Fragmentation or Integration?
An Overview of EU and U.S. Financial Regulation Relating to Derivatives and Structured Products

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Speakers:  Peter J. Green
           Julian E. Hammar
           Jeremy C. Jennings-Mares
           James E. Schwartz

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Presented By
Peter Green
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Background – the G-20 Commitments

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

• As a result, the G-20 jurisdictions have been working on parallel, but not identical, reforms that generally resemble each other but differ in their details.

• Principal areas of focus for international legislators and regulators have included:
  
  ➢ 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;
  ➢ improving the conduct of major market participants.
Background – the G-20 Commitments (cont’d)

- However, the swaps marketplace has historically been profoundly international.
- As a result, the question comes to the forefront: which jurisdiction’s rules will apply to which swaps?
Regulation in Europe

Principally contained in:

• EU Regulation on OTC derivatives, central counterparties and trade repositories ("EMIR"):  
  ➢ central clearing of OTC contracts between financial counterparties and, in some cases, non-financial counterparties;  
  ➢ risk mitigation requirement for uncleared transactions including collateral and margining requirements;  
  ➢ reporting requirements for derivative transactions;  
  ➢ came into force on August 16, 2012 but some provisions, including the central clearing requirements are not yet effective.

• MiFID II  
  ➢ makes major changes to existing Markets in Financial Instruments Directive ("MiFID") including under the new Markets in Financial Instruments Regulation ("MiFIR");  
  ➢ includes provisions relating to exchange trading of derivatives and pre- and post-trade transparency requirements (public reporting of data);  
  ➢ came into force in July 2014 and will become effective from start of 2017.
EMIR - Clearing Transactions

- 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 an EU relevant non-financial counterparty ("NFC+”);
  - by two EU NFC+s;
  - by an EU financial counterparty or EU 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 established in the EU or recognized under EMIR)
EMIR - Clearing Transactions (cont’d)

• 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 by late 2015.
EMIR - Clearing Transactions (cont’d)

- 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;
  - 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;
  - ESMA has submitted to the European Commission draft regulatory technical standards (“RTS”) for central clearing of interest rate derivatives and has consulted a draft RTS for credit and FX non-deliverable forwards;
  - final clearing RTS expected by mid/late 2015, with the relevant clearing obligation expected to take effect between 6 months and 3 years after the RTS enter into force, depending upon the counterparty’s classification;
  - 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);
  - expected that final RTS will set the threshold maturity extremely high, to minimise the number of contracts subject to front-loading.
EMIR - Non-Cleared Transactions

• 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.
EMIR - Non-Cleared Transactions (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).
EMIR - Non-Cleared Transactions (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 rehypothecated. 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.
EMIR - Reporting Obligations

- 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.
EMIR - Reporting Obligations (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.
MiFID II – Exchange Trading of Derivatives

- MiFIR provides that all derivatives subject to a clearing obligation under EMIR and determined to be subject to a trading obligation by ESMA should be traded on a regulated market, multilateral trading facility (“MTF”) or organized trading facility (“OTF”):
  - or third country venue subject to meeting equivalence and other requirements;
  - OTF is a new concept under MiFID II/MiFIR covering a wide range of facilities, systems and platforms designed to bring together buying and selling interests or orders relating to financial instruments;
  - an OTF has discretion over who it accepts to trade and over how trades are executed;
  - similar in concept to an SEF under the US legislation but the definitions do not match up precisely.
- 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.
MiFID II – Exchange Trading of Derivatives (cont’d)

• The operator of a regulated market must ensure that all transactions in derivatives that are concluded on that regulated market are cleared by a CCP.

• EMIR and MiFIR provide for clearing on a non-discriminatory basis:
  ➢ CCPs must accept financial instruments including derivatives for clearing on a non-discriminatory basis;
  ➢ trading venues must provide trade feeds on a non-discriminatory basis to any CCP authorized or recognized under EMIR.

• ESMA has issued a number of discussion and consultation papers:
  ➢ initial Consultation Paper and Discussion Paper issued in May 2014;
  ➢ second Consultation Paper published in December 2014 seeking views on draft technical standards;
  ➢ Technical Advice to EU Commission published in December 2014 on content of delegated acts to be implemented under MiFID II;
  ➢ further Consultation Paper published in February 2015 on implementation of transparency provisions for certain derivatives.
MiFID II – Exchange Trading of Derivatives (cont’d)

• In December 2014 Consultation Paper, ESMA considers meaning of “liquid market” for the purpose of granting waivers for pre-trade transparency requirements (see below).

• In relation to determining whether a derivative will be sufficiently liquid to be subject to the exchange trading requirement, ESMA considers similar factors to those relevant to the transparency rules and in many cases believes the thresholds will be the same or similar but this is not necessarily the case.

• ESMA’s approach to liquid market for transparency rules:
   each asset group is divided into more granular classes that share largely homogenous liquidity characteristics;
   each class is sub-divided further by factors such as maturity, issue sub-type, issue size, derivative type and notional amount;
   conclusions for each sub-class are set out in detailed tables.
MiFID II – Exchange Trading of Derivatives (cont’d)

• ESMA’s February 2015 Consultation Paper sets out its analysis on what constitutes a liquid market for certain non-equity instruments not covered in its December 2014 papers including:
  - fx derivatives;
  - credit derivatives;
  - contracts for difference.
MiFID II – Transparency

- Pre- and post-trade transparency for derivatives and structured products:
  - EU Commission basic principle in relation to MiFID II is the same pre- and post-trade transparency requirements should apply to regulated markets, MTFs and OTFs
  - calibration for different types of instrument and trading
  - MiFID already provides for transparency requirements for shares traded on a regulated market
  - MiFIR will extend regime including to bonds, structured finance instruments and derivatives traded on a trading venue
  - obligation to make publicly available current bid and offer prices and depth of trading interest
MiFID II – Transparency (cont’d)

• competent authorities will have powers to grant waivers from requirements – ESMA to be notified of waivers and will give opinion as to compatibility of waiver with MiFIR:
  ➢ use of waivers is more limited than was previously the case;
  ➢ available for non-equity instruments for (i) orders large in scale (ii) indications of interest in request for quote and voice trading systems above a specified size if liquidity providers would otherwise be subject to undue risk and (iii) derivatives not subject to the trading obligation and any instruments for which there is not a liquid market;
  ➢ in December 2014 paper, ESMA considers meaning of a “liquid market” for the purpose of granting waivers for pre-trade requirements - each asset group is divided into more granular classes that share largely homogenous liquidity characteristics;
  ➢ each class is sub-divided further by factors such as maturity, issue sub-type, issue size, derivative type and notional amount;
  ➢ conclusions for each sub-class are set out in detailed tables;
  ➢ in February 2015, ESMA published an additional Consultation Paper on MiFID II setting out its analysis on what constitutes a liquid market for certain non-equity instruments not covered in its December 2014 papers including fx derivatives, credit derivatives and contracts for difference.
EMIR - Extraterritoriality

• EMIR, in accordance with Article 4, regulates:
  ➢ any OTC derivative contracts entered into between financial counterparties or NFC+s that are both established in the EU;
  ➢ any OTC derivative contract entered into between a financial counterparty or NFC+ established in the EU and a non-EU entity that would come within the definition of financial counterparty or NFC+ if established in the EU; 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 if necessary or appropriate to prevent the evasion of EMIR;
  ➢ RTS relating to non-EU counterparties were adopted by the EU Commission in February 2014.
EMIR - 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 extraterritorial scope.
EMIR - Extraterritoriality (cont’d)

- RTS relating to non-EU counterparties provides the following 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 if the guarantee covers OTC derivatives with a gross notional amount of at least €8 billion and the guaranteed obligations represent at least 5% of the aggregate exposure of the guarantor to OTC derivatives or where the contract is between two EU branches of non-equivalent third-country entities;
  - 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 subsidiaries of EU parents established in a third country will not have an EU effect unless explicitly guaranteed by an EU financial counterparty.
EMIR - Extraterritoriality (cont’d)

• Substituted Compliance:
  ➢ RTS relating to non-EU counterparties provides that if at least one counterparty is located in a third country determined to have rules equivalent to EMIR, EMIR can be disapplied even if the contract has EU effect;
  ➢ equivalence determinations have been made in relation to clearing requirements in Canada, Japan, Australia, Hong Kong and Singapore;
  ➢ US has not yet been declared equivalent.

• Timing:
  ➢ cross-border issues are complicated by timing mismatches;
  ➢ in particular, EU is significantly behind US on clearing and exchange trading timetables;
  ➢ mandatory clearing expected in EU by end of 2015 but MiFIR exchange trading requirements do not come into operation until 2017.
Status of CFTC Cross-Border Guidance

- CFTC issued final cross-border guidance in July 2013:
  - the guidance is intended to address comprehensively the cross-border application of Dodd-Frank rules for derivatives;
  - guidance addresses, among other things, the question of which substantive requirements apply to which transactions and to which market participants.
Status of SEC Cross-Border Rules

• SEC issued comprehensive proposed cross-border rules in May 2013.
• SEC followed up on those proposed rules with a subset of final rules released in June 2014.
• The SEC’s final rules create no substantive requirements for market participants until after relevant substantive rulemakings have been completed.
• The SEC’s final rules address only a subset of the matters addressed in the CFTC’s guidance, including:
  - when a cross-border security-based swap transaction must count against the de minimis threshold under the definition of “security-based swap dealer”;
  - the definition of U.S. Person; and
  - a procedural rule for substituted compliance.
Status of SEC Cross-Border Rules (cont’d)

- SEC final rules do not address which substantive requirements will apply to which transactions and to which market participants.
- The SEC late last month also published for public comment proposed amendments to its cross border rules that would address how the SBSD definition would apply to transactions between non-U.S. persons where dealing activity occurs in the U.S.
Statutory Basis for Extraterritoriality

• Dodd-Frank’s provisions for extraterritorial jurisdiction differ somewhat with respect to the CFTC and the SEC:
  
  CFTC: 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;

  SEC: Under Title VII section 772(c), a person transacting a business in security-based swaps outside the U.S. may be regulated if:
  • such person transacts such business in contravention of such rules and regulations as the SEC may prescribe as necessary or appropriate to prevent the evasion of the relevant provisions of the Act.
Current Status of Cross-Border Harmonization

• Path forward:
  ➢ acknowledged simultaneous application of EMIR/Title VII could lead to conflicts of law, inconsistences and uncertainty;
  ➢ sets out high level agreement between EU Commission and CFTC as to how to resolve certain issues.
• Since then there has been little visibility into discussions among regulators.
• Scattered statements that progress has been made, but difficult to verify or specify.
Current Status of Cross-Border Harmonization (cont’d)

• Joint Statement of CFTC Chairman Timothy Massad and European Commissioner Jonathan Hill (May 7, 2015):
  ➢ “Discussions are constructive and progressing. They have been mutually satisfactory on the issue of the ability for both sides to potentially defer to each other's rules.”;
  ➢ agreed to continue discussions with the aim of finalizing an approach by this summer.

• CFTC Chairman Massad (as quoted by Reuters last week):
  ➢ “We will harmonize as much as we can but let’s not get pushed by this notion there has to be complete consistency” across different jurisdictions’ swap regulations.
EU CCP Recognition

• Recognition of U.S. central counterparties (clearinghouses) under European legislation has been in the financial press recently and is an important unresolved issue.
• Question is whether the U.S. regulatory framework is “equivalent” to the EU framework.
• If the EU were to fail to timely recognize U.S. CCPs, there comes a parade of horribles:
  ➢ U.S. CCPs will not constitute “Qualifying CCPs” for purposes of Basel III risk-weighting;
  ➢ European banks will incur prohibitive costs to clear through U.S. CCPs;
  ➢ U.S. CCPs would have difficulty in maintaining clearing member relationships with EU firms;
  ➢ U.S. CCPs would be ineligible to clear contracts subject to the upcoming EU clearing mandate.
• Deadline for recognition was extended by six months, to June 15, 2015.
• In addition, groundwork has been laid to extend the recognition deadline to December 15, 2015.
EU CCP Recognition (cont’d)

• In October of last year, the EU made its first “equivalence” decisions, for the regulatory regimes of CCPs in Australia, Hong Kong, Japan and Singapore.

• Why would the EU recognize CCPs in those jurisdictions but not in the U.S.?

• The stated reason was that, under EMIR, in order for a clearinghouse located in a non-EU jurisdiction to qualify for recognition, the country of such clearinghouse must have an effective equivalent system of recognition for clearinghouses located in the EU:
   EU officials interpret this to mean that the U.S. should not require U.S. registration of EU clearinghouses;
   currently, three clearinghouses are located in Europe but also registered with the CFTC.

• Regulators’ remarks are also revealing as to some of the broader issues at play in discussions regarding cross-border harmonization.
EU CCP Recognition (cont’d)

• In the European Commission press release announcing the recognition of CCPs in Australia, Hong Kong, Japan and Singapore, Michel Barnier, then European Commissioner for Internal Markets and Services, was quoted as saying:
  ➢ “Today's decisions show that the EU is willing to defer to the regulatory frameworks of third countries, if they meet the same objectives as EU rules. We have been working in parallel on assessing twelve additional jurisdictions and finalising those assessments is a top priority. This includes the United States: we are in close and continued dialogue with our colleagues at both the SEC and CFTC as we develop our assessments of their respective regimes and discuss their approaches to deference.”

