Comparison of the Dodd Frank Act Title VII and the European Market Infrastructure Regulation

May 21, 2014
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Overview

• Comparison of Dodd Frank Act Title VII ("Title VII") to the European Market Infrastructure Regulation ("EMIR"):  
  • Background  
  • Regulatory Responsibility  
  • Scope  
    • Products  
    • Entities  
    • Extraterritoriality  
  • Cleared Transactions  
  • Non-cleared Transactions  
  • Reporting  
  • Compliance  
  • Documentation
Background

- September 2009 - G-20 made a commitment to transparency and safety in the market place.
  
  “All standardized OTC derivatives should be traded on exchanges […] cleared through central counterparties […] OTC derivatives contracts should be reported to trade repositories”

- The regulatory framework of Title VII and EMIR are similar. Aims include:
  
  • Reducing systemic risk to the financial system posed by the swaps/OTC derivatives market.
  • Increasing transparency of the swaps/OTC derivatives market, for both pre and post execution pricing.
  • Enhancing the integrity of the swaps/OTC derivatives market.
  • Improve the conduct of major market participants.
EMIR

  - Came into force on August 16, 2012
  - Some provisions are not yet fully in force and many provisions are dependent on regulatory technical standards (RTS) or implementing technical standards (ITS) being developed by the European Securities and Markets Authority (ESMA) and being implemented by delegated regulation
  - Various ITS and RTS including rules relating to the clearing obligation, risk mitigation techniques for uncleared OTC derivatives, registration of trade repositories and capital requirements for CCPs came into force in March 2013
  - Other ITS and RTS are in varying stages of development, including in relation to extraterritorial issues
  - Final RTS re extraterritorial application took effect partially in April 2014 and partially from 10 October, 2014
Scope of EMIR

- The Regulation is generally aimed at “financial counterparties” and “non-financial counterparties” established in the EU (i.e., European entities)
- Financial counterparties are, broadly, investment firms authorized in accordance with the Markets in Financial Instruments Directive (MiFID), credit institutions, insurance, assurance and re-insurance undertakings, mutual funds and hedge funds, each authorized in accordance with applicable EU legislation
- Non-financial counterparties are undertakings established in the EU, other than “financial counterparties”
MiFID/MiFIR

- MiFID came into force in November 2007
- Review highlighted for some time
- Legislative proposals published in October 2012
  - Regulation (MiFIR)
  - Recast directive (MiFID II)
- Principal impact on derivatives are provisions relating to exchange trading of derivatives and pre and post-trade transparency requirements (public reporting of data in addition to EMIR provisions relating to reporting to trade repositories)
- Political agreement on terms of MiFIR/MiFID II announced on January 14, 2014 and subsequently adopted by EU Parliament on April 15, 2014 and EU Council on May 13, 2014
- Significant further work after MiFID II/MiFIR text finalized
- Implementation in full unlikely before 2015
Organized Trading of OTC Derivatives

- MiFIR proposes all derivatives subject to a clearing obligation under EMIR and that are determined to be subject to a trading obligation by ESMA should be traded on a regulated market, MTF or OTF
  - Or third country venue subject to meeting equivalence and other requirements
- ESMA to develop technical standards (and consult) in relation to classes of derivatives to be subject to the trading obligation
- To be subject to this obligation, ESMA must consider the class to be “sufficiently liquid”:
  - Average frequency, average size and number of trades, average size of spreads and profile of market participants to be considered
  - Systemic risk irrelevant
  - ESMA to maintain website of derivatives subject to exchange trading obligation
EMIR v Dodd-Frank – Some Key Issues

- Approach for clearing and reporting of OTC derivative transactions is broadly similar.
- EMIR clearing regime potentially provides wider exemptions for end-users through clearing threshold.
- EMIR does not establish a new registration requirement for swap dealers who will usually be required to be authorized under MiFID:
  - “Major swap participant” under Dodd-Frank is potentially wider than MiFID definitions.
- CFTC has wide definition of U.S. person and imposes U.S. swap dealer requirements on non-U.S. persons engaging in more than de minimis swap dealing activities with U.S. persons.
- EMIR applies to transactions between EU and non-EU entities and potentially between two non-EU entities if there is a direct, substantial and foreseeable effect in the EU.
• Dodd-Frank requires, for OTC derivatives required to be cleared, execution on a swap execution facility or designated contract market. EU rules contained in MiFIR are still being developed.
• EU risk mitigation rules are potentially wider than Dodd-Frank.
• EMIR exemptions for intra-group transactions are potentially wider than Dodd-Frank although CFTC has put in place rules exempting some transactions between affiliates.
• Volcker Rule not replicated in EU.
• Lincoln (“push-out”) amendment not replicated in EU.
• Recognition of trade repositories in other jurisdictions.
• Timing mismatches—many of the Dodd-Frank provisions are now in effect whereas clearing and certain risk mitigation obligations under EMIR not yet implemented.
Regulatory Responsibility

EU-EMIR

• Firms dealing in derivatives to remain regulated by national regulators under MiFID.
• CCPs to be regulated by national regulators.
• ESMA has cross-EU supervisory role, including registration and supervision of trade repositories and recognition of third country CCPs.
• ESMA also has rule making powers including determination of contracts to be subject to the clearing obligation.

