limited relief on certain aspects of the rules.
Swap Execution Facilities

• CFTC’s core principles and other requirements for SEFs:
  • define a SEF as a trading system or platform that is not a DCM, and in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants (definition excludes single-dealer platforms)
  • require SEFs to comply with a minimum functionality requirement by offering an “Order Book,” an electronic trading facility, trading facility, or trading system or platform in which all market participants have the ability to enter multiple bids and offers, observe or receive bids and offers, and transact on them
  • distinguish between “Required Transactions,” which are required to be cleared and executed on a SEF or DCM and “Permitted Transactions” not subject to mandatory SEF execution
    • Required Transactions must generally be executed on a system by which market participants send a request for a quote to buy/sell a particular instrument to at least two (after October 2, 2014, three) independent market participants
Swap Execution Facilities

- The CFTC, in its release of its core principles and other requirements for SEFs, surprised the market by stating, in a footnote, that if a facility operates in a manner that meets the SEF definition, it is required to register as a SEF, even if it facilitates the execution of only “Permitted Transactions” that are not subject to the trade execution mandate.
- This means that, unexpectedly, multiple-to-multiple FX platforms, and other platforms on which “Permitted Transactions” are traded, have been required to register as SEFs.
Swap Execution Facilities

• CFTC’s “Made Available to Trade” (“MAT”) rule provides that a swap that is subject to mandatory clearing must be executed on a SEF or DCM only if a SEF or DCM has made the swap “available to trade”
  • After listing, a SEF or DCM may make a MAT determination for a group, category, type or class of swap
  • A MAT determination is then provided to the CFTC
  • A SEF or DCM may make the initial determination that a swap is made available to trade based on any one or more of the following factors:
    • existence of ready and willing buyers and sellers;
    • frequency or size of transactions;
    • trading volume;
    • number and types of market participants;
    • bid/ask spread; and
    • usual number of firm or indicative bids and offers
Swap Execution Facilities

- As a procedural matter, the CFTC can take up to 90 days to review MAT determinations
- A number of SEFs, including Javelin, Tradeweb, and MarketAxess, submitted MAT determinations to the CFTC
- The initial MAT determinations for interest rate swaps went into effect starting on February 15
- The first MAT determinations for index CDS went into effect on February 26
- Initial reports seem to indicate generally smooth implementation, with slightly below-typical volume
- Concern still exists that standards are not sufficiently objective and MAT determinations should be made in the first instance by the CFTC, not SEFs
Swap Execution Facilities

• Treatment of “package transactions” is not yet clear
• CFTC has given no-action relief, applicable until May 15, in relation to such transactions
• A “package transaction” is defined as a transaction involving two or more instruments
  • that is executed between two counterparties;
  • that is priced or quoted as one economic transaction with simultaneous execution of all components;
  • that has at least one component that is a swap that is made available to trade and therefore is subject to the trade execution requirement; and
  • where the execution of each component is contingent upon the execution of all other components
Swap Execution Facilities

CFTC Guidance Regarding Impartial Access

• In November, 2013 the CFTC issued guidance stating that its understanding that certain market participants were using “enablement mechanisms” preventing full and impartial access to SEFs by certain market participants

• According to the CFTC, such mechanisms included
  • requirement that a breakage agreement be in place
  • limiting the streaming of indicative bids and offers to certain participants
  • requiring a market provider to be a dealer to respond to a RFQ, thus preventing non-dealers from acting as liquidity providers

• The CFTC stated that all ECPs, including individuals, should have full and impartial access to SEFs, both as liquidity providers and liquidity takers
Swap Execution Facilities

• Extraterritoriality issue in relation to SEF registration:
  • In a guidance letter issued on November 15, 2013 the CFTC’s Division of Market Oversight stated its expectation that a multilateral swaps trading platform located outside the United States that provides U.S. persons or persons located in the U.S. (such as agents of non-U.S. persons located in the United States) with the ability to trade or execute swaps on or pursuant to the rules of the platform, either directly or indirectly through an intermediary, will register as a SEF or DCM
  • This meant that many multilateral swaps trading platforms outside of the U.S. are, under CFTC guidance, required to register with the CFTC
  • However, the registration issue has been at least partially addressed in two linked no-action letters, which, among other things, provide relief from the registration requirement to EU-regulated multilateral trading facilities overseen by “competent authorities”
Swap Execution Facilities