• The press release continued:
  ➢ Equivalence assessments are undertaken using an outcome based approach. This requires that the relevant rules operating in the third country satisfy the same objectives as in the EU, i.e. a robust CCP framework promoting financial stability through a reduction in systemic risk. It does not mean that identical rules are required to be in place...
U.S. Relief for EU MTFs

• Earlier last year, an issue arose as to the CFTC’s requirements for EU-regulated multilateral trading facilities (MTFs).
• MTFs are in many ways parallel to swap execution facilities (SEFs), defined by the CFTC as trading systems or platforms in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants:
  ➢ many of the transactions that are subject to mandatory clearing are required to be executed on SEFs;
  ➢ in a guidance letter issued in November 2013 the CFTC 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. with the ability to trade or execute swaps would register as a SEF.
U.S. Relief for EU MTFs (cont’d)

• Registration with the CFTC as a SEF is a time-consuming process.
• European MTFs requested, and received, no-action relief from the CFTC with respect to the registration requirement.
• However, the CFTC’s no-action letter (CFTC Letter 14-46), issued in April 2014, while offering some relief, appeared to impose on EU MTFs many arguably idiosyncratic U.S. requirements:
  ➢ in order to receive relief, an MTF was required to submit a letter containing lists of regulatory requirements established by governmental authorities in the home country of the MTF that were in accordance with the SEF regulatory requirements concerning trading methodology, and that were comparable to, and as comprehensive as, the SEF regulatory requirements concerning non-discriminatory access by market participants and an appropriate level of oversight;
  ➢ the lists were to be accompanied by supporting explanations, on a requirement-by-requirement basis, addressing each specified CFTC regulation, as to why such non-U.S. regulatory requirements were either in accordance with, or comparable to, and as comprehensive as, each specified SEF requirement.
U.S. Relief for EU MTFs (cont’d)

- Not easy to detect much “deference” to EU regulators in the CFTC no-action letter for MTFs.
- The letter, in requiring a requirement-by-requirement analysis addressing each specified CFTC regulation, also seems to come close to requiring, as a precondition to relief, virtually identical non-U.S. regulations.
- Not clear that many MTFs have taken advantage of the relief, or why they would want to adhere to U.S. rules for their non-U.S. customers.
Swap Market Fragmentation

• In part because of the requirement that many swaps with U.S. market participants be traded on SEFs, liquidity has fragmented between the U.S. and other jurisdictions.
• Fragmentation results from the decision of the CFTC to finalize its regulations to implement mandatory clearing and mandatory trading platform execution of swaps prior to regulators in other jurisdictions, while at the same time, with its cross-border rules, placing significant regulatory burdens on market participants in other jurisdictions transacting or facilitating transactions with U.S. parties.
• Disincentives to transact with U.S. parties.
• CFTC Commissioner J. Christopher Giancarlo, in a speech entitled “The Looming Cross-Atlantic Derivatives Trade War: ‘A Return to Smoot-Hawley’”:

➢ “Since the start of the CFTC’s SEF regime in October 2013, and accelerating with mandatory SEF trading in February 2014, swaps markets have divided into separate trading and liquidity pools between those in which US persons are able to participate and those in which US persons are shunned… Non-US person market participants are curtailing transactions with US counterparties to avoid getting caught up in the CFTC’s peculiar US swaps trading rules.”;

➢ “[I]t’s as if the US Center for Disease Control, in order to protect the US population from an offshore outbreak of a deadly virus, dictated that EU doctors could give vaccines to American patients only in accordance with US protocols for syringe sterilization and disposal. How would such a requirement prevent a contagion from spilling onto US shores? It’s difficult to make the connection. Similarly, it’s difficult to make the connection between the application of US trade execution rules to offshore trades and risk to the US economy. The prescription is unrelated to prevention of the disease.”
Swap Market Fragmentation (cont’d)

- Commissioner Giancarlo in late January released a “White Paper,” in which he argued for a fundamental reconsideration of the CFTC’s SEF rules, arguing that the rules are having the effects of:
  - driving global market participants away from transacting with entities subject to CFTC swaps regulation;
  - fragmenting swaps trading into numerous artificial market segments;
  - increasing market liquidity risk; and
  - making it highly expensive and burdensome to operate SEFs.
Harmonization and the CFTC’s Guidance

• Apart from the particular issues relating to SEFs and MTFs, the CFTCs’ cross-border guidance appears to contain features that, from the perspective of a non-U.S. regulator, might well complicate attempts at harmonization.
Harmonization and the CFTC’s Guidance (cont’d)

• Under the cross-border guidance, many of the CFTC’s substantive rules, including for mandatory clearing and trade (SEF) execution, will apply to any swap involving a U.S. Person (as defined):
  ➢ however, in a transaction between, for example, New York head office of a U.S. swap dealer and the German head office of a German swap dealer, the EU’s rules should presumably govern the transaction to the same extent the U.S. rules do;
  ➢ if the EU were to take a position parallel to that of the CFTC and require the application of the EU’s rules to a transaction involving an EU swap dealer, the transaction would be governed by both U.S. and EU rules;
  ➢ any material differences between these two sets of rules could be a significant issue for the parties to such a transaction and, by extension, for the swaps market as a whole.
Harmonization and the CFTC’s Guidance (cont’d)

- Another feature of the CFTC’s cross-border that could frustrate a reciprocal approach is the CFTC’s stance regarding swaps with non-U.S. Persons located within the U.S.
- The CFTC taken the view that the U.S. branch of a non-U.S. swap dealer would be subject to Transaction-Level requirements, including clearing and SEF execution, because of the CFTC’s strong interest in regulating dealing activities occurring within the United States.
- However, the CFTC did not recognize an equally strong interest of non-U.S. regulators in regulating the dealing activities of branches of U.S. swap dealers located in their jurisdictions.
- With respect to transactions entered into by U.S. swap dealers acting through non-U.S. branches, the CFTC stated that, if such branches faced a U.S. Person (other than the foreign branch of another U.S. swap dealer) in a swap, then the CFTC’s own Transaction-Level Requirements would apply.
- Once again, if a foreign regulator were to take a position parallel to that of the CFTC, requiring that the branches of swap dealers within its geographical jurisdiction adhere to the foreign regulator’s rules, then a transaction could be governed by both U.S. and non-U.S. rules.
In addition, with respect to such Transaction-Level requirements, the CFTC has stated that, even if a non-U.S. branch of a U.S. swap dealer were facing a non-U.S. Person in a swap, then substituted compliance would apply.

Under the CFTC’s substituted compliance regime, the CFTC’s own rules apply unless the CFTC determines that the analogous foreign rules are sufficiently comprehensive and comparable to its own rules.
Substituted Compliance

• Basic idea of substituted compliance is that a market participant may substitute compliance with a local non-U.S. rule for compliance with a U.S. rule.

• To make a substituted compliance determination, the CFTC must determine that the foreign jurisdiction’s requirements “are comparable with and as comprehensive as the corollary area(s) of regulatory obligations encompassed by” the CFTC’s own rules.

• The language of substituted compliance informs much of the discussion around harmonization.

• Tension between a requirement-by-requirement approach and a “holistic” or “outcome based approach”.

• The SEC has indicated that it, like the CFTC, will adopt a substituted compliance regime.
Substituted Compliance (cont’d)

• CFTC substituted compliance determinations to date:
  ➢ on December 20, 2013, the CFTC announced comparability determinations for various entity-level requirements for Australia, Canada, the EU, Hong Kong, 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;
  ➢ no substituted compliance determinations yet with respect to mandatory clearing or trade execution.
Harmonization and CFTC Advisory 13-69

• Taking the CFTC’s view of its authority one step further, the CFTC in November 2013 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”.
• In the advisory, the CFTC took the position that, because of its supervisory interest in swap dealing activities within the United States, even where a swap is between a non-U.S. branch of a non-U.S. swap dealer and another non-U.S. Person, the CFTC’s Transaction-Level Requirements will apply to the swap if it is “arranged, negotiated, or executed by personnel or agents of the non-U.S. swap dealer located in the United States.”
• It appeared that the CFTC would require counterparties to a swap to comply with certain transaction level requirements even if both were foreign and entered into a swap through non-U.S. offices, if one entity employed U.S.-based front office personnel or agents in relation to the swap.
Harmonization and CFTC Advisory 13-69 (cont’d)

• However, a series of no-action letters have granted relief, currently extended until September 30, 2015 (or any prior date of CFTC action), 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 has issued a request for comment on “whether the Commission should adopt” the advisory “as Commission policy, in whole or in part”.
• Similarly, the SEC, in its release of its final cross-border rules, stated that it anticipated soliciting additional public comment regarding approaches by which the cross-border application of the “security-based swap dealer” definition could reflect activity between two non-U.S. persons where one or both are conducting dealing activity within the United States.
CFTC Advisory 13-69 – Comparison with SEC

• On April 29, 2015, SEC published for public comment proposed amendments to its cross border rules that would address how the SBSD definition would apply to SBSD transactions between non-U.S. persons where dealing activity occurs in the U.S. (the “Proposal”).

• The comment period closes 60 days after publication in the Federal Register, which is forthcoming.

• Under the Proposal, an SBS-dealing transaction that is entered into by a non-U.S. person will count toward that non-U.S. person’s de minimis threshold for registration as a SBSD, regardless of whether the counterparty is a “U.S. person,” if the transaction is “arranged, negotiated or executed” through personnel of:
  - the non-U.S. person located in a U.S. branch or office; or
  - an (affiliated or unaffiliated) agent of such non-U.S. person located in the U.S.
CFTC Advisory 13-69 – Comparison with SEC

• The SEC approach contrasts with the CFTC’s in that the CFTC’s Advisory does not require that transactions “arranged, negotiated or executed” in the U.S. count toward a person’s de minimis threshold for swap dealing and registration status.

• Further, unlike the CFTC in its Advisory, the SEC would not require transaction-level requirements, such as mandatory clearing and trade execution, to apply to swap transactions of a non-U.S. registered swap dealer and a non-U.S. counterparty, where the transactions are “arranged, negotiated or executed” by personnel of the non-U.S. registered swap dealer located in the U.S.

• However, the SEC specifically requested comment on whether it is “appropriate not to apply the clearing and trade execution requirements to transactions that a non-U.S. person, in connection with its dealing activity, arranges, negotiates, or executes using personnel located in a U.S. branch or office.”
SEC Proposal: “Arranged, Negotiated, or Executed”

- “Arranged, negotiated, or executed” is not defined in the proposed rules; instead, guidance is provided in the Proposal’s preamble.
- Under the guidance, “arranged, negotiated, or executed” in the U.S. encompasses “market-facing activity” -- *i.e.*., the activity of sales and trading personnel, including communications with potential counterparties or their agents -- that is conducted through a branch or office in the territorial United States by personnel of the non-U.S. person or by an (affiliated or unaffiliated) agent of such person.
- The non-U.S. person would not be required to consider the location of its counterparty’s operations or personnel (or that of the counterparty’s agent) in determining whether the transaction should be considered in its own de minimis calculation, which it might have been required to do under the SEC’s original May 2013 proposal.
- This clarification is intended to avoid unnecessary costs and complexity that may make compliance difficult for market participants.
Market-Facing Activity

• Only activities that involve arrangement or negotiation of trade specific terms of particular SBS transactions, or execution of transactions, are considered “market-facing activities” under the Proposal.

• Execution refers to market facing activity that, in connection with a particular transaction, causes the person to become irrevocably bound under the SBS under applicable law.

• “Arranging,” “negotiating,” and “executing” also includes directing other personnel to arrange, negotiate, or execute a particular SBS.

• No exception for an SBS that is entered into anonymously on an execution facility or national securities exchange and are cleared through a clearing agency if the transaction is arranged, negotiated or executed in the U.S.
Personnel of the non-U.S. Person or Agent

• “Personnel” in this context is to be interpreted in a manner consistent with the definition of the term “associated person of a security-based swap dealer” in the Securities Exchange Act of 1934, regardless of whether the non-U.S. person or its agent is itself an SBSD.

• The SEC states its expectation that it will examine whether a particular entity is able to control or supervise the actions of an individual in determining whether such individual is considered “personnel” of a U.S. branch, office, or agent of the SBSD.
Non-Market Facing Activities

- According to the guidance, activities that would not be considered market-facing include:
  - designing SBSs (but not communicating with the counterparty regarding the contract in a specific transaction or executing trades in the contract);
  - collateral management activities (e.g., the exchange of margin payments) that may occur in the U.S. or involve U.S. banks or custodians;
  - preparation of master agreement and related documentation;
  - performing ministerial or clerical tasks;
  - submission of SBS transactions for clearing in the U.S.; and
  - reporting SBS transactions to U.S. swap data repositories.
- Involvement of U.S.-based attorneys in the negotiation of the terms for a transaction also would not, by itself, bring a transaction within market-facing activity.
External Business Conduct Standards

• In addition, the Proposal would apply the SEC’s external business conduct requirements, which have not yet been adopted, to the “U.S. business” of a registered SBSD, but not its “foreign business,” other than certain diligent supervision standards.

• “U.S. business” would be defined to include transactions entered into or offered to be entered into by or on behalf of a non-U.S. SBSD with a U.S. person (other than a transaction conducted through a foreign branch of the U.S. person) or any transaction arranged, negotiated or executed by personnel of the foreign SBSD or of its agent located in a U.S. branch or office.

• “U.S. business” also would include transactions made by or on behalf of a U.S. SBSD, wherever it occurs, except for transactions conducted through a foreign branch of the U.S. SBSD with a non-U.S. person or another U.S. person that is itself engaged in a transaction conducted through a foreign branch.