U.S.-Title VII

• Title VII has bifurcated the regulatory responsibility between:
  • CFTC regulating swaps, swap dealers, and major swap participants; and
  • SEC regulating security-based swaps, security-based swap dealers and major security-based swap participants.
Scope
Scope: Products Regulated

**EMIR**

- Defines OTC derivatives broadly:
  - Includes interest rate, commodity, equity and credit linked swaps as set out in Annex 1 of MiFID.
  - Exclusions: Spot foreign exchange and certain physically settled commodity swaps. N.B. European Commission currently addressing uncertainties as to definitions of these instruments.

**Title VII**

- Title VII is concerned with “swaps” and “security based swaps.”
- CFTC rule-making has given further detail to the definitions.
- Swaps defined widely:
  - Exclusions: certain consumer and commercial transactions, spot FX, physically settled fx swaps or forwards or commodity forwards.
  - Security Based Swaps are swaps on a single security or loan or narrow-based security index and single-issue CDS.
  - Treasury Secretary exempts foreign exchange forwards and swaps from the definition of “swap.”
Scope: Entities Regulated under EMIR

- **Financial Counterparties**
  - Investment firms authorized under MiFID, credit institutions, insurance, assurance and re-insurance undertakings and certain authorised mutual funds and hedge funds. Includes non-EU branches of EU banks.

- **Relevant Non-Financial Counterparties (or NFC+)**
  - Any other institution established in the EU where the aggregate value of derivative activities (not related to hedging) have exceeded a “threshold”.
    - The threshold is divided into 5 asset classes (credit, equity, interest rate, foreign exchange, commodities and others) as follows:
      - €1 billion in gross notional value of OTC derivative contracts in respect of credit derivative contracts and equity derivatives; and
      - €3 billion in gross notional value of OTC derivative contracts in respect of other relevant contracts.
    - Calculated on the basis of a rolling average position over 30 working day period.
    - Once the threshold has been exceeded in respect of any single asset class, the institution is considered an NFC+ in respect of all asset classes.
Scope: Entities Regulated by EMIR (cont’d)

• Relevant Non-Financial Counterparties (Continued)
  • Threshold calculation excludes hedging activity comprising any derivative contract “objectively measurable as reducing risk directly relating to a commercial activity or treasury funding activity of a non financial party”.
  • Conditions that must be met to be considered hedging include whether the contract:
    • covers risks incurred in the normal course of business; or
    • covers risks arising from fluctuations in interest rates, inflation rates, FX rates, credit risk etc; or
    • qualifies as hedging under IFRS.

• Central Counterparties (CCPs)
• Trade Repositories
• Exemptions
  • Non-financial entities involved in derivative activities not in excess of the threshold.
  • Certain central banks, certain EU public bodies, certain multilateral development banks and the Bank of International Settlements.
Scope: Entities Regulated under Title VII

• **Swap Dealers (SDs)** - Includes any person who:
  • Holds itself out as a swap dealer;
  • Makes a market in swaps;
  • Regularly enters into swaps with counterparties as an ordinary course of business for its own account; or
  • Is commonly known in the trade as a dealer or market maker in swaps.

• **Major Swap Participants (MSPs)** - Includes any person who is not a dealer and:
  • Maintains a substantial position in swaps, excluding positions held for hedging or mitigating commercial risk;
  • Has outstanding positions which create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets; or
  • Is a highly leveraged financial entity that maintains a substantial position in swaps and is not subject to a Federal banking agency’s capital requirements.
Scope: Entities Regulated under Title VII (cont’d)

• Derivatives Clearing Organizations (DCOs)
• Swap Execution Facilities (SEFs)
• Swap Data Repositories (SDRs)
• Exemptions:
  • End users of derivative instruments using the derivative to hedge risk (exempt from clearing and trade execution rules).
    • End-user exception is quite limited in the United States. To qualify as an end-user, the user cannot be a financial entity, and must use swaps in order to hedge or mitigate commercial risk.
  • Central banks (exempt from clearing and from registration).
**Scope: Extraterritoriality**

- Both regulatory frameworks exercise an extraterritorial reach, particularly for mandatory clearing of transactions.
- **EMIR**, in accordance with Article 4, regulates:
  - Any OTC derivative contracts entered into between financial counterparties or relevant non-financial counterparties that are both established in the EU;
  - Any OTC derivative contracts entered into between financial counterparties or relevant non-financial counterparties where at least one entity is established in the EU; and
  - Any OTC derivative contracts entered into between two entities established in one or more third countries that would be subject to mandatory clearing obligations if they were EU entities, provided “a direct, substantial and foreseeable effect within the Union” can be established, or where imposing such mandatory clearing obligations is “necessary or appropriate to prevent evasion” of EMIR (Final RTS adopted by European Commission in March 2014, taking effect from April/October 2014)
Scope: Extraterritoriality (cont’d)

• The risk mitigation provisions in Article 11 of EMIR may also apply to third-country entities but only in circumstances where such entities are trading with other third-country entities and:
  • Would be subject to risk mitigation obligations if they were domiciled in the EU; and
  • The relevant derivatives have a “direct, substantial and foreseeable effect” within the EU (or the obligation is necessary or appropriate to prevent the evasion of any provision of EMIR).