- CFTC Letter 14-15 provides time-limited no-action letter for EU-regulated multilateral trading facilities overseen by “competent authorities” from the U.S. SEF registration requirement
  - Additionally, the letter provides relief to parties executing swap transactions on MTFs from the requirement that swaps subject to mandatory clearing be executed on a SEF
  - The relief provided by the letter will expire no later than March 24, 2014
- CFTC Letter 14-16, provides potentially longer-term conditional no-action relief for:
  - EU-regulated multilateral trading facilities from the SEF registration requirement;
  - parties executing swaps on qualifying MTFs from the SEF trade execution mandate, as well as reporting obligations under Part 43 (Real-Time Public Reporting) and Part 45 (Swap Data Recordkeeping and Reporting Requirements) of the CFTC’s rules; and
  - swap dealers and major swap participants executing swap transactions on qualifying MTFs from (i) certain external business conduct requirements, (ii) the confirmation requirement under CFTC Rule 23.501; and (iii) the swap trading relationship documentation requirements under CFTC Rule 23.504
- The relief provided by letter 14-16 will expire upon the effective date of final rules implementing the CFTC’s authority to exempt non-U.S. facilities that are subject to comparable supervision and regulation by governmental authorities in their home country
Swap Execution Facilities

• The no-action letters reflect progress made by the CFTC and EU authorities in implementing the “path forward” statement that they issued in July, 2013
• More broadly, at the G20 finance meeting held last month, the G20 committed to cooperate across jurisdictions with a renewed focus on timely and consistent implementation supported by meaningful peer reviews, with a particular attention to OTC derivatives reform
• The OTC Derivatives Regulators Group is expected to provide a list of remaining cross-border implementation issues (in April, 2014), and a report on relevant solutions (by September, 2014)
Volcker Rule

• In December, 2013 the five relevant U.S. regulatory agencies approved the final version of the Volcker Rule
• Very detailed release of almost 900 pages
• The rule, based on section 619 of Dodd-Frank, will substantially limit the circumstances in which many banking entities may enter into derivatives
• Because of prohibitions of trading activities, could substantially reduce market liquidity
Volcker Rule

• Entities to which the rule applies to a very broad range of banking entities, including insured depository institutions, companies controlling an insured depository institution, and companies treated as bank holding companies, and any affiliate or subsidiary of any of the foregoing
• Two primary parts:
  • Prohibition on proprietary trading and
  • Prohibition on ownership interests in certain investment companies and commodity pools
• We will focus on proprietary trading, and permitted risk-mitigating hedging and market-making activities
Volcker Rule/Proprietary Trading

- The general rule is that a banking entity may not engage in proprietary trading – “engaging as principal for” its own “trading account” in a “purchase or sale of one or more financial instruments,” including derivatives
  - definition of “trading account” incorporates concept of “short-term” resales, price movements or arbitrage profits
  - definition of “financial instrument” includes most derivatives
  - definition of “swap” under Title VII does not align with the definition of derivatives that are financial instruments
- There is a rebuttable presumption that if a banking entity holds a financial instrument for less than 60 days, the purchase or sale of such instrument is for the banking entity’s trading account
Volcker Rule/Hedging Activities

• However, the prohibition on proprietary trading does not apply to certain risk-mitigating hedging activities or certain market-making activities (as well as certain underwriting activities)
• Permitted risk-mitigating hedging activities do not explicitly include a “portfolio hedge”
  • However, they do permit hedging activities that are:
    • “in connection with and related to individual or aggregated positions, contracts or other holdings” and
    • “designed to reduce the specific risks to the banking entity” that are “related to such positions, contracts or other holdings”
Volcker Rule/Hedging Activities

• Additional requirements for risk-mitigating hedging activities:
  • An internal compliance program containing written policies and procedures regarding positions, techniques and strategies that may be used for hedging, including:
    • documentation indicating what positions, contracts or other holdings a particular trading desk may use
    • position and aging limits
    • analysis designed to ensure that the positions, techniques and strategies that may be used for hedging may be reasonably be expected to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risks being hedged
  • The extent of the required internal compliance program will depend upon the size and activities of the relevant banking entity, but for entities engaging in proprietary trading with consolidated assets of $10 billion or more it will be quite substantial.
    • Rule is quite prescriptive with respect to reporting and recordkeeping requirements, as set out in Appendices A and B
Volcker Rule/Hedging Activities