• “Foreign business” would be any business that is not “U.S. business.”
Applicability of Reg. SBSR

- The scope of the SBS trade reporting and public dissemination requirements under the recently adopted Reg. SBSR also would be amended under the Proposal by:
  - requiring that all transactions that are “arranged, negotiated or executed” in the U.S. (including such transactions by de minimis SBSDs) are both reported and publicly disseminated;
  - changing the reporting hierarchy so that when a non-U.S. de minimis dealer faces a U.S. person, the parties may choose who reports (rather than putting the burden on the U.S. person); and
  - requiring reporting when two non-U.S. persons trade through a U.S. platform or broker-dealer, including a security-based swap execution facility.
U.S. Person Definition

• The definition of “U.S. Person” is a lynchpin under both the CFTC’s and SEC’s framework:
  ➢ whether one or both counterparties to a transaction qualify as U.S. Persons may determine which substantive regulatory requirements will apply to such transaction;
  ➢ in addition, transactions may or may not need to be counted toward de minimis thresholds for dealer registration, depending on whether a counterparty is a U.S. Person.
U.S. Person Definition – CFTC

• CFTC definition of U.S. Person “generally” includes, but may “not be limited” to:
  - natural person resident of the United States or an estate thereof;
  - any corporation, partnership, or other forms of enterprise 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;
  - U.S. pension plans;
  - any trust governed by the laws of a state or other jurisdiction in the United States;
  - any commodity pool, pooled account, investment fund, or other collective investment vehicle that is majority-owned by U.S. Persons;
  - any legal entity (other than an entity where all of the owners of the entity have limited liability) that is directly or indirectly majority-owned by specified types of U.S. Persons and in which such U.S. Person(s) bears unlimited responsibility for the obligations and liabilities of the legal entity; and
  - Certain individual accounts or joint accounts owned by U.S. Person(s).
U.S. Person Definition – SEC

• For purposes of the SBSD and MSBSP determinations, the SEC defines “U.S. person” as:
  ➢ any natural person who resides in the United States;
  ➢ any partnership, corporation, trust, investment vehicle, or other legal person organized, incorporated, or established under the laws of the United States or having its principal place of business in the United States;
  ➢ any discretionary or non-discretionary account of a U.S. person; or
  ➢ any estate of a decedent who was a resident of the United States at the time of death.
SEC vs. CFTC Definitions

• The SEC definition of U.S. person is narrower in scope than the CFTC’s, as contained in the Cross-Border Guidance adopted by the CFTC:
  ➢ the SEC’s definition is self-contained, unlike CFTC’s definition, which states that a U.S. person will “generally” include, “but may not be limited to,” the persons described within its prongs;
  ➢ the SEC expressly declined to include within the U.S. person definition collective investment vehicles that beneficially are majority-owned by U.S. persons, which are included in the CFTC’s definition;
  ➢ SEC’s definition does not include any legal person that is directly or indirectly majority-owned by one or more U.S. persons that bear unlimited responsibility for the obligations and liabilities of such legal person within its definition, which is included in the CFTC’s definition;
  ➢ SEC’s definition does not include pension plans for a U.S. person legal entity that are included in the CFTC’s definition.

• In both definitions, foreign branches, offices or agencies of a U.S. person are themselves U.S. persons.
Exclusion for International Entities

• SEC also expressly excludes certain entities from the U.S. person definition, which were not excluded by the CFTC.

• The excluded entities are the International Monetary Fund, the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the United Nations, and their agencies and pension plans, and any other similar international organizations, their agencies and pension plans.

• The CFTC took a different approach to these entities, not excluding them from the U.S. person definition, but instead exempting them from substantive rulemakings, including from swap dealer and major swap participant registration.
Global Initiatives

• FSB report on ability of G20 members to defer to regulations of another jurisdiction.

• OTC Derivatives Regulators Group (ODRG):
  - Reports in September and November 2014 focussing on potential gaps and duplications in the treatment of branches and affiliates and the approach to implementation of the G20 trading commitment.
Global Initiatives (cont’d)

• FSB September 2014 Report:
  ➢ states that deference (in part or in full) to another jurisdiction’s regime for derivative regulation is an important tool for addressing differences in regulatory reforms aimed at meeting G20 objectives;
  ➢ FSB asked member jurisdictions to provide information on frameworks for deference to another jurisdiction’s derivatives regulation relating to trade repositories, CCPs and exchanges/electronic trading platforms;
  ➢ responses from all 19 FSB member jurisdictions;
  ➢ all but five (Argentina, Brazil, China, India and Indonesia) reported having some ability to defer to regulations of another jurisdiction;
  ➢ most jurisdictions state they do not require rules in other jurisdictions to be identical to be able to grant deference;
  ➢ many jurisdictions require information sharing or cooperation arrangements as a condition to granting deference;
  ➢ as of September 2014, only Australia, Canada, the US and the EU actually had deference arrangements in place or well advanced.
Global Initiatives (cont’d)

• ODRG September and November 2014 Reports:
  ➢ ODRG has current focus on two areas it is looking to develop approaches to address cross-border issues:
    • treatment of branches and affiliates;
    • organized trading platforms and implementation of the G20 trading commitment.
Global Initiatives (cont’d)

• Treatment of branches and affiliates:
  ➢ ODRG has focused on treatment of guaranteed affiliates in relation to (i) clearing obligations, (ii) trading obligations and (iii) risk mitigation techniques for uncleared transactions;
  ➢ it notes many regimes seek to extend regulation to guaranteed affiliates in other jurisdictions;
  ➢ ODRG is considering approaches to be applied in relation to guaranteed affiliates, particularly where guarantor jurisdiction seeks to extend regulation to such affiliates;
  ➢ relevant factors include the nature of the regulation (e.g. clearing or trading), whether the other jurisdiction has equivalent regulation, gaps between the rules in the two jurisdictions and the level of risk the relevant activity poses to the guarantor jurisdiction;
  ➢ further work to be carried out by the ODRG.
Global Initiatives (cont’d)

• Organized trading platforms (OTPs) and implementation of G20 trading commitment:
  ➢ ODRG believes one or more of the following approaches should be adopted to avoid unnecessary burdens and unintended consequences for foreign OTPs:
    • recognition;
    • registration and substituted compliance;
    • registration categories and exemptions;
  ➢ there should be appropriate transitional measures including a limited transition period for foreign OTPs;
  ➢ ODRG also seeks early consultation by authorities on mandatory trading determinations to the extent practicable.

• ODRG is also working on practical aspects of deference to other regimes building on the FSB summary.
Global Initiatives (cont’d)

- Relevant areas the ODRG is working on include:
  - equivalence and substituted compliance:
    - it notes progress to date by EU in recognising certain jurisdictions/regimes and equivalent and the comparability determinations by the CFTC;
  - clearing determinations:
    - ODRG members have agreed to inform each other early in the process of making a determination of mandatory clearing for a derivative or class of derivatives;
    - members also agreed to review expeditiously derivatives subject to a clearing determination in another jurisdiction;
  - risk mitigation for non-centrally cleared derivatives:
    - ongoing consultation by ODRG members to seek to minimize divergences in approach
  - data in trade depositaries and barriers to reporting to trade depositaries:
    - ODRG concerned about existence of barriers preventing reporting of counterparty-identifying information to trade repositories – FSB is continuing work to require removal of such barriers;
    - ODRG continues to explore ensuing authorities have access to relevant data held in trade repositories in other jurisdictions.
Questions?

Peter J. Green
PGreen@mofo.com
+44 (20) 79204013

James Schwartz
JSchwartz@mofo.com
(212) 336-4327

Julian E. Hammar
JHammar@mofo.com
(202) 887-1679

Jeremy C. Jennings-Mares
JJenningsMares@mofo.com
+44 (20) 79204072
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• Because of the generality of this presentation, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.
2014 was a very active year for financial regulation in the European Union (EU). There was a push to finalise much of the outstanding primary legislation on the regulatory reform agenda in advance of the European Parliamentary elections in May 2014. This resulted in the adoption of many EU Regulations and Directives in the first half of the year. However, much still remains in the in-box of EU legislators and regulators. Most of the legislation that has been adopted envisages a significant amount of further legislation and rulemaking regulation in the form of delegated regulations to be adopted by the EU Commission, much of it to comprise regulatory technical standards (RTS) and implementing technical standards (ITS) to be drafted by the European Supervisory Authorities (the ESAs), being the European Securities and Markets Authority (ESMA), the European Banking Authority (the EBA) and the European Insurance and Occupational Pension Authority (EIOPA). Therefore, even though the EU regulatory reform programme is now beginning the transition from legislation to implementation, a lot remains on the regulatory agenda into 2015 and beyond (with some measures not due to be implemented until 2025).

We have set out below a summary of some of the main developments during 2014 and the likely key areas of activity during 2015.

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1. EMIR IMPLEMENTATION

The European Market Infrastructure Regulation (EMIR)\(^1\) relating to the regulation of derivatives in the EU came into force in August 2012, but most of the relevant provisions require further delegated acts, RTS and ITS to be put in place before coming effective. That process continued during 2014. Some of the principal developments and expected further action in 2015 are set out below.

Reporting

After the commencement of the majority of EMIR’s risk mitigation requirements in 2012, on 12 February 2014\(^2\) we finally saw the introduction of trade reporting, ensuring that all derivatives transactions (whether traded over the counter (OTC) or otherwise) entered into, modified or terminated by European counterparties are required to be reported to a trade repository within certain specified time limits. On 11 August 2014, the reporting regime was further expanded to include the reporting of collateral and valuation information, although this requirement only applies to financial counterparties and non-financial counterparties above the clearing threshold.

Almost immediately after the February reporting requirement became effective, concerns arose as to the ability and readiness of counterparties to provide the information required to complete the pro-forma trade reports. In its relevant ITS\(^3\), ESMA created 85 data fields for counterparty completion but provided minimal guidance on how to generate the required data. These difficulties were also compounded initially by a backlog of applications to the trade repositories, as well as difficulties in obtaining Legal Entity Identifiers (LEIs) (required to help identify a reporting entity and match up trades between counterparties). The reporting process does now appear to have settled down although in a consultation paper published on 10 November 2014\(^4\), ESMA recognises that the “practical implementation of EMIR reporting showed some shortcomings” and as such, recommendations have been made for changes to the relevant RTS\(^5\) and ITS governing the application of the reporting obligation for counterparties and central counterparties (CCPs). Once ESMA’s final report is submitted to the EU Commission, the Commission will have three months to decide whether to endorse ESMA’s proposed changes – it is therefore likely that there will be some technical amendments to the derivatives reporting regime in early 2015.

Clearing

As regards the clearing obligation, the implementation progress has been slower. As we reported in our recent article on the clearing of derivatives transactions in the EU\(^6\), between July and October of 2014, a number of consultations and reports have been published by ESMA, setting out the initial classes of derivatives likely to be subject to a clearing obligation. In particular, certain types of interest rate derivatives (fixed to floating rate swaps, floating to floating rate (or basis) swaps, forward rate agreements and overnight index swaps), credit derivatives (trades referencing certain untranked credit indices) and foreign exchange derivatives (non-deliverable forwards) are all likely to be covered.

These reports also provide detail on the likely phase-in schedule with respect to clearing. ESMA’s proposals include sub-dividing market participants into different categories in order to ensure that the largest and most active market participants are required to clear first. In summary, Category 1

\(^2\) This was the reporting start date for trades entered into (1) on or after 16 August 2012 and still outstanding as of 12 February 2014, or (2) on or after 12 February 2014. For those trades entered into prior to 16 August 2012 that were not outstanding as of 16 August 2012, there is no reporting obligation. For those trades entered into either (1) prior to 16 August 2012 that were still outstanding as of 16 August 2012 or (2) on or after 16 August 2012 but in each case where such trade was not outstanding as of 12 February 2014, the trade reporting date is 12 February 2017. For those trades entered into prior to 16 August 2012 that were still outstanding as of 12 February 2014, the trade reporting start date was 13 May 2014.
\(^3\) Commission Implementing Regulation (EU) No. 1247/2012
counterparties will be comprised of clearing members of an authorised CCP. Category 2 and 3 counterparties will include (non-clearing member) financial counterparties and alternative investment funds that trade above the clearing threshold. Category 4 counterparties include all other non-financial counterparties above the clearing threshold.

Given the categorisation of a particular counterparty, it is possible to determine the applicable clearing obligation phase-in date, which is presently proposed to be six months for Category 1 counterparties, 12 months for Category 2, 18 months for Category 3 and three years for Category 4, in each case after the date the applicable RTS governing the clearing of a particular class of derivatives enters into force. When this date might be, however, remains unknown. As with the reporting consultation referred to above, as soon as ESMA submits the RTS proposals for each derivative class to the Commission, the Commission will have three months to decide whether or not to endorse them.

The first RTS in relation to Interest Rate Swaps (the IRS RTS)\(^7\) was sent to the Commission on 1 October 2014. In a letter from the Commission dated 18 December 2014, it was confirmed that it intends to endorse the IRS RTS, subject to certain amendments. As a consequence, ESMA now has a period of six weeks to amend and re-submit the IRS RTS to the Commission. The required amendments have arisen as a result of a lack of certainty in respect of timing. In particular, ESMA had proposed that the frontloading requirement would commence from the date the technical standards are published in the Official Journal of the EU. However, concerns were raised by market participants that this would not allow enough time for Category 1 counterparties to implement the arrangements necessary for frontloading. Further, entities which could potentially fall into either Category 2 or 3 (depending on whether they are above or below a €8 billion threshold for the monthly average of non-centrally cleared derivatives over the three-month period prior to the relevant RTS coming into force) did not know when to begin the monitoring process for such three-month look-back period. As a consequence, the commencement of the frontloading requirement has been delayed for Category 1, until two months after entry into force of the applicable RTS and for Category 2, until five months after entry into force of the applicable RTS.

**Collateral**

In accordance with a requirement to develop technical standards governing the timely, accurate and appropriate segregation of collateral (under Article 11(15) of EMIR), in April 2014, the ESAs published RTS on risk mitigation techniques for the collateralisation of uncleared derivatives transactions\(^8\). At the centre of the ESA’s proposals are requirements to (1) collect variation margin on a daily basis to cover the mark-to-market exposure of counterparties during the life of an existing trade and (2) collect initial margin upon inception of the trade, as calculated either in accordance with a model referred to as the Standardised Method (set out in such RTS) or another initial margin model acceptable to the regulators. Only certain assets may be posted for this purpose and a list of eligibility criteria must be satisfied. Once collected, the margin must be segregated from proprietary assets in the books and records of the custodian or third party that is holding it. Initial margin also cannot be rehypothecated.

Primarily impacting European financial counterparties and non-financial counterparties trading above the clearing threshold, the requirements are somewhat controversial in that they fail to exempt third-country entities trading below the clearing threshold (even though counterparties established in the EU with equivalent “NFC minus” status would be so exempt). Other exemptions are provided, however, including (but not limited to) where the total collateral exchanged between two counterparties at a group level would be equal to or less than €50 million, where trading is with an entity that is exempt from EMIR (such as an EU-based central bank), or where the relevant trade to be collateralised is a physically settled foreign exchange swap or forward.

The collateralisation of uncleared trades will be phased in from 1 December 2015. However, only the largest market participants will be subject to initial margin collection requirements from that date (i.e., only


those that trade non-centrally cleared derivatives in excess of €3 trillion in monthly aggregate notional amount). Counterparties trading non-centrally cleared derivatives in excess of €8 billion will be subject to the requirements by December 2019.