• Reporting obligations under EMIR have no direct extraterritorial scope.
Scope: Extraterritoriality (cont’d)

• Under Title VII section 722(d), activities outside the U.S. may 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.
Scope: Extraterritoriality (cont’d)

• The scope of Title VII extraterritoriality is extremely extensive as per CFTC guidance on the definition of U.S. and non-U.S. Persons:
  • Swap Dealer requirements will apply to a non-US entity who has more than de minimis swap dealing activity with US persons (although non-US persons may be able to comply with certain requirements through compliance with home country rules).
  • Entity-level requirements will apply to all swap entities required to register with the CFTC. These include capital adequacy, CCO requirement, risk management and recordkeeping requirements.
  • Transactional requirements will generally apply only to swaps between US persons or between a US person and a non-US person and not necessarily to a swap between a non-US Swap Dealer and a non-US person.
  • Branches of US entities will generally be treated as a US person but branches of US banks that are Swap Dealers may meet transactional requirements for swaps with non-US Persons by compliance with local rules if the CFTC determines comparability.
Scope: Extraterritoriality (cont’d)

• Substituted Compliance:
  • **EU** – ESMA decides whether a non-EU entity's local rules are compliant or not, and if not the non-EU entity must abide by EMIR standards:
    • Initial assessments on equivalence made for various jurisdictions including the US, Canada, Japan, Australia, Hong Kong and Switzerland.
    • US considered equivalent in almost all respects – *but not for reporting of trades*
  • **US** – With respect to many requirements, the CFTC provides it may be possible for foreign entities to comply with their local comparable regulatory requirements.
Scope: Extraterritoriality (cont’d)

• Path forward:
  • Acknowledged simultaneous application of EMIR/Title VII could lead to conflicts of law, inconsistencies and uncertainty
  • Set out high level agreement between EU Commission and CFTC as to how to resolve certain issues
  • There were questions, however, about how effective the high level agreement was
Scope: Extraterritoriality (cont’d)

• In general, though, there now seems to be improving cross-jurisdictional cooperation
  • At the G20 finance meeting held in February, 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 in March prepared a report regarding remaining cross-border implementation issues, and it is expected to prepare a series of further reports this year
Scope: Extraterritoriality (cont’d)

- Final RTS set out the following position in relation to whether contracts have a direct, substantial and foreseeable effect in the EU (“EU effect”):
  - Contracts between two third country entities would have EU effect if guaranteed by an EU financial counterparty (covering OTC derivatives with a gross notional amount of at least 8 billion euros and with the guaranteed obligations being at least 5% of the aggregate current exposure of the guarantor on OTC derivatives)
  - Contracts between two third country entities would have EU effect where entered into between two EU branches of third-country entities that would qualify as financial counterparties if established in the EU
Scope: Extraterritoriality (cont’d)

- Unless such guarantee exists, contracts between a third-country entity and EU branch of a third-country entity would generally not have an EU effect.
- Currency and underlying asset of contract will not be considered in determining if the contract has EU effect.
- Contracts entered into by non-EU subsidiaries of EU parents will not have an EU effect unless explicitly guaranteed by an EU financial counterparty.
- If at least one counterparty is located in a third country declared to have rules equivalent to EMIR, EMIR can be disapplied if such third country rules are complied with even if the contract has EU effect.
- “EU effect” provisions take effect from 10 October 2014.
CFTC Final Guidance

Organization of the Final Guidance
• Interpretation of Section 2(i) of the CEA concerning the application of Title VII of Dodd Frank
• The Term “U.S. Person”
• Registration Requirements
• The Term “Foreign Branch”
• Entity-Level and Transaction-Level Requirements
  • Including Application to Swap Dealers and Major Swap Participants
• Substituted Compliance
• Application of Swap Regulations to Non Swap Dealers and Major Swap Participants
Key Considerations – U.S. Person

- 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. affiliate may be a “guaranteed affiliate” or “affiliate conduit” and, for that reason, in certain circumstances, subject to many of the CFTC’s transaction level requirements
- Whether a non-U.S. person is a “guaranteed affiliate” or “affiliate conduit” depends on consideration of several factors that focus on the closeness of the relationship between the non-U.S. person and the U.S. affiliate (e.g., ownership, control, concerted action, consolidated financial statements)
Key Considerations – Swap Dealer Registration (Affiliates)

- A non-US entity which has more than de minimis swap dealing activity with US 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)

• US branches of foreign swap dealers and footnote 513:
  • In this footnote in its cross-border guidance, the CFTC stated its view that “a US branch of a non-US swap dealer or MSP” is subject to transaction level requirements, without the possibility of substituted compliance
  • Even though a “branch does not have a separate legal identity” and is therefore part of a non-US Person, the CFTC has a “strong supervisory interest in regulating the dealing activities that occur with the United States, irrespective of the counterparty”
  • In addition to fn 513, in mid November, 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-US 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 swap
CFTC Final Guidance (cont’d)