• Additional requirements for risk-mitigating hedging activities:
  • Activity must be conducted in accordance with written policies, procedures and internal controls
  • Activity must be designed to reduce or otherwise significantly mitigate and demonstrably reduces or otherwise significantly mitigates one or more specific, identifiable risks arising in connection with identified positions, contracts, or other holdings
  • Activity must not give rise, at the inception of the hedge, to any significant new or additional risk that is not itself hedged contemporaneously
  • Continuing review, monitoring and management that requires ongoing recalibration of the hedging activity
  • Compensation arrangements of persons performing risk-mitigating hedging activities are designed not to reward or incentivize prohibited proprietary trading
  • Additional documentation requirements apply with respect to risk-mitigating hedging activities established by a trading desk other than the desk responsible for the underlying positions, or to hedge aggregated positions across trading desks
Volcker Rule/Market-Making Activities

- The prohibition on proprietary trading does not apply to certain market-making activities.
- Requirements for permitted market-making activities:
  - Trading desk that establishes and manages the financial exposure routinely stands ready to purchase and sell one or more types of financial instruments related to its financial exposure and is willing and available to quote, purchase and sell, or otherwise enter into long and short positions in those types of financial instruments for its own account in commercially reasonable amounts and throughout market cycles.
  - The amount, types, and risks of the financial instruments in the trading desk’s market-maker inventory are designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties.
Volcker Rule/Market-Making Activities

• Additional Requirements for permitted market-making activities:
  • Internal compliance program that states
    • the instruments in which each trading desk will make a market
    • actions the trading desk will take to demonstrably reduce or otherwise significantly mitigate promptly the risks of its financial exposure
    • Limits for each trading desk, based on the nature and amount of the trading desk’s market making-related activities
    • Internal controls and ongoing monitoring and analysis of each trading desk’s compliance with its limits
    • Authorization procedures, including escalation procedures that require review and approval of any trade that would exceed a trading desk’s limit(s)
  • The compensation arrangements of persons performing the market-making activities are designed not to reward or incentivize prohibited proprietary trading.
Extraterritoriality

• Perhaps the most controversial issue arising from Title VII is the extraterritorial application of Title VII and the harmonization of Title VII requirements (and effective dates under Title VII) with foreign (non-U.S.) requirements

• Under Section 722(d) of Title VII, non-U.S. Persons will be regulated if:
  • they have a direct and significant connection with activities in, or effect on, commerce of the U.S.; or
  • they contravene such rules or regulations as may be prescribed under the Act, necessary or appropriate to prevent the evasion of the relevant provisions of the Act
CFTC Final Guidance

• The scope of Title VII extraterritoriality is quite extensive, as set out in CFTC final guidance
  • Transaction-Level requirements will apply to swaps to which one party is a U.S. Person, or a U.S. branch of a foreign swap dealer. They will not necessarily apply, however, to a swap between two non-U.S. Persons
    • Transactional-Level requirements include clearing, margin and segregation for uncleared swaps, trade execution, and documentation requirements
    • In many cases, foreign branches of U.S. swap dealers may, based on a possible substituted compliance determination by the CFTC, be able to comply with the analogous rules of their jurisdiction of residence rather than the CFTC’s rules regarding Transaction-Level requirements
CFTC Final Guidance (cont’d)

• The CFTC Swap Dealer registration requirement applies to a non-U.S. entity which has more than de minimis swap dealing activity with U.S. persons

• Entity-Level requirements will apply to all swap entities that are required to register with the CFTC
  • Entity-Level requirements include capital adequacy, the chief compliance officer requirement, risk management and recordingkeeping
  • In many cases, non-U.S. entities may, based on compliance determinations made by the CFTC, be able to comply with the analogous rules of their home jurisdiction rather than the CFTC’s rules regarding Entity-Level requirements
CFTC Final Guidance (cont’d)

Key Considerations – U.S. Person

• Definition of U.S. Person is central to CFTC cross-border guidance, in part because CFTC requirements for market participants will generally apply to a U.S. Person