2. MiFID II IMPLEMENTATION

MiFID II is the overhaul of the Markets in Financial Instruments Directive which originally came into force in 2007. The primary MiFID II legislation comprises a Regulation (MiFIR) and recast Directive (together with MiFIR referred to as MiFID II). MiFID II was published in the Official Journal of the EU on 12 June 2014 and entered into force 20 days after that date. The provisions will not, however, become effective in the EU until January 2017.

MiFID II significantly expands the scope of the existing MiFID legislation, including:

- some amendments to the investor protection provisions including a narrowing of the execution-only exemption so structured UCITS are now outside the exemption, together with bonds or other forms of securitised debt that incorporate a structure which makes it difficult to understand the risk involved;
- structured deposits are now subject to a number of the provisions of MiFID II;
- the extension of many provisions of MiFID II to “organised trading facilities” or OTFs which will cover many forms of organised trading (not being regulated markets or multilateral trading facilities (MTFs)) of bonds, structured finance products and derivatives;
- requiring all derivatives, that are subject to the clearing obligation under EMIR and that ESMA determines to be sufficiently liquid, to be traded on a regulated market, MTF or OTF;
- extending the pre- and post-trade transparency regime (which currently only applies to shares) to bonds, structured finance instruments and derivatives traded on a trading venue;
- wider product intervention powers granted to ESMA and competent authorities including the ability to temporarily prohibit or restrict marketing of certain products in the EU;
- increased regulation of algorithmic and high-frequency trading;
- significantly expanding the scope of the regulation of commodities and commodity derivatives.

Although the primary legislation is now in place, a significant amount of detail still needs to be drafted. Much of this will be in the form of delegated acts of the EU Commission, mostly comprising regulatory and implementing technical standards to be drafted by ESMA and the other ESAs. In advance of the preparation of this secondary legislation, ESMA published in May 2014 a Consultation Paper and a Discussion Paper outlining its initial thinking in a number of respects. In addition, in August 2014 the European Banking Authority (EBA) published a consultation paper containing draft technical advice to the EU Commission on delegated acts to be published in relation to intervention powers in respect of structured deposits.

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On 19 December 2014, ESMA published its final technical advice to the EU Commission and a second consultation paper on MiFID II and is likely to spend much of 2015 engaged in the consultation process for MiFID II. It is expected to submit the bulk of the final regulatory technical standards to the EU Commission by the end of 2015 and the final implementing technical standards by 2016. Amongst the areas likely to be of key interest to market participants are ESMA’s proposals as to which derivatives or classes of derivative will be regarded as sufficiently liquid to be subject to the trading obligation under MiFIR and its guidance as to the availability of waivers from the pre-trade transparency requirements for bonds, structured finance instruments and derivatives (with liquidity likely to be the key consideration). In its recent technical advice and consultation paper, ESMA undertakes a detailed consideration of what constitutes a liquid market for the purpose of granting waivers of pre-trade transparency requirements for bonds, structured finance instruments and derivatives. As required by MiFIR, it focuses on average frequency and size of transactions, number and type of market participants, and average size of spreads. It proposes determining liquidity by dividing each asset group into more granular classes that share largely homogeneous liquidity characteristics and then sub-divides such classes further by factors such as maturity, issue sub-type and issue size (for bonds) and derivative type, number of instruments, number of trades and total notional amount (for derivatives). Its conclusions for each sub-class are set out in detailed tables in the technical advice. In relation to determining whether a derivative is sufficiently liquid to be subject to the exchange trading requirement, ESMA considers similar factors and indicates in many cases the thresholds will be the same or very similar as in relation to the test for the transparency rules but this will not necessarily always be the case.

3. BRRD IMPLEMENTATION

The Bank Recovery and Resolution Directive (BRRD) came into force in July 2014. The majority of the BRRD’s provisions must be implemented into EU member states’ national laws by 1 January 2015. The exceptions to this are the provisions relating to the bail-in tool, which are required to be implemented by 1 January 2016 at the latest. However, the UK Treasury has indicated that it will apply all of the provisions of the BRRD in the UK from 1 January 2015, including the bail-in requirements, with the exception of the minimum requirement for eligible (or bail-inable) liabilities (MREL), and the requirements for instruments governing bail-inable liabilities to contain contractual agreement/acknowledgement by the creditor that the liability could be subject to bail-in.

The BRRD requires EU credit institutions and certain investment firms to prepare recovery plans and for their relevant competent authorities to prepare resolution plans for such institutions based on information and other data provided to the authority by such firms. It also provides a mechanism for co-operation between resolution authorities in applying resolution tools and powers to cross-border groups. The BRRD also gives powers to competent authorities to take certain early intervention measures to seek to prevent a firm from going into resolution and, where a firm does need to be resolved, sets out resolution tools and powers available to authorities, namely the sale of business tool, the bridge institution tool, the asset separation tool and the bail-in tool. Various general principles are to govern the use of such bail-in powers, including that the firm’s shareholders should bear the first loss, following which creditors should then bear losses in accordance with their order of priority, and no creditor should incur greater loss than would have been the case if the firm had been wound up under a normal insolvency.

The bail-in power gives resolution authorities the power to determine when the firm has reached the point of non-viability and enables them to impose losses on certain creditors by writing their claims down or off or converting them into equity. The power is applicable to a wide range of unsecured liabilities of the firm with certain limited exceptions. The BRRD also requires firms to maintain a minimum amount of own funds and “eligible liabilities” (being liabilities that can be bailed-in under the bail-in tool) and referred to as the MREL. The EBA must produce RTS in respect of the criteria to be used by competent authorities for

determining the MREL for individual firms, and it produced a consultation paper setting out draft RTS in this respect in November 2014.\textsuperscript{17}

The EBA’s draft RTS were based in part on recommendations published by the Financial Stability Board (FSB) in November 2014\textsuperscript{18} on the adequacy of the loss-absorbing capacity of global systemically important banks (G-SIBs). The FSB’s proposals include that the minimum total loss-absorbing capital (TLAC, which is broadly equivalent to the MREL) to be held by a G-SIB should be in the region of 16 to 20% and at least twice the Basel III tier 1 leverage ratio requirement.

In relation to the provisions regarding contractual recognition of bail-in, the EBA must develop draft RTS to determine the contents of the required contractual term, and these must be submitted to the EU Commission by 3 July 2015. It produced a consultation paper with draft RTS in this regard in November 2014\textsuperscript{19}. The EBA has also produced various other draft RTS required under the BRRD to be delivered to the EU Commission during 2015, and work will continue on finalising these in 2015.

In the UK, we expect to see the Treasury’s proposals on the required levels of MREL in the first half of 2015, in order that these can be implemented by the end of 2015, as required. In the meantime, it is proposed in the draft version of the UK Bank Recovery and Resolution Order 2014\textsuperscript{20}, published in November 2014 that, as from 1 January 2015, the Bank of England will be empowered to set a minimum requirement for own funds and eligible liabilities on an institution-by-institution basis. The Prudential Regulation Authority (the PRA) in the UK is currently considering whether the provisions on contractual recognition of the bail-in tool should be implemented with effect from January 2015 for contracts such as regulatory capital and other debt market instruments, and as from January 2016 for all other relevant liabilities. It acknowledges, though, that the publication of the final draft RTS by the EBA by July 2015 may entail some changes to its rules in this regard.

4. SRM IMPLEMENTATION

Closely coupled with the BRRD is the European single resolution mechanism (SRM) established by the SRM Regulation\textsuperscript{21}. The SRM applies to all banks that are subject to the Single Supervisory Mechanism (SSM), and the SSM applies to all banks in the Eurozone and in certain other participating member states – around 6,000 of them – and establishes the European Central Bank (the ECB) as the single bank supervisory authority. The SRM further develops the “single rulebook” concept of the SSM. It does this by adopting recovery and resolution mechanisms that essentially mirror those in the BRRD and by establishing a Single Resolution Board (SRB) as the main resolution authority for all banks subject to the SSM. As the UK has opted out of the SSM, banks established in the UK will not be subject to the SRM.

The SRB (which will consist of a member appointed by each SSM member state, as well as an Executive Director, Deputy Executive Director and a member appointed by each of the EU Commission and the ECB) will determine whether the conditions for resolution of an individual bank have been met, and if so will recommend to the EU Commission that the bank be put into resolution, as well as the resolution tools that should be applied, and how the Single Bank Resolution Fund (SBRF) should be used. The EU Commission will then have the final decision as to whether or not to place the bank into resolution and what tools to use.

The SBRF will be funded by bank contributions in a similar way to the national resolution funds under the BRRD, with a similar target fund level and time frame for reaching it.

In terms of the interaction between the BRRD and the SRM, where a resolution procedure would affect only banks governed by the SSM, then the SRM would apply. Where a resolution procedure would affect only banks outside the scope of the SSM, then the BRRD would apply. Where a resolution procedure would affect both banks within and outside the scope of the SSM, then the BRRD will apply, with the SRB representing the national resolution authorities of the SSM–participating member states.

The majority of the provisions of the SRM Regulation will apply from 1 January 2016. From 1 November 2014, the EU Commission and the EU Council have had the power to adopt delegated and implementing acts, respectively, in relation to contributions to the funding of the SBRF. The SRB became fully operational on 1 January 2015, and the EU Commission is required to publish an evaluation report by 31 December 2018, and every five years after that, on the application of the SRM Regulation.

5. EU BANKING STRUCTURAL REFORM PROPOSALS

January 2014 saw the publication by the EU Commission of a draft Regulation mandating structural separation of certain EU banking activities. This draft Regulation is a culmination of the initiative started by the establishment of a high-level expert group and the resulting Liikanen report in 2012, although this legislative proposal has moved a long way from that original initiative.

The draft Regulation is intended to apply to the largest 30 or so banking groups in the EU, those designated as global systemically important institutions (G-SIIs) under the CRD IV legislation, and will catch EU credit institutions and their parent companies, and branches and subsidiaries of these entities, wherever they are located in the world.

It will also apply to certain non-G-SIIs if they have had, for a period of three consecutive years, total assets of at least €30 billion and trading activities amounting to at least €70 billion or 10% of total assets. This will include the EU branches of US and other non-EU banks and also the non-EU subsidiaries of EU parent companies, unless those branches and subsidiaries are subject to regulations deemed equivalent to those in the EU.

The Regulation will firstly prohibit proprietary trading (defined as using capital or borrowed money to take a position in a financial instrument or commodity for the sole purpose of making a profit for own account (i.e., excluding activities connected to actual or anticipated client activities)) by in-scope entities.

It will also prohibit in-scope entities from investing capital or borrowed money in a hedge fund (or fund-linked instrument) or other entity that engages in proprietary trading or itself invests in hedge funds, again where the sole purpose of the investment is making a profit for own account.

In-scope entities are also subject to the possibility that a national competent authority may force them to separate off one or more of their trading activities where these are considered to pose a threat to the institution’s financial stability or that of the EU financial systems as a whole. “Trading activities” are defined as meaning any activities other than a list of permitted activities, such as taking deposits, lending, payment services, custody and safekeeping services, etc., but specifically included as trading activities are market-making, sponsoring securitisations and trading in derivatives (other than a narrow range of permitted hedging instruments).

The draft Regulation is currently scheduled to be considered by the European Parliament during its plenary session in April 2015, and the Commission intends for the Regulation to be adopted by June 2015 and for the secondary rule-making to be completed by the end of 2015. It intends that a list of in-scope banking groups would be published by 1 July 2016, and annually thereafter. The proprietary trading prohibition is intended to become effective from 1 January 2017, and the provisions on potential separation of trading activities from 1 July 2018. It should, however, be noted that the provisions remain controversial in many member states with many differing views as to how structural reform of banks

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should be effected. There are concerns in some quarters that the proposals are too narrow compared with provisions in other jurisdictions, including the Volcker Rule in the US. Other jurisdictions are concerned as to the effect of the prohibition on proprietary trading on banks in their jurisdiction. The final outcome is therefore far from certain.

6. IMPLEMENTATION OF BANKING REFORM ACT IN THE UK

The UK Financial Services (Banking Reform) Act 2013 (the Banking Reform Act)\(^{24}\) enacts a number of changes to the UK banking system, in particular in relation to the requirement to ring-fence retail banking services. As expected, the main provisions as to the excluded activities and prohibitions applying to ring-fenced banks will come into force on 1 January 2019.

As mentioned in relation to the BRRD above, the bail-in stabilisation option under the Banking Act 2009 largely came into force on 31 December 2014. However, the provisions relating to the primary loss-absorbing capacity of ring-fenced banks and UK global systemically important banks have been delayed, as these overlap with the provisions regarding MREL under the BRRD (see above).

The provisions relating to giving preference to depositors, to the extent their deposits are covered by insurance under the Financial Services Compensation Scheme, came into force on 31 December 2014.

The new senior persons regime, licensing regime and banking standards rules all came into force in July 2014. However, the new criminal offence of reckless misconduct in the management of a bank, which will potentially apply to individuals who are covered by the senior persons regime, has not yet had a date announced for its commencement. When this commences, the maximum sentence for individuals found guilty of the offence will be seven years in prison and/or an unlimited fine.

It currently looks likely that ring-fenced banks (broadly, banks engaging in significant non-institutional deposit-taking) will not be permitted to sell structured products or derivatives unless they fall within a specified range of hedging transactions for customers. In addition, it seems that neither their subsidiaries, nor their parent companies, will be able to engage in such activities, and banking groups that contain a ring-fenced bank will need to engage in these activities through “sibling” entities. These proposals are controversial and likely to be subject to further debate into 2015. The ring-fence will not come into force until 2019, but banks are already planning the transition to the new regime.

7. PRIIPS REGULATION

On 9 December 2014, the final text of the EU Regulation on key information documents (KIDs) for packaged retail and insurance-based investment products (PRIIPs) was published in the Official Journal of the EU\(^{25}\) and came into force on 29 December 2014. The provisions of the Regulation will not, however, become effective until two years later (so 29 December 2016).

Under the Regulation, when a person is advising on or selling a PRIIP to retail investors, a KID must be provided to the investor prior to any contract being concluded. The primary obligation to draw up the KID will be on the manufacturer of the PRIIP (including any entity that makes significant changes to an existing PRIIP). The Regulation contains detailed requirements as to the form and content of the KID, which must be a maximum of three sides of A4 paper. The KID should be a “stand-alone” document separate from marketing materials and contain key information relating to the product. Although “key information” is not defined, an explanatory statement to be included in the KID will state that the information is intended to help the investor understand the nature, risks, costs and potential gains and losses of the product, and to help comparison with other products.