• US branches of foreign swap dealers and footnote 513 (cont’d)
  • It appeared that, by means of fn 513 and the additional Advisory, the CFTC would require counterparties to a swap to comply with certain transaction level requirements even if both were foreign and enter into a swap through non-US offices, if one entity employed US-based front office personnel or agents in relation to the swap
  • However, the status of the Advisory is now ambiguous
  • 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. person
  • 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
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 the “Category A” transaction level requirements
  • This amounts to all of the transaction-level requirements except for external business conduct standards
## Territorial Triggers

<table>
<thead>
<tr>
<th>CFTC</th>
<th>SEC</th>
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<tbody>
<tr>
<td>• US persons</td>
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<tr>
<td>• US residence or domicile</td>
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<td>• US principal place of business</td>
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<tr>
<td>• US owned account</td>
<td>• US owned account</td>
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<tr>
<td>• US ownership of collective investment vehicles</td>
<td>• Transactions conducted in US</td>
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<tr>
<td>• US unlimited liability</td>
<td>• Non-US persons</td>
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<td>• Non-US persons</td>
<td>• Guaranteed by US persons</td>
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<td>• Non-US affiliates</td>
<td>• Guaranteed by US persons</td>
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<td>• Conduit for US persons</td>
<td>• Registered SD/MSPs</td>
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<td>• Registered SD/MSPs</td>
<td>• Registered SB SD/MSPs</td>
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<td>• Affiliate aggregation</td>
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# US Personhood

## Definition of “US Person”

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| i. any **natural person who is a resident** of the United States;  
ii. any **estate of a decedent who was a resident** of the United States at the time of death;  
iii. any corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund or any form of enterprise similar to any of the foregoing (other than an entity described in prongs (iv) or (v), below) (a “**legal entity**”), in each case that is **organized or incorporated under the laws** of a state or other jurisdiction in the United States or **having its principal place of business** in the United States;  
iv. any **pension plan** for the employees, officers or principals of a **legal entity described in prong (iii)**, unless the pension plan is primarily for foreign employees of such entity;  
v. any **trust governed** by the laws of a state or other jurisdiction in the United States, if a court within the United States is able to exercise primary supervision over the administration of the trust; | (A) **natural person resident** in the United States;  
(B) partnership, corporation, trust, or other **legal person organized or incorporated under the laws of** the United States or **having its principal place of business in** the United States; and  
(C) **account (whether discretionary or non-discretionary)** of a U.S. person |
# US Personhood (cont’d)

## Definition of “US Person” (cont’d)

<table>
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<th>CFTC</th>
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<tr>
<td>vi. any commodity pool, pooled account, investment fund, or other collective investment vehicle that is not described in prong (iii) and that is <strong>majority-owned by one or more persons described in prong (i), (ii), (iii), (iv), or (v)</strong>, except any commodity pool, pooled account, investment fund, or other collective investment vehicle that is publicly offered only to non-U.S. persons and not offered to U.S. persons;</td>
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<tr>
<td>vii. any legal entity (other than a limited liability company, limited liability partnership or similar entity where all of the owners of the entity have limited liability) that is <strong>directly or indirectly majority-owned by one or more persons described in prong (i), (ii), (iii), (iv), or (v)</strong> and in which such person(s) bears unlimited responsibility for the obligations and liabilities of the legal entity; and</td>
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<tr>
<td>viii. any individual account or joint account (discretionary or not) where the beneficial owner (or one of the beneficial owners in the case of a joint account) is a person described in prong (i), (ii), (iii), (iv), (v), (vi), or (vii).</td>
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**US Conduct**

When is a swap conducted in the US?

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<th>CFTC</th>
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| • No specific equivalent  
  • But overlapping jurisdiction when US persons are captured because they have a principal place of business in the US (i.e., a place where they likely negotiate or execute swaps)  
  • Principal place of business for collective investment vehicles:  
    • “majority-owned by one or more [US persons]”  
    • “direct beneficial owners”  
    • “eliminated the reference to ‘indirect’ majority ownership” | • A SB swap transaction is “conducted within the United States” if it is *solicited, negotiated, executed, or booked* within the United States, by or on behalf of either counterparty to the transaction, regardless of the location, domicile or residence status of either counterparty to the transaction  
  • Excluding transactions “conducted through a foreign branch”  
  • “Foreign Business” |
## Non-US Persons

### Which non-US persons remain of interest?

<table>
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<tr>
<th>CFTC</th>
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<tr>
<td>• Any non-US person guaranteed by a US person</td>
<td>• Any non-US person guaranteed by a US person</td>
</tr>
<tr>
<td>• Non-US affiliates of US persons</td>
<td>• Any non-US person “conducting” a transaction in the US</td>
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<tr>
<td>• Guaranteed by a US person</td>
<td>• Non-US registered SB/MSPs</td>
</tr>
<tr>
<td>• Acting as a conduit (whether or not guaranteed for a US person)</td>
<td>• Non-US aggregated affiliates</td>
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<tr>
<td>• Non-US registered SD/MSPs</td>
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<tr>
<td>• Non-US aggregated affiliates</td>
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CFTC Final Guidance