• CFTC definition of the term is long and open ended (the CFTC interprets the term “generally to include, but not be limited to”…)

• Definition includes, among other things, any commodity pool, pooled account, investment fund, or other collective investment vehicle that is majority-owned by certain types of U.S. Persons
CFTC Final Guidance (cont’d)

• A non-U.S. person does not become a U.S. person by virtue of a guarantee by U.S. affiliate
• However, such a non-U.S. person may be a “guaranteed affiliate” or “affiliate conduit” and, for that reason, in certain circumstances, subject to many of the CFTC’s transaction-level rules
• Whether a non-U.S. person is a “guaranteed affiliate” or “affiliate conduit” depends on consideration of a number of factors that focus on the closeness of the relationship between the non-U.S. person and the U.S. affiliate (e.g., the existence of a guarantee by a U.S. Person, ownership, control, consolidated financial statements)
CFTC Final Guidance (cont’d)

Key Considerations – Swap Dealer Registration (Affiliates)

- A non-US entity which has more than de minimis swap dealing activity with U.S. persons must register as a swap dealer.
- When determining whether swap dealing activities exceed the de minimis threshold, a person must include the aggregate notional value of swap dealing transactions by affiliates under common control.
- The guidance interprets this requirement as applicable to all affiliates in a corporate group regardless of whether they are U.S. or non-U.S. persons.
- But this does not apply to activities of an affiliate that is already registered as a swap dealer.
- For U.S. and non-U.S. persons in an affiliated group, this effectively means that if the group exceeds the de minimis threshold then one or more members of the group would have to register as a swap dealer to bring the group’s dealing activity below the de minimis threshold.
CFTC Final Guidance (cont’d)

Key Considerations – Foreign Branches

• A foreign branch of a U.S. person is considered a part of the U.S. person
• Therefore a foreign branch would not register separately from the U.S. person as a U.S. swap dealer
• The foreign branch is expected to comply with all of the CFTC’s entity-level requirements
• For a swap transaction between the foreign branch and a non-U.S. person, the swap is eligible for substituted compliance with respect to many Transaction-level requirements
CFTC Final Guidance (cont’d)

U.S. branches of foreign swap dealers and footnote 513

• In this footnote in its cross-border guidance, the CFTC stated its view that “a U.S. branch of a non-U.S. swap dealer or MSP” is subject to Transaction-Level requirements

• Even though “a branch does not have a separate legal identity” and is therefore part of a non-U.S. Person, the CFTC has a “strong supervisory interest in regulating the dealing activities that occur with the United States, irrespective of the counterparty”
CFTC Final Guidance (cont’d)

• In addition to footnote 513, in November, 2013 the CFTC’s Division of Swap Dealer and Intermediary Oversight issued a “Staff Advisory” regarding swaps “arranged, negotiated or executed, or executed by personnel or agents of the non-U.S. SD located in the United States”

• Under this advisory, what appears to matter, for purposes of the applicability of Transaction-Level requirements, is not the SD office entering into the swap as a legal matter, but instead the location of the persons arranging or negotiating the terms of a swap

• By means of footnote 513 and the additional advisory, it appears that the CFTC may require counterparties to a swap to comply with certain Transaction-Level Requirements even if both are foreign and enter into a swap through non-U.S. offices, if one entity employs U.S.-based front-office personnel or agents in relation to the swap
CFTC Final Guidance (cont’d)

- However, a CFTC no-action letter, issued subsequent to the advisory, grants relief until September 15, 2014 to non-U.S. swap dealers failing to comply with the Transaction-Level Requirements in relation to swaps with many non-U.S. persons.
- In addition, the CFTC issued a request for comment on “whether the Commission should adopt” the advisory “as Commission policy, in whole or in part”.
- As a result, the extent of the applicability of the Transaction-Level Requirements remains unsettled in certain circumstances, notably in relation to swaps between a non-U.S. dealer and another non-U.S. Person.
CFTC Final Guidance (cont’d)

Substituted Compliance

• Under the CFTC’s cross-border guidance, for certain swaps and certain parties, the CFTC may make substituted compliance determinations.

• These are determinations that a foreign jurisdiction’s requirements “are comparable with and as comprehensive as” the CFTC’s own regulations and, therefore, market participants can comply with the foreign jurisdiction’s rules instead of the CFTC’s rules.