On 17 November 2014, the ESAs released a joint discussion paper in relation to the KID. The paper sets out their thoughts as to the presentation and content of each element of the required KID content, the methodology underpinning the presentation of risk and reward, such as the risk indicator and performance scenarios and the methodology for calculation of costs including the specification of summary indicators. The risk and reward section of the discussion paper focuses on issues such as defining risk and reward; defining market, credit and liquidity risk; and the different possible measures and ways of presenting each type of risk. These include various possible presentations of a summary risk indicator in pictorial form. In relation to the costs section, the paper discusses different types of costs and the scenarios in which they can occur in relation to different types of PRIIP. It also explores different possible options for presenting costs, including different visual ways of presenting a summary costs indicator.

The ESAs invite comments to be submitted by 17 February 2015, and they will use the feedback on the discussion paper to prepare draft regulatory technical standards. They expect to publish a consultation on these technical standards in the autumn of 2015. However, before this, there will be a consumer testing exercise organised by the EU Commission to assist the ESAs in developing the standards. It is also expected that a further technical discussion paper on the KID will be published in the first half of 2015.

8. AIFMD

The Alternative Investment Fund Managers Directive (the AIFMD) came into effect in the EU on 22 July 2013 and governs the management and marketing within the EU of alternative investment funds (AIFs) by alternative investment fund managers (AIFMs). The definition of an AIF is very broad, being a collective investment undertaking which is not a UCITS fund but which raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors. However, AIFs categorized as “small AIFs” are exempted from the majority of the provisions of the Directive. An AIFM is defined simply as a legal person whose regular business is the managing of one or more AIFs. Managing an AIF involves performing portfolio management activities and/or risk management activities for an AIF.

The AIFMD creates a harmonised set of rules in the EU for the supervision of AIFMs and requires AIFMs to be authorised and subject to supervision by their home competent authority. It also imposes a capital requirement of at least €125,000 on AIFMs. The AIFMD sets out various requirements as to governance and conduct of business, including rules relating to remuneration policies and practices. AIFMs are also subject to various transparency obligations requiring financial reports and information to be submitted to the relevant competent authority.

There is no requirement for a fund or a manager to be established or based in the EU in order to fall within the remit of the AIFMD. Non-EU AIFMs marketing one or more AIFs to professional investors in an EU country are currently required to comply with that country’s AIFMD implementing legislation irrespective of the domicile of such AIFs. However, such non-EU AIFMs cannot benefit from the AIFMD passporting regime across the EU until the EU Commission implements delegated legislation extending the passporting regime to non-EU AIFMs (following a positive opinion from ESMA). This is expected to be in place by the end of 2015, but until then non-EU AIFMs can only actively market AIFs to professional investors in an EU jurisdiction in accordance with that jurisdiction’s national private placement regime.

After the passporting regime becomes available to non-EU AIFMs, they can either seek authorisation under the AIFMD (and benefit from the pan-European marketing passport) or continue to rely upon those national private placement regimes that continue to exist, although it is currently expected that all national private placement regimes in the EU will be abolished from 2018, subject to an opinion of ESMA.

2015 is expected to bring about the culmination of the work of ESMA further to its call for evidence in November 2014 relating to the functioning of (i) the passport for EU AIFMs managing and marketing EU AIFs under the AIFMD and (ii) the national private placement regimes. This is to consider whether the passport should be extended to the management and marketing of AIFs by non-EU AIFMs and to the marketing of non-EU AIFs by EU AIFMs. ESMA is due to provide an opinion and advice to the European Parliament, the Council and the Commission in July 2015, and in October 2015 the Commission will, subject to a positive ESMA opinion, adopt a delegated act to specify when such passport will become available. In addition in 2015, ESMA will continue its consultation in relation to asset segregation by depositaries holding assets for AIFMs.

9. SHADOW BANKING REFORMS

The “shadow banking” sector continues to be an area of key regulatory focus. This has been spearheaded at international level by the FSB following a mandate at the G20 leaders’ meeting in St. Petersburg in November 2010. The FSB has avoided giving a specific definition of shadow banking but has focused on non-bank intermediation which it regards as credit intermediation involving entities and activities fully or partially outside the regular banking system. The FSB has stressed that any definition by national regulators should be capable of adapting with changes and developments in the financial markets.

The FSB’s work has focused on five workstreams: (a) interaction of the regular banking system with shadow banking, (b) the regulation of shadow banking entities, (c) securitisation and excess leverage, (d) regulation of securities lending and repos and (e) money market regulation. It has, together with the International Organization of Securities Commissions (IOSCO) in some cases, published a number of reports and policy recommendations covering these areas.

In the EU, the EU Commission in its March 2012 Green Paper on shadow banking approved the FSB’s general definition of shadow banking and sought to give a non-exhaustive indication of the types of entities and activities that it believes fall within the scope of shadow banking. Activities comprise primarily securitisation and securities lending and repos. Entities include SPVs (such as ABCP conduits) performing liquidity and/or maturity transformation, money market funds, leveraged investment funds (including ETFs) and finance companies and insurance/reinsurance undertakings issuing or guaranteeing credit products. It subsequently published a Communication on shadow banking in September 2013 setting out more detail on priority areas where it believes further work and legislation is needed.

The existing regulatory reform programme in the EU has already led to many of the proposals from the FSB workstreams being implemented in the EU. CRD IV (and previous amendments to the Capital Requirements Directive) has implemented Basel III including increased capital requirements for banks’ exposures to resecuritisations and liquidity facilities provided to securitisation vehicles and enhanced disclosure requirements. As described above, the AIFMD has imposed a harmonised EU regulatory regime for alternative investment funds. EMIR has also imposed a comprehensive reporting regime for OTC derivatives. Two areas where there is ongoing work in the EU, which will continue into 2015, are the regulation of securities financing transactions and money market funds. The current status of each is as follows:

(a) Securities Financing Transactions: Although the securities lending and repo markets are vital in meeting many financial institutions’ financing needs, supporting market liquidity and facilitating market-making, the FSB believes that many transactions are entered into by non-banks, giving rise to maturity and liquidity transformation risks. Concerns raised by the FSB include potential build-up of leverage, liquidity risks, the extent of reinvestment of cash collateral, potential pro-cyclicality due to the relationship
between funding levels and fluctuating asset values and volatility caused by valuation haircuts and risks relating to rehypothecation of collateral. It has developed 11 policy recommendations including minimum regulatory standards for cash collateral reinvestment and new regulatory requirements relating to rehypothecation including sufficient disclosure to enable clients to understand their potential exposure in the event of a failure of the intermediary. In October 2014 the FSB published a Regulatory Framework for haircuts on non-centrally cleared securities financing transactions including proposed numerical floors for haircuts.

In January 2014, the EU Commission published a draft Regulation on reporting and transparency of securities financing transactions which focuses on transparency, disclosure and rules relating to rehypothecation. The draft Regulation provides for EU entities (whether or not financial entities) to report details of securities financing transactions to a trade repository similar to the reporting requirements for OTC derivatives under EMIR. For these purposes, the definition of securities financing transactions is wide and includes repos, reverse repos, securities borrowing and lending transactions and equivalent financing structures. The draft also contains additional disclosure requirements for managers of UCITs funds and alternative investment funds including criteria for counterparties and collateral and valuation methodologies and details of rehypothecation policies. In relation to rehypothecation, the draft Regulation proposes that the client or counterparty must consent in writing to an asset being rehypothecated, the risks of rehypothecation must be explained in writing to the collateral provider and assets received as collateral must be transferred to an account in the name of the receiving counterparty.

The EU Council recently announced that it has agreed its negotiating position in relation to the draft Regulation, and discussions between the EU Commission, EU Parliament and EU Council are expected to progress in the early part of 2015. It is therefore possible that the Regulation may be adopted at some time during 2015.

(b) Money Market Funds: The FSB has acknowledged that MMFs are an important source of credit and short-term funding for the regular banking system and provide maturity transformation and leverage. It also expressed concern, however, that some MMFs suffered large losses during the financial crisis, often due to ABS holdings, leading to significant redemptions, runs and subsequent bail-outs for some funds. IOSCO has driven much of the work on this workstream and published a final report in October 2012 setting out 15 policy recommendations for a common approach in relation to MMF regulation, including that MMFs offering a stable NAV should be subject to measures designed to reduce specific risks related to this feature. Other recommendations included a requirement for fair value principles for portfolio valuations and requirements for MMFs to hold a minimum amount of liquid assets to meet redemptions.

The EU Commission published a draft Regulation relating to money market funds in September 2012. This draft contains provisions limiting investments by MMFs to certain low-risk investments, including money market instruments with high internal credit ratings and deposits with eligible credit institutions with a maximum maturity of 12 months. It also proposes stricter diversification and concentration limits. The draft Regulation does not seek to abolish constant NAV MMFs but proposes they be subject to a capital buffer of at least 3% of total assets. Concerns have been raised that this buffer may make such funds uneconomical. It also proposes minimum average maturity and weighted average life requirements and a prohibition on external credit ratings.

The draft Regulation differs in a number of important respects from the approach taken by the SEC in the US in adopting new rules for MMFs which came into force in October 2014. The new SEC rules impose a floating NAV requirement for non-retail and non-governmental MMFs. The draft Regulation also provides


for liquidity fees and gates to be imposed in certain circumstances where the fund’s board determines it is in the fund’s best interests to do so.

As we move into 2015, there is likely to be considerable activity in the EU to seek to reach agreement on the draft MMF Regulation referred to above, and it will be interesting to see if the proposals move closer to the SEC position as the Regulation goes through the EU legislative process. The EU Council of Ministers has proposed a compromise draft which would bring the Regulation more in line with the new SEC rules, including eliminating the proposed buffer for retail and small professional constant NAV funds and requiring the board of such funds to consider imposing redemption gates and fees when the proportion of weekly maturing assets falls below 30% of net assets. The draft report of the European Parliament’s Committee on Economic and Monetary Affairs (ECON) also proposes amendments to the Regulation, although it takes a different approach to the EU Council. In relation to constant NAV funds, ECON is still exploring various options, including (i) maintaining the proposed capital buffer, (ii) developing a system based on liquidity fees and redemption gates, (iii) developing a European variation on the SEC rules with a carve-out for governmental MMFs or (iv) developing a system of low-volatility NAV funds. Negotiations are likely to continue through 2015, and it remains to be seen if political agreement can be reached to enable the Regulation to be finalised in the coming year.

10. BENCHMARK REGULATION

The use of benchmarks in financial transactions has been the subject of focus from international regulators in recent years following investigations of a number of financial institutions for alleged misconduct in relation to the setting of LIBOR as well as other financial benchmarks. In the UK, following a review by Martin Wheatley, CEO of the Financial Conduct Authority, a number of reforms have been made in relation to the setting of LIBOR in the Banking Reform Act 2013. In September 2014, following a review by the Bank of England, HM Treasury published a consultation paper recommending that additional financial benchmarks be subject to regulation in the UK. In December 2014, HM Treasury confirmed that the UK government would implement the recommendations in respect of seven benchmarks. At the same time, the FCA published a consultation paper on bringing additional financial benchmarks under its supervision. On a global level, IOSCO published principles for financial benchmarks in July 2013 which have been endorsed by the FSB and the G20 setting out a framework of standards in relation to issues of governance, benchmark quality and calculation methodology.

In September 2013, the EU Commission published a draft Regulation in relation to indices used as benchmarks in financial instruments and contracts with the stated aim of improving the governance and controls applicable to financial benchmarks (and in particular the avoidance or appropriate management of conflicts of interest), the quality of data used in setting the benchmark and methodologies used by benchmark administrators and ensuring that contributors to benchmarks are subject to adequate controls. The draft Regulation imposes various obligations on benchmark administrators, contributors and users. Benchmark administrators located in the EU will be subject to authorisation and supervision by their competent authorities including detailed governance requirements. A benchmark administrator will also be required to ensure that the input data is sufficient to represent accurately and reliably the market or economic reality that the benchmark is intended to measure and is responsible for ensuring that there are adequate and effective systems and controls to ensure the integrity of input data and to put appropriate monitoring in place. The administrator is also required to publish relevant input data immediately after publication of the benchmark, although it may delay publication where there would otherwise be serious adverse consequences for the contributors or if immediate publication would adversely affect the reliability or integrity of the benchmark.

In relation to benchmark users, an entity that is subject to supervision in the EU will only be permitted to issue or own a financial instrument or be party to a financial contract which references a benchmark or use a benchmark that measures the performance of an investment fund if the benchmark is provided by an administrator authorised under the Regulation or is an administrator located outside the EU that is registered by ESMA subject to specified criteria.

Having regard to the systemic importance of certain benchmarks, the EU Commission will be required to maintain a list of critical benchmarks. If at least 20% of the contributors to a critical benchmark cease or are likely to cease to make contributions, the relevant competent authority has the power to take various actions, including requiring selected supervised entities to contribute input data; determining the form in which and the time by which any input data must be contributed; and changing the code of conduct, methodology or other rules of such benchmark.

The draft Regulation is still going through the EU legislative process. ECON largely welcomed the draft Regulation but expressed concerns as to the breadth of the scope of the definition of “index”, suggesting that the scope be narrowed to benchmarks in certain specified categories of financial index. It also recommended that national competent authorities be given more powers to ensure mandatory contributions to critical benchmarks and further consideration be given to the treatment of benchmarks administered outside the EU - many benchmarks used in financial instruments, including derivatives, originate from outside the EU and it would cause considerable disruption to financial markets if many of these could not continue to be used. The EU Council has also published compromise drafts of the Regulation. Discussions will continue into 2015 and there are likely to be considerable efforts to have the text of the Regulation agreed and finalised during 2015.

11. CRD IV IMPLEMENTATION

The Basel III reforms, in the form of the new Capital Requirements Regulation (CRR) and the CRD IV Directive (and, together with the CRR referred to as CRD IV), largely came into effect on 1 January 2014 in Europe. This included the revised requirements in relation to minimum capital requirements for firms and the introduction of new capital buffers. These requirements are now being phased in in accordance with the terms of CRD IV. CRD IV also provides for a significant number of RTS and ITS to be drafted, principally by the EBA. This process is now well underway, with many of these already having been adopted by the EU Commission through delegated acts.