• 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
  • On December 20, 2013, the CFTC announced comparability determinations for various entity-level requirements for Australia, Canada, the EU, HK, Japan and Switzerland.
  • However, with respect to transaction-level requirements, the CFTC’s comparability determinations were limited to a few provisions for Japan and the EU
Litigation over CFTC Guidance

• The CFTC’s cross-border guidance led to the most recent lawsuit by industry groups (SIFMA, ISDA, IIB) challenging the CFTC’s implementation of Title VII

• Plaintiffs allege that the CFTC, in adopting and promulgating its cross-border guidance:
  • Failed to engage in required cost-benefit analysis;
  • Violated the Administrative Procedures Act by failing to provide interested persons sufficient opportunity to participate in 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

• The complaint also alleges that the CFTC’s SEF registration rule is arbitrary and capricious in regulating entities and activities with an insufficient connection to US commerce
Litigation over CFTC Guidance

• Current status: the parties have made cross-motions for summary judgment
• A motion for summary judgment looks beyond the pleadings to the facts of a case and states that, even if the facts are determined in the way most favorable to the other party, the other party cannot prevail as a matter of law
Mandatory Clearing
Clearing Transactions: EMIR

- Mandatory clearing applies to OTC derivatives contracts subject to the clearing obligation entered into by
  - two EU financial counterparties
  - by an EU financial counterparty and a NFC+
  - by two EU NFC+s; by an EU financial counterparty or NFC+ and a non-EU entity that would be subject to clearing if it were an EU entity
  - by two non-EU entities that would be subject to clearing if established in the EU if the transaction has a direct, substantial and foreseeable effect in the EU, or needs to be subject to mandatory clearing to avoid evasion of EMIR.
- To be cleared by a CCP authorized in accordance with EMIR (either formed in the EU or recognized under EMIR)
Clearing Transactions: EMIR

• ESMA will publish on its website a public register, being a list of all OTC derivatives that are subject to mandatory clearing and the effective dates for clearing and any phase-in for certain categories of counterparty.
  • Top down approach: ESMA can dictate that certain contracts must be cleared by an authorized CCP. Relevant factors include standardization of contracts, liquidity and reliability of available pricing. The effective date from which clearing is mandatory will be determined by the expected volume and the ability for CCPs to manage the volume.
  • Bottom up approach: Competent authorities of each member state must notify ESMA of contracts authorized for clearing in such member state. ESMA will then determine whether to require mandatory clearing of such contracts in all member states.

• No clearing obligation is currently in force in the EU (but see later discussion of “front loading”).

• Clearing obligation is expected to be phased in commencing in late 2014.
Title VII – 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)
Title VII – Mandatory Clearing (cont’d)

• A swap or security based swap must be cleared if the CFTC or SEC deems it to be a class of derivative instruments that is subject to mandatory clearing.
• Classes are defined by the CFTC, but may also be suggested by clearing organisations.
• In its initial clearing determination, the CFTC required the clearing of broad categories of interest rate swaps and index CDS.
• Mandatory clearing of standard IRS and CDS products commenced on March 11, 2013 for Category 1 entities, June 10, 2013 for Category 2 entities and September 9, 2013 for end-users (subject to applicable exceptions).
• Section 2(h)(7)(A) of the CEA provides an exception to the clearing requirement (the “end-user exception”).

• In the adopting release of the CFTC’s final rules addressing the end-user exception, the CFTC announced that it intended to look into a possible additional exception for inter-affiliate swaps.

  • A final rule excepting inter-affiliate trades under specified conditions was adopted in early April 2013
Clearing Transactions: Intra-group Exemption

- **EMIR**
  - For Financial Counterparties, a number of intragroup transactions may have the benefit of an exemption including:
    - OTC derivatives between counterparties in the same group where certain conditions are met, including the need for the Financial Counterparty to be established in the EU or a jurisdiction declared equivalent
    - Transactions where both counterparties are part of the same institutional protection scheme under the Banking Consultation Directive
    - Transactions where both counterparties are credit institutions affiliated to the same central body
  - For Non-Financial Counterparties, an intra-group exemption might apply in respect of an OTC derivative contract entered into with another group entity if the entities “are included in the same consolidation on a full basis and are subject to appropriate centralised risk evaluation, measurements and control procedures”.
  - Application must be made by entities to their local competent authorities, or if one of the entities is non-EU, by the EU counterparty.