• Under a CFTC’s exemptive order relating to its cross-border guidance, December 21, 2013 was a key date, the date on which, to the extent there was no relevant substituted compliance determination, many of the CFTC’s rules became effective to non-U.S. market participants.
CFTC Final Guidance (cont’d)

• With regard to many Entity-Level Requirements, last December the CFTC made broad substituted compliance determinations for jurisdictions including Australia, Canada, the European Union, Hong Kong, Japan and Switzerland
  • These determinations amount to a pragmatic view that the primary, non-U.S. regulation of non-U.S. swap dealers renders it largely unnecessary for its rules to apply directly to non-U.S. entities
• With regard to the Transaction-Level Requirements, the CFTC to date has been far more insistent on the application of its own rules, making substituted compliance determinations only for a small number of European Union and Japan transactional rules
Litigation Over CFTC Final Guidance

• The CFTC’s cross-border guidance led to the most recent lawsuit based on the CFTC’s implementation of Title VII
• Late last year, industry groups, including SIFMA, ISDA and the IIB, challenged the CFTC’s cross-border guidance, seeking a court order to vacate that guidance
• Still early days for the lawsuit, and there are unconfirmed rumors of preliminary settlement discussions
• Significantly, at the outset of the lawsuit, the plaintiffs did not seek injunctive relief, which means that implementation of the cross-border guidance is continuing while the suit is pending
• The plaintiffs’ allegations are not limited to the cross-border guidance and could conceivably cause a court to vacate certain substantive CFTC rules to the extent of their extraterritorial application
Litigation Over CFTC Final Guidance

• The plaintiffs allege in their complaint that the CFTC, in adopting and promulgating its cross-border guidance,
  • failed to engage in the cost-benefit analysis required under the Commodity Exchange Act;
  • violated the Administrative Procedure Act by
    • failing to provide interested persons, including foreign swap dealers, sufficient opportunity to participate in a rulemaking;
    • failing to respond adequately to comments, and
    • acting arbitrarily and capriciously with regard to the scope of the entities and transactions covered by its rules,
  • adopted a rule applicable to activities outside of the United States without a sufficient connection to the United States
Litigation Over CFTC Final Guidance

• In addition, the plaintiffs allege that in promulgating certain rules, the CFTC failed to evaluate the costs and benefits of their extraterritorial application or respond to comments regarding their extraterritorial application.

• These allegations pertain to, among others, certain CFTC rules regarding the registration of swap entities, portfolio reconciliation and documentation, real-time reporting, SDR reporting, large trader reporting and SEF registration.

• Finally, the Complaint alleges that the CFTC’s SEF registration rule is arbitrary and capricious in regulating entities and activities with an insufficient connection to U.S. commerce.
SEC Proposed Cross-Border Rules

- On May 1, 2013, SEC issued its proposed cross border rules with respect to the security-based swaps market
- A sweeping proposal, 650 pages in length, which attempts to address the cross-border implications of each major aspect of the SEC’s Title VII regime, from US Person status and security-based SD and major security-based swap participant registration issues, to the application of entity and transaction level requirements to registered entities, to the jurisdictional implications for SDRs and clearing agencies
  - In its proposing release, the SEC acknowledges that the DFA calls upon SEC and CFTC to consult and coordinate with each other and prudential regulators to ensure “regulatory consistency and comparability” and also, to the extent possible, to consult and coordinate with foreign regulators on the “establishment of consistent international standards” for the swaps markets
  - Noteworthy that the SEC approaches this a rulemaking exercise rather than following the CFTC in proposing to issue guidance
Comparison of CFTC and SEC

• While there are many similarities between the SEC’s proposed rules and CFTC’s proposed guidance, there are also significant differences and (with a few exceptions) these differences are viewed as making the SEC’s approach somewhat less problematic for cross-border swap activities.