Certain provisions of CRD IV were always intended to take effect at a later date. In particular, the Liquidity Coverage Ratio (LCR) provisions are to become effective from 2015. The EU Commission in October 2014, adopted a delegated Regulation in relation to the LCR, containing detailed provisions for the ratio. The delegated Regulation generally followed the Basel III LCR standard, with certain amendments, including in relation to giving certain covered bonds extensive recognition and also including, as part of the permitted liquid assets, certain types of securitised asset, such as securities backed by auto loans. The LCR is to be phased in from 1 October 2015, commencing at 60% of the full requirement and rising to 100% of the full requirement by 2018.

The CRR provides for the European Banking Authority to report to the EU Commission by 31 December 2015 on whether the Net Stable Funding Ratio (NSFR) prescribed by Basel III should be introduced and on appropriate methodologies and definitions for calculating the ratio. The EU Commission is required by 31 December 2016, if appropriate, to submit a legislative proposal to the European Parliament and the Council, with the aim of the NSFR applying, if at all, by 1 January 2018.

The other major part of the CRD IV package which has not yet entered into force is in relation to the leverage ratio. The ratio, which is a measure of a firm’s Tier I capital, compared to the non-risk weighted values of its assets, is required to be disclosed publicly by each firm as from 1 January 2015. In October

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2014, the EU Commission adopted a delegated Regulation\textsuperscript{46} making changes to the calculation of the leverage ratio by amendments to the capital measure and the total exposure measure. These included provisions to address the treatment of the exposure values of derivatives and securities financing transactions. By the end of December 2016, the EU Commission is required to submit a report on the impact and the effectiveness of the leverage ratio, and this will be accompanied by a legislative proposal, introducing the leverage ratio as a binding measure, if the EU Commission decides this is appropriate. The binding leverage ratio is intended to be applicable from 1 January 2018 onwards.

An area of CRD IV that has been controversial is that concerning provisions relating to firms' remuneration policies and, in particular, the requirement that a person's variable remuneration should not exceed the amount of fixed remuneration (with the possibility of it being 200% of fixed remuneration only with shareholder approval (66% majority required with a minimum quorum of 50%)). Variable remuneration must also be subject to clawback arrangements. The UK launched a legal challenge to the cap on variable remuneration on the grounds that it fell outside the powers of the EU. However, following an adverse opinion from the advocate general of the European Court of Justice, the UK abandoned its challenge in 2014. The “bonus cap”, as it has been referred to, will therefore continue to be applicable into 2015. Concern was raised by the EBA and the EU Commission during 2014 as to the practice by some firms of redesignating some variable pay into allowances. Their view was that in many cases, the allowances would still be regarded as variable pay. In October 2014, the EBA published an opinion\textsuperscript{47} outlining what sort of pay structures it would consider to be variable pay. However, the paper has no binding force in the EU, and it is therefore possible that some firms could press ahead with allowance-type arrangements, leaving open the possibility of competent authorities seeking to impose sanctions and possible future legal action in this area.

12. FINANCIAL TRANSACTIONS TAX

Initially based on a set of failed EU-wide proposals in relation to a tax on financial transactions (the FTT) dating back to September 2011, the current revised proposals for the FTT\textsuperscript{48} are now intended to be applied in just 11 member states\textsuperscript{49} (the FTT Zone) based on a principle of enhanced cooperation which allows a subset of member states that wish to continue to work more closely together to do so, while respecting the legal framework of the Union. In short summary, the purpose of the FTT is to harmonise legislation on the indirect taxation of financial transactions. Specifically, proposals are to impose a tax of 0.1% on all transactions relating to financial instruments other than derivatives (such as options, futures, contracts for difference or interest rate swaps), which will attract a tax rate of 0.01% on the notional amount of the transaction. Under the proposals a tax would be imposed, broadly, where at least one party to a transaction was a financial institution in a participating member state. However, it also sought to impose the FTT on transactions relating to an instrument issued by an entity incorporated or registered in a participating member state even if the parties to the transaction were both outside the FTT zone (e.g. a put option between UK and US banks over shares in a French entity would be potentially subject to the FTT – referred to as the “issuance principle”).

Opting to remain firmly outside of the FTT Zone, the UK has argued strongly that the implementation of the FTT would, when coupled with existing EU tax legislation on mutual assistance and administrative cooperation, result in negative extraterritorial effects for itself and other non-participating states. In April 2014, the UK lost its legal challenge in the European Court of Justice to the granting of authorisation to use enhanced cooperation. While clearly a blow to the UK’s attempt to stop the revised FTT proposals in their tracks, it should be understood that the UK was not (at that stage) taking steps to challenge the implementing measures which will ultimately be adopted by the FTT Zone states. Whether it does so in the future remains to be seen.

\textsuperscript{49}Belgium, Germany, Estonia, Greece, Spain, France, Italy, Austria, Portugal, Slovenia and Slovakia.
On 31 October 2014, the Italian Presidency of the EU published a report on the status of the revised FTT proposals\(^{50}\). The report confirms that efforts have continued to clarify two “key open issues”, being (i) the need to define the scope of the transactions which shall form part of the “first phase” of implementation and (ii) the basic “principle of taxation” that should apply to the levy of the FTT and distribution of income across the FTT Zone. In respect of the scope of transactions, it is stated that most participating member states are in favour of taxing transactions in derivatives linked to an underlying that itself falls under the scope of the FTT (e.g. equity derivatives, where transactions relating to the underlying shares will be within the scope of the FTT). As regards the principal of taxation, it is suggested that either a “residence” or an “issuance” principle shall apply (or some combination of the two), meaning that it is yet to be decided whether the appropriate taxing authority should be (a) that of the place of establishment of the parties to the taxable transaction (residence) or (b) that of the place of the establishment of the issuer (issuance) or both.

In a press release of the European Council on 7 November 2014\(^{51}\), it is stated that work shall be intensified in order to enable an agreement in the near future, with the aim of implementing the first phase of the FTT by 1 January 2016. Given the relatively limited amount of detail currently available and the possibility of another legal challenge from the UK, we are likely to see plenty of further activity on the proposed FTT during 2015.

13. MAD IMPLEMENTATION

On 16 April 2014, the revamped legislative package governing market abuse, consisting of the Market Abuse Regulation (MAR)\(^{52}\) and the Criminal Sanctions for Market Abuse Directive (CSMAD)\(^{53}\), was formally adopted by the Council of the European Union. As a result of the UK’s special position under the Lisbon Treaty, it has powers to opt out of measures governing EU criminal law and as such has not signed up to CSMAD. MAR, however, will apply automatically in all EU states (including the UK) when it becomes effective in July 2016.

The principal changes that will be brought into effect under MAR include an extension of scope to cover a significantly broader range of securities than are presently covered under the existing Market Abuse Directive (MAD)\(^{54}\). MAD regulates derivatives traded on the EU’s primary investment exchanges (known as regulated markets). However, in order to take account of the significant amount of off-market trading, MAR will also cover instruments traded on MTFs and OTFs as well as OTC transactions. Commodity derivatives (and related spot commodity contracts), emission allowances and benchmarks will also receive greater regulatory coverage.

Other changes brought about by the introduction of MAR include the regulation of market soundings (discussions with investors, prior to commencement of an actual transaction, to gauge their interest and determine pricing), a new offence of attempted insider dealing and market manipulation, and the prohibition of algorithmic or high-frequency trading strategies where they are used to manipulate markets. The initial proposals to expand the scope of inside information to cover that which a reasonable investor would be likely to consider as part of the basis of his/her investment decision, was not retained in the adopted version of MAR\(^{55}\).

On 15 July 2014, ESMA initiated the consultation process for preparing RTS and ITS in relation to MAR\(^{56}\). These technical standards will cover a variety of areas, including (amongst other things) (i) the conditions that buy-back programmes and stabilisation measures must meet (such as conditions for trading, restrictions regarding time and volume and disclosure and reporting obligations); (ii) appropriate

\(^{52}\)http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0596&from=EN.
\(^{55}\)See Article 7 (Inside information) of the April 2014 text of MAR.
arrangements, procedures and record-keeping requirements for persons to comply with the new market soundings requirements; and (iii) appropriate public disclosure of inside information (as well as rules governing any necessary delay). The deadline for responses to the consultation closed on 14 October 2014. ESMA has indicated that it will finalise the technical standards for submission to the Commission no later than 12 months after the entry into force of MAR57 (i.e., by July 2015). In the coming year, we therefore expect to see continued development of ESMA’s technical proposals as we head closer towards implementation in 2016.

14. UCITS V / VI

The UCITS V Directive was published in the Official Journal of the EU on 28 August 201458 and makes various changes to the existing UCITS Directive (UCITS IV)59. It came into force on 17 September 2014, and EU member states have until 18 March 2016 to transpose it into their national laws. The principal amendments made by UCITS V seek to make some of the rules for UCITS funds more consistent with those applicable to alternative investment funds under the AIFMD and include:

- changes to the provisions relating to the appointment of a depositary in respect of a UCITS fund, including new rules relating to duties of oversight, cash monitoring, custody duties and conflicts management;
- rules setting out the terms on which the depositaries’ safekeeping duties can be delegated;
- revision of eligibility criteria for depositaries so only credit institutions and investment firms will be able to act as depositaries;
- clarification of scope of a depositary’s liability in the event of losses relating to an asset held by the depositary;
- the requirement that UCITS management companies put in place remuneration policies and practices for senior management and persons whose professional activities have a material impact on the risk profile of the management company or the UCITS; the policies and practices must be consistent with, and promote, sound and effective risk management and discourage disproportionate risk taking;
- imposition of minimum harmonisation rules to seek to provide more consistency in sanctions provisions in member states.

UCITS V requires the EU Commission to publish and implement various delegated acts and technical standards and guidance. In particular, the EU Commission has to set out various requirements as to the rules relating to depositaries. ESMA published a consultation paper in September 201460 in relation to such delegated acts, focusing on insolvency protection of the assets of a UCITS, where the depositary has delegated safekeeping duties to a third party and the requirements on the management company and depositary to act independently. Following the end of the consultation process, ESMA’s final technical advice was published in November 2014. The EU Commission is likely to publish the delegated acts based on this advice during 2015.

In July 2012, the EU Commission published a consultation paper seeking views on possible further changes to the UCITS regime – such possible changes have been generally referred to as UCITS VI. The Commission did not make specific proposals but outlined possible areas to be covered by further legislation, including eligible assets and the use of derivatives, efficient portfolio management techniques,

57 MAR was published in the Official Journal of the EU on 12 June 2014 and came into force 20 days later, on 2 July 2014.  
extraordinary liquidity management rules, the possibility of a depositary passport, money market funds and long-term investments.

In November 2014, Steven Maijoor, the chairman of ESMA, indicated that many of the major issues that could have been the subject of specific UCITS VI legislation have been or are in the process of being dealt with in other legislation, including the draft Regulation on money market funds and the draft Regulation on European long-term investment funds (ELTIFs)\textsuperscript{61}. It therefore currently seems unlikely that the EU Commission will make any further proposals for amendment of the UCITS regime during 2015.

15. CENTRAL SECURITIES DEPOSITARIES REGULATION

The Central Securities Depositaries Regulation (CSDR) came into force on 17 September 2014\textsuperscript{62} and imposes a new regulatory regime on central securities depositaries and securities settlement in the EU. Provisions requiring the recording of securities in book-entry form, where the trade takes place on a regulated venue, and general requirements to settle transactions in specified financial instruments on the intended settlement date are already in force. Provisions requiring transactions in securities to be executed on trading venues not later than the second business day after the trade is executed apply from 1 January 2015. Other provisions requiring EU issuers to arrange for specified securities to be represented in book-entry form do not come fully into force until 1 January 2025. ESMA is required to draft various technical standards and guidelines under the CSDR and to deliver the draft technical standards to the EU Commission by 18 June 2015. In March 2014 ESMA published a Discussion Paper setting out draft proposals in relation to most of the required RTS and ITS\textsuperscript{63}.

16. PAYMENT SERVICES DIRECTIVE

The Payment Services Directive (PSD) became law in most of the EU in 2009 and aimed to harmonise the regulatory regime for payment services across the EU by enabling a new type of regulated financial institution (a payment institution) to compete with banks in the provision of payment services. It established an EU-wide licensing regime for payment institutions, as well as harmonised conduct of business rules. In July 2013, the EU Commission published a draft Directive which amends the PSD and other relevant EU legislation (referred to as PSD2)\textsuperscript{64}. The draft Directive will update the existing framework relating to payment services and expand the scope of regulated payment institutions. New transparency requirements will also apply.

PSD2 will expand the scope of the current Directive by also applying certain provisions when only one payment service provider in a transaction is located in the EU. PSD2 will also now apply the provisions relating to transparency and information requirements to all currencies, not only EU currencies, as is currently the case. The definition of payment services will also be widened to cover services provided in the form of payment initiation services or account information services. A number of the existing exemptions available under the PSD are narrowed or removed, and various amendments are made to the conduct of business requirements.

The EU Council has proposed compromise drafts of the draft PSD2 Regulation, and the EU Parliament has also proposed amendments. Negotiations will continue into 2015. If PSD comes into law, it will be required to be transposed into national law in EU member states within two years of its coming into force.

\textsuperscript{64}http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2013:0547:FIN:EN:PDF.
AUTHORS

Peter Green
London
+44 (20) 79204013
pgreen@mofo.com

Jeremy Jennings-Mares
London
+44 (20) 79204072
jjenningsmares@mofo.com

Nimesh Christie
London
+44 (20) 79204175
nchristie@mofo.com

Lewis Lee
London
+44 (20) 79204071
lewislee@mofo.com

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CFTC Proposes Relief from Trade Option Reporting and Recordkeeping Requirements for Commercial End Users

By Julian E. Hammar

On April 30, 2015, the Commodity Futures Trading Commission ("CFTC") approved for publication in the Federal Register proposed amendments to the trade option exemption (the "Proposal") that would reduce reporting and recordkeeping requirements for trade option counterparties that are not swap dealers or major swap participants ("Non-SD/MSPs"). Notably, the Proposal would eliminate the annual Form TO filing requirement for Non-SD/MSPs in connection with their trade options, while requiring them to notify the CFTC’s Division of Market Oversight ("DMO") if their trade options have, or are expected to have, an aggregate notional value in excess of $1 billion in any calendar year. The Proposal will be available for public comment for 30 days after its forthcoming publication in the Federal Register. The Proposal is available here.