- **Title VII**
  - Similar provisions have been adopted by the CFTC between affiliates. The exemption is dependent on various conditions being satisfied.
Title VII – Mandatory Clearing/Affiliate Exception

• The CFTC released final Rule 50.52 on April 1, 2013
• CFTC has made clear it anticipates that the exemption will be used primarily for trades between affiliated financial entities that are less likely to be able to use the end-user exception
• The rule allows the **eligible affiliate counterparties** to a swap to elect not to clear a swap that would otherwise be subject to mandatory clearing, subject to numerous limitations, including the following:
  • Only **majority-owned affiliates** eligible for exemption
  • Both counterparties would have to elect not to clear the swap
  • **Swap trading relationship documentation** 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
Clearing Transactions: Effective Dates

- **EMIR**
  - All derivative contracts subject to mandatory clearing, created or novated on or after the date on which clearing obligation is specified to take effect; and
  - Contracts subject to mandatory clearing created or novated between the time when CCPs are authorised to clear that contract and the date the obligation takes effect will be subject to mandatory clearing if they exceed a threshold maturity ("front loading").
  - 18 March 2014, NASDAQ OMX authorised in Sweden to clear certain interest rate and equity derivatives
  - By 18 September 2014, ESMA must submit to the European Commission draft RTS, specifying its proposals for which classes of derivatives should be compulsorily cleared and from what dates
  - Legal, operational and financial uncertainty for contracts entered into / novated between 18 March 2014 and date when RTS enter into force (following adoption by European Commission and publication)
  - ESMA has proposed to the European Commission an approach whereby mandatory clearing only applies to those contracts entered into / novated after RTS enter into force
Mandatory Exchange Trading of Derivatives

• **EU**
  • Under the draft MiFIR, ESMA determines which classes of derivatives subject to the clearing obligation will be subject to mandatory trading.
  • To be subject to the requirement, the relevant class must be admitted to trading or trading on a regulated market, MTF (multilateral trading facility) or OTF (organized trading facility) and must be sufficiently liquid to trade only on these venues.
  • MTFs and OTFs cover swaps, equities, commodities and other derivatives
  • An OTF has discretion over who they accept to trade and over how trades are executed
  • ESMA is required to consider various factors including average frequency of trades, average size of trades and number of active market participants.

• **Title VII**
  • All swaps subject to the clearing requirement must be executed on an exchange or swap execution facility (SEF) unless no exchange or swap execution facility makes such swap available to trade.
  • Customers who are not “eligible contract participants” may only enter into swap executed on or subject to the rules of a designated contract market.
Title VII - SEFs

• 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.

• Dodd-Frank generally defines 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).

• The CFTC approved final rules for SEFs in May of last year.
Title VII - SEFs

• CFTC’s core principles and other requirements for SEFs:
  • 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
  • provide that Required Transactions, other than block trades, must be executed on an Order Book or a Request for Quote (RFQ) 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
Title VII - SEFs

• 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, and then the MAT determination is 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 off
  • The initial five MAT determinations went into effect starting on February 15 and apply to many USD and EUR interest rate swaps and certain index CDS
Title VII - SEFs

- 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, are required to register as SEFs.
Title VII - SEFs

• Extraterritoriality issue in relation to SEF registration:
  • In a guidance letter issued in November, the CFTC’s Division of Market Oversight stated its expectation that a multilateral swaps trading platform located outside the United States that provides US persons or persons located in the US (such as agents of non-US 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 a DCM
  • This means that many multilateral swaps trading platforms outside the United States are, based on this guidance, required to register with the CFTC
  • It has been reported that, in response, some non-US platforms have denied access to US firms and US based traders of non-US firms
Title VII - SEFs

• The CFTC has provided no-action letters, most recently last month, intended to provide relief to (i) multilateral trading facilities ("MTFs"), the European equivalent of SEFs, overseen by competent European authorities from the CFTC’s SEF registration requirement and (ii) parties executing swap transactions on such qualifying MTFs from the U.S. trade execution requirement

• However, the take-up of the CFTC’s relief appears to have been minimal

• Many believe that the CFTC’s rules regarding SEFs and extraterritoriality effectively penalize non-U.S. market participants from dealing with the U.S. and have effectively split market liquidity into U.S. and non-U.S. segments for many products
Title VII - SEFs

- The phase-in of SEF trading has caused issues in relation to so-called “package trades”
- These are transactions with multiple inter-dependent component legs, priced based on simultaneous execution of all components, at least one leg of which is “available to trade” and thus subject to the trade execution requirement
- After issuing a no-action letter containing broad but temporary no-action relief in February of this year, in May the CFTC issued another no action letter, granting further temporary relief from the SEF execution requirement for package transactions
- The expiration dates of the relief granted in the May letter vary from June 1 to November 15 of this year according to the nature of the transactions forming part of the particular package transaction
- Given the complications inherent in the execution and clearing of package transactions, the industry’s readiness to meet the specified expiration dates is open to question
Non-Cleared Transactions
Non-Cleared Transactions: EMIR

• Financial counterparties and non-financial counterparties must ensure appropriate procedures are in place to measure, monitor and mitigate operational and counterparty risk. Transactions between two non-EU counterparties are subject to these provisions only where:
  • the parties would be subject to them if they were EU-established and
  • the transactions have an “EU effect” or it is necessary or appropriate to prevent evasion of EMIR
• Formalised process to reconcile portfolios and to identify disputes between parties.
• Techniques to facilitate risk mitigation include:
  • Provision and segregation of collateral (certain intra group transactions exempt)
  • Proportionate holding of capital (Financial Counterparties only)
  • Daily marking-to-market or model (Financial Counterparties and NFC+s only)
• Timely confirmation of trades (where possible by electronic means) is also required:
  • Cut-off date for timely confirmation of trades will vary by reference to factors such as whether party is a financial institution, the date on which trades are concluded and the type of trades.
Non-Cleared Transactions: EMIR (cont’d)

• For financial counterparties, any un-collateralized risk will give rise to an additional capital requirement.