• Major question facing the swaps market is the extent to which convergence may occur between SEC and CFTC approaches as well as with EMIR/MiFID and other international regulatory approaches.
Comparison of CFTC and SEC

• Among the important areas of difference between SEC and CFTC approaches are the following:
  • US Person definition: CFTC for investment pools looks through to majority equity ownership and for other entities looks through to majority equity ownership if owners also responsible for entity’s liabilities; SEC proposal does not have similar look through concepts and are generally more territorial in focus
  • US Person definition: CFTC has broader coverage for certain pension plans, trusts and estates than SEC proposal
  • Dealer determinations
    • CFTC aggregates among non-US affiliates that deal with US Persons, but excludes US affiliates
    • SEC aggregates among all affiliates, but excludes affiliates registered as swap dealers
Comparison of CFTC and SEC

• Dealer determination: CFTC focuses on dealings with US Persons, while SEC focuses on dealing with US Persons or transactions conducted in the US
• Dealer determination: CFTC attempts to capture conduit activity (i.e., swap by a non-US Person that has also executed a back to back trade with a US affiliate), while SEC proposal does not purport to capture this activity
• Entity vs Transaction Level Requirements
  • Margin is an entity level requirement for SEC, but a transaction level requirement for CFTC
  • In general, SEC is taking a more “territorial” approach to transaction level requirements (such as business conduct, clearing, trade execution) than CFTC, particularly with respect to foreign branches of US SD/MSPs
  • CFTC imposes requirements for swaps with non-US Person guaranteed by US Person, while SEC does not
• Substituted Compliance:
  • SEC comparability determination focuses on outcomes, rather than looking for comparability rule by rule
  • CFTC comparability determination focuses on rules and specific regulatory requirements
Comparison of CFTC and SEC

• Market seems particularly pleased with SEC’s approach:
  • narrower US Person definition
  • more accommodating approach for foreign subsidiaries guaranteed by a US Person
  • outcomes oriented substituted compliance approach rather than rule based
Margin Requirements

- There will be margin requirements for uncleared (OTC) swaps
- The margin requirements have not been finalized, although it is anticipated that levels will be at least comparable to, and likely higher, than those for cleared swaps (keeping in mind, however, that clearing houses and FCMs can increase the level of margin on a cleared swap)
- Given the international nature of the swaps market, margin levels will require international coordination and agreement
- Once margin requirements are finalized, market participants will need to evaluate their credit support arrangements determine what modifications are necessary
Margin Requirements (cont’d)

• Basel Committee on Banking Supervision (“BCBS”) and the International Organization of Securities Commissions (“IOSCO”) in September, 2013 issued their final framework for margin requirements for uncleared swaps. While not law, it is influencing the discussion on margin.

• Key principles include:
  • Margin requirements for uncleared swaps should promote central clearing by reflecting the higher risk associated with uncleared swaps.
  • All financial firms and systemically important non-financial entities should exchange initial and variation margin.
  • Initial margin should be exchanged by both parties, on a gross, unnetted basis.
  • Initial margin should be rehypothecated only in very narrow circumstances.
  • Variation margin may generally be rehypothecated or otherwise re-used.
Segregation of Initial Margin

• Title VII gives end-users the right to require that any initial margin they post be segregated and, if it chooses, held by a third-party custodian

• CFTC late last year issued regulations under which, prior to the execution of an uncleared swap, but not more often than annually, a swap dealer must:
  • give notice to its counterparty stating the counterparty’s right to require the segregation of initial margin provided by the counterparty;
  • identify one or more acceptable custodians that are legal entities independent of the dealer and the counterparty; and
  • provide information regarding the price of segregation for each custodian, to the extent the dealer has such information.

• Under the rule, segregated initial margin may only be invested in a limited number of instruments
Margin Requirements for Cleared Swaps

• Cleared Swaps
  • For cleared swaps, clearinghouses will drive how much margin will be required
  • Margin posted in respect of cleared swaps (but not futures contracts) is required to be “legally separate but operationally commingled” (“LSOC”)
  • Under LSOC, FCMs and DCOs may operationally commingle customer funds, but must maintain legally segregated accounts, and are not permitted to use a non-defaulting customer’s collateral to cover losses resulting from the default of another customer
Re-Proposed Position Limits Rules

• CFTC originally proposed position limits in January, 2011 and first finalized them later that year.
• However, ISDA and SIFMA were successful in lawsuit that they brought to vacate the CFTC’s final rules.
• Court ruled, on summary judgment, that CFTC had failed to make a required finding that position limits were actually necessary before imposing such limits.
• As a result, the CFTC re-proposed position limits rules in November 2013.
• CFTC re-proposal release contains a “preliminary finding,” spread over 12 pages of the Federal Register, that position limits are necessary to achieve the purpose of the Commodity Exchange Act.
Re-Proposed Position Limits Rules