BACKGROUND

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") amended the Commodity Exchange Act ("CEA") to include a definition of the term “swap,” which includes commodity options, whether physically or financially settled. Commodity options that qualify for the trade option exemption are exempt from most requirements applicable to swaps under Dodd-Frank. Under current CFTC rules that the Proposal would not modify, to qualify for the trade option exemption, a commodity option must involve a nonfinancial commodity (i.e., an exempt or agricultural commodity) and must be:

- offered by either an “eligible contract participant” as defined in the CEA (generally, a financially sophisticated entity) or a producer, processor, commercial user of, or merchant handling the underlying physical commodity;
- offered to a producer, processor, commercial user of, or merchant handling the underlying physical commodity; and
- intended to be physically settled, so that, if exercised, the option would result in the sale of an exempt or agricultural commodity for immediate or deferred shipment or delivery.

Under existing CFTC regulations that the CFTC now proposes to modify, trade options that meet these conditions must be reported to a swap data repository in accordance with Part 45 of the CFTC’s regulations, if, during the 12 months prior to the trade option being entered into, one of the counterparties has been obligated to report a non-trade option swap under Part 45. If neither counterparty has had to report non-trade option swaps under Part 45 during that period, then both counterparties may report their trade option transactions annually on the CFTC’s
Form TO. Eligibility to use Form TO was extended pursuant to a CFTC staff no-action letter issued in April 2013. Under the no-action letter, if one of the parties is required to report non-trade option swaps under Part 45 during the 12-month period (and thus cannot use Form TO under the rule), and that party is a non-SD/MSP, then it may use Form TO, provided that it notifies DMO by email no later than 30 days after entering into trade options having an aggregate notional value in excess of $1 billion in any calendar year. Trade options are also subject to requirements in addition to reporting under Part 45, including, among others, recordkeeping, swaps large trader reporting, and position limits, as well as anti-fraud and anti-manipulation provisions.

THE PROPOSAL

The CFTC’s Proposal would eliminate the Part 45 reporting requirement for Non-SD/MSPs in connection with trade options. In addition, the CFTC proposes to eliminate the Form TO annual notice reporting requirement applicable to Non-SD/MSPs for trade options not reported under Part 45. Instead, under CFTC Reg. 32.3 as proposed to be amended, a Non-SD/MSP would only need to provide email notice to DMO within 30 days after entering into trade options (whether reported or unreported) that have an aggregate notional value in excess of $1 billion in any calendar year. In the alternative, a Non-SD/MSP could provide notice by email to DMO that it reasonably expects to enter into trade options (whether reported or unreported) having an aggregate notional value in excess of $1 billion during any calendar year.

In its release explaining the proposed new rules, the CFTC states that, while there may be surveillance benefits from Form TO data, completing Form TO imposes costs that may be significant for Non-SD/MSPs, particularly small commercial end users. Moreover, the CFTC observes that Non-SD/MSPs would remain subject to recordkeeping requirements under Part 45, which require market participants to maintain full and complete records and to open their records to CFTC inspection upon request, so that the CFTC would remain able to collect information regarding trade options as necessary. The proposed email notice requirement for trade options in excess of $1 billion is intended to give the CFTC insight into the market for unreported trade options and the identities of the largest trade option market participants.

Although the Proposal would require a Non-SD/MSP to comply with the applicable recordkeeping requirements of Part 45 in connection with their trade options, including the requirement to obtain a legal entity identifier (“LEI”) pursuant to CFTC Reg. 45.6 and provide such LEI to its counterparty that is an SD/MSP, a Non-SD/MSP would not be required to meet the requirements of CFTC Regs. 45.5 and 45.7 regarding use of unique swap identifiers and unique product identifiers, respectively.

The Proposal also would eliminate for now, at least, the requirement that trade options be subject to position limits, which the CFTC states should be addressed in the position limits proposed rulemaking currently under consideration.

If adopted, the CFTC’s Proposal will provide welcome relief for many Non-SD/MSP commercial end users with respect to their physically settled trade options.
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Clearing Derivative Transactions in the EU: What You Need To Know

Key Highlights

- All counterparties within scope of the European Market Infrastructure Regulation (“EMIR”) and subject to the clearing obligation will soon be required to centrally clear their applicable derivatives transactions.

- Draft regulatory technical standards (“RTS”) have now been published, establishing the basis for a clearing obligation to apply with respect to certain over the counter (“OTC”) interest rate, credit and foreign exchange derivative transactions.

- The phase-in dates for the central clearing of transactions will apply equally as between counterparties established in the EU and outside of the EU.

- Non-EU counterparties trading OTC derivatives with EU counterparties, or with other non-EU counterparties where there is a significant connection to the EU, should be aware of their classification under EMIR and categorisation as presented in the RTS.

Background

EMIR places a number of obligations on counterparties to OTC derivative transactions. These include the central clearing of trades deemed to be subject to a ‘clearing obligation’, trade reporting and other risk-mitigation requirements for uncleared trades (such as portfolio reconciliation and trade collateralisation). While the requirements apply mostly to institutions established in the EU, a number of EMIR’s provisions (including the clearing obligation) also have extraterritorial effect. As a consequence, certain entities established outside of the EU (so-called ‘third-country entities’), may have positive obligations under EMIR, dependent upon what their status would be under EMIR if they were hypothetically established in the EU and upon the extent to which they are either (i) trading with EU counterparties, or (ii) entering into derivatives trades which have a “direct, substantial and foreseeable” effect within the EU.

Although EMIR has been in force for over two years, a number of the obligations have been phased in gradually. The reporting requirement, for example, came into effect on February 12, 2014. The clearing requirement, however, has taken longer to implement and confirmation of its effective date for different asset classes and counterparties has remained dependent upon a number of factors, not least of which includes the requirement for the European Securities and Markets Authority (“ESMA”) to determine which derivatives trades should, in

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1 An obligation may also arise where it is necessary or appropriate to prevent the evasion of any of the provisions of EMIR.
accordance with EMIR’s criteria, be mandatorily cleareable.

On July 11, 2014, ESMA published its initial consultation on the clearing of certain OTC credit derivatives (the “CD Consultation”). On October 1, 2014, ESMA published its final report covering draft technical standards on the clearing obligation, in respect of Interest Rate OTC Derivatives ("IRS Report"). Simultaneously, it published a consultation on the clearing obligation to be applied with respect to foreign exchange non-deliverable forwards ("FX NDF Consultation"). Each of these publications sets out the extent to which particular derivatives trades might be appropriate for central clearing, in accordance with the criteria required to be satisfied under Article 5(4) of EMIR (the "Criteria"). For example, consideration is given to, amongst other things, the degree of standardisation of contractual terms, the volume and liquidity of the market for such transactions and the availability of relevant pricing information. The publications then go on to state when the applicable clearing obligation might apply and with respect to whom.

**Interest Rate Derivatives**

The IRS Report specifies that the interest rate derivative products available for central clearing fall broadly into four categories:

- Fixed-to-Floating Interest Rate Swaps (plain vanilla IRS);
- Floating-to-Floating Interest Rate Swaps (known as basis swaps);
- Forward Rate Agreements (FRA); and
- Overnight Index Swaps (OIS).

These categories are then further broken down in order to define the applicable class that is subject to the clearing obligation. Characteristics used for this purpose include settlement currency (primarily EUR, GBP, USD and JPY), maturity (e.g., between 28 days and 50 years for a basis swap, or between 3 days and 3 years for an FRA), the existence of any optionality and the notional type (constant or variable).

The draft RTS in the IRS Report set out the complete list of clearable derivative classes in Annex 1 thereto. However, ESMA makes clear that it continues to assess the scope of other interest rate derivatives denominated in non-G4 currencies and that it can “add at any moment classes that were not previously declared to be subject to the clearing obligation”.

**Credit Derivatives**

Unlike the clearing of interest rate and foreign exchange derivatives, the market for credit derivatives is typically more bespoke and less standardised. As a consequence, there are fewer transaction types which satisfy the Criteria and therefore lend themselves to clearing. Nevertheless, given that the credit market represented circa $21 trillion in outstanding notional at the end of 2013, ESMA recognises the significance of the market and the priority need to try and clear such trades where possible. In particular, it proposed in the CD Consultation that the clearing obligation should be applied to trades referencing certain untranched indices, specifically the iTraxx Europe Main Index and the iTraxx Europe Crossover Index. Such trades should reference Series 11 of the relevant index onwards, have a 5 year maturity and settle in EUR. It remains to be seen how (if at all) these conclusions might be amended following publication of ESMA’s final report on the clearing of credit derivatives.

Foreign Exchange Derivatives

In the FX NDF Consultation, ESMA makes clear that it considers non-deliverable forward transactions (“NDFs”) to be cash-settled foreign exchange forward contracts. Such transactions will typically specify an exchange rate against the currency of delivery (the convertible currency⁶), a notional amount of the non-convertible currency and a settlement date. Given the cash-settled nature of these transactions, there is no physical delivery of the designated currency at maturity. Instead, at the time of settlement, spot market exchange rates are compared to forward rates and the trades are cash-settled on a net basis, in the convertible currency, based on the notional amount. Such NDFs are commonly referred to in the context of a particular currency-pair, such as Taiwan Dollar (TWD) / U.S. Dollar (USD) or Brazilian Real (BRL) / U.S. Dollar (USD).

Based on its analysis of the market and the required Criteria, ESMA has provisionally concluded that the following NDF currency pairs should be subject to a clearing obligation (assuming cash settlement in USD with a maturity range between 3 days and 2 years):

- Brazilian Real (BRL) / U.S. Dollar (USD)
- Chilean Peso (CLP) / U.S. Dollar (USD)
- Chinese Yuan (CNY) / U.S. Dollar (USD)
- Colombian Peso (COP) / U.S. Dollar (USD)
- Indonesian Rupiah (IDR) / U.S. Dollar (USD)
- Indian Rupee (INR) / U.S. Dollar (USD)
- Korean Won (KRW) / U.S. Dollar (USD)
- Malaysian Ringgit (MYR) / U.S. Dollar (USD)
- Philippine Peso (PHP) / U.S. Dollar (USD)
- Russian Ruble (RUB) / U.S. Dollar (USD)
- Taiwan Dollar (TWD) / U.S. Dollar (USD)

Categorisation of Market Participants

Given the details provided with respect to which transactions are likely to become clearable, the next question is when this is likely to happen? Since ESMA recognises that different counterparties are subject to different levels of readiness for central clearing, its preference is to operate a phased-in approach, whereby the largest and most active participants shall be required to centrally clear their derivatives trades first. Accordingly, it has opted to divide market counterparties into four categories as follows:

**Category 1 = Clearing Members.** ESMA regards that Clearing Members are the group of counterparties that should have to clear first, since they are the most active participants and they already have direct access to the CCPs to clear their derivatives.

⁶ This is typically USD.
Category 2 = Financial Counterparties or Alternative Investment Funds (“AIFs”) that are also Non-Financial Counterparties above the clearing threshold (“NFC+”), which:

- are not Clearing Members satisfying the Category 1 requirements; and
- have an aggregate month-end average notional amount of non-centrally cleared derivatives equal to or greater than, €8 billion.

Category 3 = Financial Counterparties or AIF’s that are also NFC+ entities, which:

- are not Clearing Members satisfying the Category 1 requirements; and
- do not have an aggregate month-end average notional amount of non-centrally cleared derivatives equal to or greater than, €8 billion.

Category 4 = All NFC+ entities which are not covered by Categories 1, 2 or 3.

It should be noted that these categories reflect the position as stated in the IRS Report, following ESMA’s analysis of the market’s response to its proposals. At present, the CD Consultation makes reference to the application of only three phase-in categories, as per the position in the initial IRS consultation (published in July 2014). We expect, however, that the phase in of credit derivative clearing will follow the approach described above (as is also the case for foreign exchange derivatives).

Considerations for Third-Country Entities

The categorisation of entities established in third-countries is exactly the same as it is for EU counterparties. This is because third-country entities are deemed to belong to the category of counterparty to which they would belong, if they were established in the Union. Essentially, a non-EU entity that is subject to the clearing obligation shall therefore be required to make the following determinations:

- If the relevant entity were ‘hypothetically’ established in the EU, would it be either a Financial Counterparty or an NFC+?

A large number of third-country entities, particularly those which trade derivatives with EU counterparties, have already been asked by such EU counterparties to consider their classification under EMIR, for example, in order for the EU counterparty to work out how often portfolios of non-cleared derivatives need to be reconciled. As a consequence, for many entities, this analysis may not be entirely new. However, entities looking at this for the first time will need to consider a variety of factors, including the nature of their business and the volume of derivatives trades that they enter into.

- Is the relevant entity a direct Clearing Member of a CCP authorised under EMIR?

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7 The clearing thresholds refer to thresholds above which EMIR requires that a Non-Financial Counterparty shall be subject to the clearing requirement. They are as follows: €1 billion in gross notional value for OTC credit derivative contracts, €1 billion in gross notional value for OTC equity derivatives, €3 billion in gross notional value for OTC interest rate derivatives, €3 billion in gross notional value for OTC foreign exchange derivatives, €3 billion in gross notional value for OTC commodity derivatives and €3 billion in gross notional value for OTC derivative contracts not otherwise specified. Once an entity breaches the clearing threshold for any one class of derivatives, it is required to centrally clear all classes of derivatives subject to the clearing obligation.

8 Morrison & Foerster has acted for a significant number of third-country entities in performing this analysis and would be happy to assist if this were required.
To fall into Category 1 for all classes of derivatives subject to the clearing obligation, an entity only needs to be a Clearing Member (of a CCP that is authorised under EMIR to clear such derivatives) for the purpose of clearing one of the classes of derivatives subject to the clearing obligation.

- If the relevant entity were established in the EU, would it be an Alternative Investment Fund (AIF) that qualifies as an NFC+?