• In April 2014, 3 European Supervisory Authorities published draft RTS on collateralisation requirements, based on September 2013 BCBS-IOSCO standards:
  • Requirement to exchange initial margin and variation margin applies to all uncleared OTC derivatives

• Some exceptions:
  • not required where total collateral to be exchanged between 2 counterparties does not exceed EUR500,000
  • initial margin can be waived by a counterparty where it opts to hold capital against its counterparty exposures instead
  • transactions with EU-based central banks and 0% risk-weighted multilateral development banks
  • initial margin not required for physically-settled FX swaps and forwards, or a principal exchange element of currency swaps
  • covered bonds (subject to certain conditions
Non-Cleared Transactions: EMIR (cont’d)

• Variation margin based on mark-to-market values. Calculation of initial margin based on standardised method contained in RTS, or on an initial margin model

• Broad range of asset types eligible for margining, provided sufficiently liquid (including securitisation bonds and certain listed shares and UCITS units)

• Initial margin may not be rehypothenated. Must be segregated from proprietary assets of custodian and (if required by margin-provider) from assets of other margin-providers

• Proposed to come into force December 2015 for heavy users of non-cleared derivatives (EUR 3 trillion in aggregate notional amount) and gradual staged application for lighter users until December 2019 when it applies for all users of EUR 8 billion aggregate notional amount upwards
Non-Cleared Transactions: Title VII

- In the U.S., CFTC proposal applies to SDs/MSPs that are not prudentially regulated (banking agencies have released a proposal for SDs/MSPs subject to prudential regulation)
- Current margin proposals are:
  - SDs and MSPs must exchange initial and variation margin on a non-cleared swaps based on whether counterparty is a SD/MSP, financial entity or non-financial entity subject to possible thresholds.
- Initial margin: required to cover 99% of the price volatility over a 10 day period to be posted at or before execution of the transaction:
  - Alternatively, if insufficient market data, a regulator approved model may be used.
  - Margin must consist of cash, U.S. Treasuries or senior debt obligations of certain approved government sponsored entities.
Non-Cleared Transactions: Title VII (cont’d)

- Variation margin: this will be determined daily based on any uncovered exposure.
  - Margin must consist of cash or U.S. Treasuries.
- With the Basel Committee on Banking Supervision (“BCBS”) and the International Organization of Securities Commissions (“IOSCO”) having issued their final framework for margin requirements for uncleared swaps, it would seem that additional CFTC rules could be forthcoming soon.
Non-Cleared Transaction: Exemption

- **EMIR**
  - Intragroup Entities, who have prior approval by a competent authority and are under the threshold for clearing, will be exempt from the margin requirement.

- **Title VII**
  - The default position is that all SDs and MSPs must enter into a collateral arrangement with their counterparties.
  - The applicability of thresholds, below which no collateral is required will be determined depending on the type of counterparty (SD, MSP, financial or non-financial).
Segregation of Cleared Swap Customer Collateral

- **EMIR**: CCPs must offer a choice between omnibus segregation and individual segregation in separate accounts. For individual segregation, asset-by-asset accounting is required. CCPs must take all reasonable steps to ensure that they have legal powers to liquidate proprietary positions of a defaulting clearing member and to transfer or liquidate the positions of the defaulting clearing member’s clients.

- **Title VII**: for cleared swaps, legal segregation and operational commingling – customer collateral can be maintained in an omnibus account, but FCM/DCO are prohibited from using collateral allocated to one customer’s position to satisfy the liabilities related to another customer’s positions.
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 pursuant to 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 that the dealer has such information.
- Under the rule, segregated initial margin may only be invested in a limited number of instruments.
Trade Repositories and CCPs

• Trade repositories:
  • Similar registration system in US and EU
  • US provisions do not specifically provide for recognition of non-US repositories
  • EU rules do envisage recognition of foreign repositories subject to conditions
  • Similar provisions re risk control, disclosure, governance, etc.

• Regulation of CCPs:
  • More detailed conduct of business, organizational and prudential rules in EU; US regulators have produced core principles
  • Grandfathering of existing CCPs in EU and US
  • Both EU and US provide for recognition of foreign CCPs subject to conditions (but in practice may be difficult for non-U.S. CCPs to obtain recognition from CFTC)
  • Both provide for minimum capital requirements – US requirements are less detailed
  • No ownership cap in the EU but disclosure of shareholdings and changes in shareholdings required at specified thresholds
Reporting
Reporting Obligations: EMIR

• All CCPs and financial and non-financial counterparties must report details of any derivative trade (exchange traded and OTC derivative) they have concluded, modified or terminated to a registered (in the EU or recognized under EMIR) trade repository, or if none is available, to ESMA directly.