- Proposed rule would limit speculative position limits in 28 physical commodity contracts and applies to “economically equivalent” futures, options and swaps based on these physical commodities.
- The proposed rules include three type of limits:
  - spot-month position limits (applicable in the period immediately before settlement)
  - conditional spot-month position limits – Exemption for up to 5 times the spot-month position limits for positions that are cash settled in a referenced contract
  - non-spot-month position limits (applicable during other times of year)
- Subsequent levels will be readjusted no less frequently than every two years.
Re-Proposed Position Limits Rules

- Revised Definition of Bona Fide Hedging for Exemption Purposes
  - Purpose must be to offset price risk incidental to commercial cash operations ("Incidental Test")
  - Position must be established and liquidated in an orderly manner in accordance with sound commercial practices ("Orderly Trading Requirement")
  - Plus different factors for excluded (financial) commodity hedges and physical (agricultural) commodity hedges and exempt (metals and energy) commodity hedges.
  - Additional specific exemptions (e.g. unfilled anticipated requirements for resale by a utility).
Re-Proposed Position Limits Rules

• Amendments to Aggregation Standards
• Aggregation of Positions for Purposes of Position Limits Still Based on Ownership and Control
• Proposed Exemptions from Aggregation
  • Sharing of information would create a "reasonable risk" of a violation of a federal, state or foreign jurisdiction law or rule
  • An ownership interest is less than 50 percent and trading is independently controlled
  • An ownership interest is greater than 50 percent in a non-consolidated entity whose trading is independently controlled, and an applicant certifies that such entity's positions either qualify as bona fide hedging positions or do not exceed 20 percent of any position limit
  • Ownership of less than 50 percent results from broker-dealer activities in the normal course of business
  • Other enumerated exemptions
CFTC Enforcement

• Key Areas of Enforcement
  • Manipulation and Disruptive Trading Practices (e.g., “spoofing”) –
    • Defendants designed algorithm to place and quickly cancel large bids - $1.4 million fine
  • Failure to Supervise
    • RFED and FCM permitted trading system that gave the firm pricing advantage over and harmed thousands of retail customers - $1.8 million in restitution and approximately $900,000 fine
  • False Statements
    • Bank president made false statement during interview with CFTC - $25,000 fine
  • Protection of Customer Funds
    • MF Global Inc. and Peregrine Financial Group, Inc. matters
  • Precious Metals Fraud
    • Hunter Wise – CFTC alleges illegal off-exchange precious metals transactions requiring firms and their principals to pay more than $4.1 million in restitution.
  • Position Limit Violations
Exchange and NFA Developments

• In November, 2013 CME Group Issued Advisory Concerning Wash Trades
  • Rule 534 - Prohibition against a person placing buy and sell orders for accounts held by the same beneficial owner where the person “knows or reasonably should know that the purpose is to avoid taking a bona fide market position exposed to market risk.”
  • Advisory sets forth two primary elements for a wash trade.
    • Orders must actually result in a wash
    • Party intended on achieving wash
    • Party does not need to intend to violate Rule 534

• In January, 2014 NFA requested comments on CPO/CTA Capital Requirements and additional Customer Protection Measures
  • Comments are due by April 15, 2014
The SEC and Security-Based Swaps

- Swaps are subject to the jurisdiction of the CFTC and include interest rate swaps, floors, caps and collars, commodity swaps, cross-currency swaps, total return swaps on broad-based security indices or two or more loans and credit default swaps on broad-based security indices.

- Security-based swaps are subject to the jurisdiction of the SEC and include swaps on a single security, loan, or narrow-based securities index.

- “Narrow based security index” means, among other things, an index with nine or fewer components, or in which a component security comprises more than 30 percent of the index’s weighting.

- The SEC and CFTC have adopted joint rules for the regulation of mixed swaps, which combine characteristics of both swaps and security-based swaps.
SEC Title VII Rulemaking

- SEC is taking a different approach to Title VII rulemaking
  - It appears that no registration requirements will be imposed until all substantive Title VII rulemaking by SEC is complete
  - SEC’s substantive rulemaking has lagged significantly behind the CFTC’s
    - It has finalized relatively few rules
    - In some cases, the SEC is yet to publish a proposed rule on matters that the CFTC has long since published proposed rules on or even proceeded to adopt final rules
    - Even where SEC has published proposed rules, the timeline for finalizing these rules is unclear
Status of SEC Rules

• The SEC has granted broad temporary relief with respect to many of the consequences that arise from Dodd-Frank’s treatment of security-based swaps
• The SEC provided time-limited relief from Dodd-Frank requirements in three pieces:
  • a general exemptive order;
  • interim final rules; and
  • another exemptive order, specifically under the Exchange Act
Status of SEC Rules (cont’d)

• Last month the SEC extended the relief that it granted in its interim final rules until February 11, 2017, representing an additional three-year extension

• The SEC also extended last month the relief that it granted under its exchange act exemptive order
  • Subject to certain exceptions, the extension will expire on the earlier of (i) three years following the effective date of the order extending the relief or (ii) until such time that the SEC issues an order or rule determining whether continuing exemptive relief is appropriate for security-based swap activities with respect to any of the underlying exchange act exemptions

• There has been no need to extend general exemptive order because expiration of the relief that it provides is generally linked to compliance dates for rules that had not yet gone into effect
SEC Relief – Interim Final Rules

- Interim Final Rules provide relief under each of the
  - Securities Act
  - Exchange Act, and
  - Trust Indenture Act of 1939
- Rules relieve concerns arising from the treatment of security-based swaps as “securities” under the securities laws
- The postponements of expiration dates aim to maintain status quo
SEC Relief – Interim Final Rules

- Specifically, the interim final rules, subject to conditions, exempt offers and sales of security-based swap agreements that became security-based swaps on the effective date of Title VII from:
  - All provisions of the Securities Act (other than anti-fraud provisions), including registration requirements;
  - Exchange Act registration requirements; and
  - Provisions of the Trust Indenture Act
SEC Relief – General Exemptive Order

• Unlike the relief under the Interim Final Rules, the relief provided by the General Exemptive Order is aimed not at relieving concerns arising from the treatment of security-based swaps as “securities” under the Securities Act, the Exchange Act and the Trust Indenture Act, but instead assuring that market participants are not required prematurely to come into compliance with requirements imposed by Dodd-Frank.

• Relief is aimed at particular Dodd-Frank requirements, such as swap data reporting.

• Generally, the relief by its terms is to be effective until after the happening of certain events, such as the SEC’s adoption of final rules related to the relief given.
SEC Relief – Exchange Act Exemptive Order

- Exchange Act Exemptive Order addresses matters pertaining to Exchange Act other than the registration-related matters addressed in the Interim Final Rules
- Exemptions include
  - a broad temporary exemption in connection with security-based swap activity;
  - a temporary exemption specific to security-based swap activities of registered brokers and dealers; and
  - an exemption providing partial relief for certain market participants, including certain brokers and dealers and central counterparties, in connection with their security-based swap activities
Lincoln Amendment

• Section 716 of Dodd-Frank (known as the “Lincoln Amendment” or the “Swaps Pushout Rule”) is intended to prevent taxpayers from bearing market participants’ swap-related losses
• A controversial and complex provision
• Section 716 generally prohibits the provision of “Federal assistance” to any swaps entity with regard to any swap, security-based swap, or other activity of the swaps entity.
• The term “Federal assistance” is defined to include “the use of any advances from any Federal Reserve credit facility or discount window that is not part of a program or facility with broad-based eligibility under Section 13(3)(A) of the Federal Reserve Act”
Lincoln Amendment (cont’d)

• “Swaps entity” generally means any registered swap dealer, security-based swap dealer, major swap participant, or major security-based swap participant

• Insured depository institutions are permitted by the terms of Section 716 to limit their swaps activities to certain specified swaps activities, such as hedging, without being subject to the prohibition on obtaining Federal assistance

• The Swaps Pushout Rule was to become effective on July 16, 2013

• However, many U.S. banks and U.S. branches and agencies of foreign banks have been granted extensions of two years to continue dealing in swaps, with the possibility of an additional year