• Reporting obligation will apply to all derivatives, including exchange traded contracts which:
  • Were entered into before August 16, 2012 and remained outstanding on that date; or
  • Were or are entered into on or after August 16, 2012.

• Timetable for commencement of reporting requirements are set out in RTS relating to format and frequency of trade reports to trade repositories:
  • Obligations to commence initially for credit and interest rate derivatives, subject to a trade repository being registered by ESMA
  • Reporting obligation came into force for all asset classes on February 12, 2014 for contracts entered into on or after August 16, 2012 and still outstanding. ESMA has now registered six trade repositories
  • ESMA requested a delay of one year for exchange traded derivatives but request was declined by EU Commission
Reporting Obligations: EMIR (cont’d)

• All OTC derivative contracts must be reported no later than one working day following the conclusion, termination or modification.

• Details to be included:
  • The parties;
  • The beneficiaries; and
  • Main characteristics of the contract.

• The obligation to report exists in respect of all contracts, even if they are exempt from clearing and can be delegated by counterparties and CCPs.

• Counterparties must keep records, for at least 5 years, of any derivative contracts entered into.

• MiFIR will also apply post-trade transparency rules. Details are being developed.
Reporting Obligation: Title VII

- Reporting obligations are now generally in effect
- Swaps (whether cleared or not) must be reported to swap data repositories (SDRs) in the US
- Details must be reported according to differing timeframes depending on the type of swap and whether it is subject to mandatory clearing
- Reported details must include primary economic terms and any variation to the data
The obligation to report in respect of an exchange traded swap is the responsibility of the SEF. If the swap is cleared, then the relevant clearing organization must report confirmation data.

If the swap is not traded on a SEF, then the obligation to report exists in the following order:

- A SD.
- If none, then a MSP.
- If none, then a financial entity.
- If none, then as decided between the parties.

Reporting of swaps between a U.S. and non-U.S. Person are generally the responsibility of the U.S. person.
Documentation & Compliance
Documentation

EMIR

• Clients will have to sign one or more clearing agreements in addition to their existing trading agreements.

• Additionally, cleared transactions may require the preparation of a:
  • Master give-up and back-loading agreement (between the executing broker and clearing member); and/or
  • Compensation agreement, between the executing broker and client.

Title VII

• Additional and modified trading documentation will be required and the ISDA Master Agreement may play a lesser and/or different role for clearing.

• Three proposed new documents include:
  • Futures Account Agreement (“FAA”) - governing the relationship between the swap parties and other regulated clearing members.
  • Cleared OTC Derivatives Addendum to the FAA - addressing close-out rights.
  • Cleared Swaps Execution Agreement.
ISDA Protocols

- ISDA has published a number of protocols that parties can adhere to in relation to both EMIR and Title VII to seek to assist in compliance with requirements including:
  - 2013 EMIR Portfolio Reconciliation, Dispute Resolution and Disclosure Protocol
  - 2013 EMIR NFC Representation Protocol
  - 2013 Reporting Protocol
  - March 2013 DF Protocol
  - August 2012 DF Protocol
Compliance: Business Conduct

• EU
  • MiFID governs business conduct requirements. Financial counterparties governed by MiFID will be subject to obligations including:
    • Pre and post trade transparency.
    • Data consolidation in a standardised format.
    • Extended transaction reporting and recordkeeping requirements.
    • Provision of fair, clear and not misleading communications.

• US
  • Business conduct standards for SPs and MSPs under the Dodd Frank Act include a duty of fair dealing and good faith communication, duty to disclose material risks, material incentives or conflicts of interest.
Chambers USA 2013 ranks MoFo as a leading derivatives practice. *Chambers* says, “This firm is widely respected for the broad scope of its derivatives expertise, with strength in credit and equity derivatives, and commodity, equity, index, insurance, currency and rate-linked products. The group also wins praise for its familiarity with restructuring and regulatory reform issues.” Several of our derivatives partners are ranked by *Chambers USA*.

*Legal 500* 2013 ranks MoFo’s derivatives practice as a leader in the U.S., as well as in the UK. *Legal 500* writes, “Morrison & Foerster LLP provides ‘very high levels of service – response times are minimal even when lawyers are out of the office’ and clients ‘would recommend it to anyone in the derivatives world’.”

*mtn-i* named us a “Legal Leader” in 2013 for our structured product work. Two of our transactions were honored with separate awards.

*IFLR1000* 2014 ranks MoFo’s derivatives practice as a leading national practice. *IFLR1000* says, “Morrison & Foerster is known for its expertise in derivatives and structured products.” *IFLR1000* also ranks several of our derivatives attorneys as leaders in their field.

US News & World Report 2013 ranks us as a Tier 1 national practice in Derivatives and Futures Law.

*Derivatives Week* named us 2013 “European Law Firm of the Year”.

*Best Lawyers in America* 2014 names several of our partners as “Best Lawyers” in the field of derivatives.
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