An AIF is essentially a collective investment undertaking, including investment compartments thereof, which raises capital from a number of investors with a view to investing it in accordance with a defined investment policy for the benefit of those investors. Certain AIFs do not qualify as Financial Counterparties but still trade a high enough volume of OTC derivatives to fall above the clearing threshold for a particular asset class. As a consequence, this may push the relevant counterparty into either Category 2 or 3.

**Phase-In of Clearing Obligation**

Given the classification of an entity in accordance with the categorisation described above, the phase-in dates for when the clearing obligation comes into effect are as follows:

- Category 1: 6 months after the applicable RTS enters into force;
- Category 2: 12 months after the applicable RTS enters into force;
- Category 3: 18 months after the applicable RTS enters into force; and
- Category 4: 3 years after the IRS RTS enters into force.

**Counterparties in Two Different Categories**

Where a contract is entered into between two counterparties included in different categories, then the clearing obligation takes effect on the latest of the two dates. Therefore, in order to know when the clearing obligation will apply in respect of clearable trades entered into between two counterparties, each counterparty must know its own categorisation, as well as the categorisation of its counterparty.

**Frontloading**

Article 4(1)(b)(ii) of EMIR provides the primary frontloading obligation. This states that after a CCP has been authorised to clear a particular class of derivative, but before the actual clearing obligation applies to that class of derivatives (the "frontloading period"), all derivatives of that class that are entered into or novated during the frontloading period and have a certain minimum remaining maturity, must be cleared.

The main concern with this obligation from an operational perspective has been that market participants have had no certainty regarding whether or not (or when) a particular derivative that they are about to enter into will become clearable. As a consequence, this has led to enormous pricing difficulties (i.e., should it be priced as a cleared trade or not?). Since a cleared OTC trade has a different collateralisation and liability regime to an uncleared OTC trade, it needs to be priced differently.

ESMA was charged with developing regulatory technical standards in relation to the appropriate minimum

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9 The Category 4 phase-in for interest rate swaps is 3 years (or 36 months) from the date the IRS RTS comes into force. Given that the effectiveness of the NDS RTS will follow that date by around three months, there will be a progressive shortening for each future class of derivative to be cleared going forwards, thereby ensuring that the clearing obligation for all classes of derivatives is likely to be fully implemented within 3 years of the IRS RTS coming into force.
remaining maturity for contracts to be frontloaded, and in a letter from ESMA to the Commission dated May 8, 2014, ESMA explains that the frontloading period can be subdivided into two categories:

**Period A**: from the time a CCP is authorised by a competent authority to clear a class of derivatives (and such authorisation is notified to ESMA) and the date of publication in the Official Journal of the RTS relating to clearing that class; and

**Period B**: from the date of publication in the Official Journal of the RTS relating to clearing that class and the date of application of the clearing obligation.

Period A is deemed to be the time of greater concern to market participants, since at that stage, there is no clarity on whether the class of derivatives will be accepted for clearing. In Period B, however, the RTS has been finalised and counterparties will have a date for when the clearing obligation becomes effective (depending on their categorisation).

For Period A therefore, ESMA has recommended setting the minimum remaining maturity requirement very high, to ensure that effectively no trades entered into or novated during that period will need to be cleared. For Period B, however, ESMA has recommended a reasonably low level which ensures that only those trades close to expiry (e.g., within 6 months) when the RTS are published will not have to be cleared.

**Next Steps**

The IRS Report has now been submitted to the European Commission. The Commission has three months within which to adopt the draft RTS in the form of a Commission Regulation. Assuming that the RTS are adopted by the end of the three month period, this means that the first phase of Category 1 clearing obligations will become applicable in mid-2015.

The CD Consultation closed for comments on September 18, 2014. We await ESMA’s final report in this regard. The FX NDF Consultation remains open for comments until November 6, 2014. Once the consultation process for these asset classes has been completed, the technical standards applicable to credit and foreign exchange derivatives will be published in final form and submitted to the European Commission for endorsement. As above, the European Commission will have three months to make its endorsement.
Global derivatives regulation: tough going on the path forward

By Peter Green, partner at Morrison & Foerster in London

IT IS NOW over a year since the end of the original deadline set by the G20 leaders at their Pittsburgh summit in September 2009 for standardised derivative contracts to be traded on exchanges or electronic trading platforms where appropriate and to be cleared through central counterparties. An additional objective of international regulators has been to obtain greater transparency of the global derivatives market through reporting of derivative transactions to trade repositories.

We focus below on progress in the US and Europe. Not surprisingly, most of the implementation of the G20 objectives has been undertaken by regulators and legislators on a jurisdiction by jurisdiction basis although EU legislation has ensured a largely coordinated approach across the European economic area. Differences in approaches in adopting the G20 objectives have led to concerns as to potential overlap, mismatches or gaps between the various international rules and the risk of market participants being subject to multiple registration, licensing or reporting obligations in different jurisdictions or derivative transactions between parties in different jurisdictions being subject to contradictory requirements. The reforms could therefore result in increased costs, market distortions and the potential for regulatory arbitrage, some of the very concerns that the G20 objectives sought to address.

Overview of legislation in EU & US

In the US, regulatory reform in relation to derivatives has largely been effected under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which was enacted in July 2010. Following a significant amount of rule-making, guidance and no action letters by the US Commodity Futures Trading Commission, the obligations relating to clearing and exchange trading of many interest rate swaps and index credit default swaps are now in force and reporting obligations are in effect for swaps of numerous asset classes (the rulemakings of the Securities and Exchange Commission for “security-based swaps” are significantly less advanced than those of the CFTC). Implementation of the G20 objectives in the EEA has lagged somewhat behind the US. The clearing and reporting obligations are primarily contained in the European Market Infrastructure Regulation with the exchange trading obligations intended to be included in the Markets in Financial Instruments Regulation which has not yet been finalised. Although EMIR came into force in August 2012 and significant rulemaking has been undertaken by the European Securities and Markets Authority, ESMA is yet to make its necessary determination of the classes of derivatives to be subject to the clearing obligation. It is, however, expected to do so during 2014. In relation to transaction reporting, ESMA has now authorised six trade repositories and the reporting obligation came into force in the EEA for all major asset classes on February 12, 2014.

Both Dodd-Frank and EMIR have express extra territorial effect. Under EMIR, the clearing obligation applies to relevant OTC derivative contracts entered into between entities which are both established outside the EEA if there is a “direct, substantial and foreseeable effect” within the EEA. In the US, Title VII applies to activities outside the US that have a direct and significant connection with activities in, or effect on, commerce of the US.

The path forward

In July 2013, the European Commission and the CFTC announced an agreement, referred to as the “path forward”. It was acknowledged that subjecting market participants to simultaneous application of EMIR/ MiFIR and Title VII could lead to conflicts of law, inconsistencies and legal uncertainty. The statement set out an intention of regulators in the EU and US to seek to mitigate these effects and to seek to follow a territorial approach to the extent appropriate.

The two principal methods by which the extra territorial scope of the relevant legislation have sought to be managed in practice are through specific relief and guidance to the rules by relevant regulators and through a process of “substituted compliance” or “deemed equivalence” as described further below.

Relief and guidance

In November 2013, ESMA published a final draft of its regulatory technical standards relating to contracts having a direct, substantial and foreseeable effect within the EEA for the purpose of the EMIR clearing obligation and these have now been adopted by the European Commission. If at least one counterparty is located in a country outside the EEA that is determined to have rules equivalent to EMIR, EMIR can be disapplied through compliance with the other jurisdiction’s rules, even if the contract has effect in the EEA. Contracts between two entities outside the EEA will be regarded as having EEA effect if guaranteed by an EEA financial counterparty where the guaranteed obligations are above a specified amount. Also transactions between two EEA branches of non EEA entities will be regarded as having effect in the EEA.

In the US, in July 2013, the CFTC published final guidance in relation to the cross-border effect of Title VII to Dodd-Frank. It has also issued relevant staff advisory notices. One of the key issues is the definition of “US Person”. There are differences between the CFTC and SEC definitions in this regard, with market participants concerned, in particular, at the scope of the CFTC definition. Although the CFTC guidance provides that a person does not become a US Person solely by virtue of its obligations being guaranteed by a US affiliate, an entity benefiting from such a guarantee may still be regarded as a “guaranteed affiliate” or “affiliated conduit” for the purpose of the guidance and, in certain circumstances, subject to many of the CFTC’s transaction level requirements. Also, to the surprise of the market, in a
footnote to its final guidance, the CFTC stated that a US branch of a non-US swap dealer or major swap participant is subject to transaction level requirements of Title VII of Dodd-Frank without any possibility of substituted compliance. In a staff advisory (now subject to a request for public comment and temporary no-action relief), it also indicated that in relation to swaps arranged, negotiated or executed by personnel or agents of a non-US swap dealer located in the US, the location of the persons arranging or negotiating the swap was relevant for determining the applicability of certain transaction level requirements. This gives rise to the possibility of counterparties to a swap being subject to transaction level requirements, even if both are non-US and enter into a swap through non-US offices if one entity employs US based front office personnel or agents in relation to the swap.

Equivalence and substituted compliance

Certain provisions in EMIR, in particular the clearing obligation, contemplate the possibility of compliance with the relevant requirements in jurisdictions outside the EEA, subject to an EU Commission determination that the relevant jurisdiction has equivalent requirements to those in EMIR and that ESMA has established appropriate co-operation and information sharing arrangements with the competent authority in such jurisdiction and it has reciprocal arrangements in place with the EEA.

In September 2013 ESMA published advice to the European Commission that central counterparties in the US are subject to effective supervision and enforcement in the US and the US framework is equivalent to EMIR for the supervision of CCPs provided that the relevant CCP has adopted internal policies, procedures and rules, models and methodologies which are equivalent to those applying to CCPs authorised in accordance with EMIR, including in relation to 10 specified areas where ESMA believes that EEA CCPs are subject to more stringent requirements under EMIR. Significantly, in relation to trade repository reporting requirements, ESMA’s advice is that the US rules are not equivalent as they do not include a requirement to report specific data on valuation of exposures and collateralisation of exposures. The European Commission has not yet made a final determination based on ESMA’s advice.

In the US, the approach of the CFTC (and the SEC in its proposed rules) is to make “substituted compliance” determinations as to whether the requirements of a non-US jurisdiction are comparable with and as comprehensive as the relevant US rules and, where they are, allow market participants to comply with the foreign jurisdiction’s rules rather than the relevant US rules. On 20 December 2013, the CFTC made comparability determinations for various jurisdictions, including the EEA, Canada, Japan and Switzerland which covered various entity and transaction level requirements and largely permit substituted compliance for the specified requirements. Relevant entity level requirements include risk management and swap data recordkeeping. Transaction level requirements for which the CFTC made substituted compliance determinations in relation to the EEA include swap confirmation, swap portfolio reconciliation and compression, and certain elements of swap trading relationship documentation and daily trading records (the CFTC made more limited transaction-level substituted compliance determinations for Japan and none for any jurisdiction other than the EEA or Japan). Significantly, the CFTC has not yet made comparability determinations in relation to clearing, swap execution or real-time public reporting and substituted compliance is therefore not yet available in respect of these requirements.

Keeping the path clear?

The path forward statement was largely welcomed by market participants but subsequent action by EU and US regulators in seeking to achieve its stated aims has been regarded by many as inflexible, limited in scope, inconsistent with its objectives and having deference to the most rigorous relevant regime in relation to clearing obligations (with a “stricter rule applies” approach applying) – and there are concerns this principle could be applied in other areas. Whilst this may limit regulatory arbitrage opportunities, it could give rise to competitive disadvantages and increased costs for those firms operating across many jurisdictions which could in turn still lead to market fragmentation and loss of liquidity.

In December 2013 a number of industry groups including ISDA, SIFMA and the IIB filed a lawsuit in the US challenging the CFTC’s implementation of Title VII of Dodd-Frank and its cross border guidance arguing among other things that the CFTC failed to engage in the required cost-benefit analysis, failed to provide interested persons sufficient opportunity to participate in rule making and adopted a rule applicable to activities outside the US without a sufficient connection to the US. That lawsuit is pending.

In February 2014, the CFTC provided temporary no-action relief for MTFs regulated in the EU from the requirement to register with the CFTC as a swap execution facility. It also provided relief from parties executing swaps on MTFs from the trade execution requirement under the Commodity Exchange Act and for swap dealers and MSPs executing swap transactions on MTFs meeting specified conditions from certain requirements under the CFTC’s business conduct rules. At the same time the EU Commission and the CFTC released a statement affirming the path forward objectives but providing little further information. However, although the no-action relief was designed to deal with concerns raised by market participants, concerns have been raised that in practice the conditions necessary for the relief to apply may mean few MTFs seek to take advantage of it.

With the reporting requirements under EMIR having just become effective and the clearing obligation expected to be phased in during the course of 2014, the concerns of market participants as to some of the extraterritorial issues highlighted above are becoming more acute. There is therefore a growing urgency for the path forward objectives to be pursued with more vigour by regulators in the US and the EU and for a more flexible approach to be taken to equivalence and substituted compliance at least while the new rules bed down. Otherwise there is a risk of the reforms failing to meet their objectives and in some cases having a counterproductive effect.
Margin for Uncleared Swaps: A Critical Look at the CFTC and Prudential Regulators Proposals

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James E. Schwartz
Julian E. Hammar
Last fall both the Commodity Futures Trading Commission ("CFTC") and five U.S. prudential banking regulators1 (the "Prudential Regulators") released proposed rules for margin requirements for uncleared swap transactions for the entities subject to their regulation (the proposed rules of the CFTC, the "CFTC Proposal,"2 the proposed rules of the Prudential Regulators, the "Prudential Regulators Proposal,"3 and the proposed rules, collectively, the "Proposals"). The margin requirements, when finalized, will play a significant role in determining the economics of the post-Dodd-Frank uncleared swaps market, including the extent to which market participants may favor or disfavor uncleared swaps in comparison with other types of transactions. In a previous Client Alert, available here, we summarized the Proposals. In this Client Alert, we take a deeper look at the Proposals and highlight some of the many challenges that they would pose for market participants if implemented in their proposed form.

Both the CFTC5 and the Prudential Regulators6 released proposals for margin in 2011. Since that time, however, there has grown an international consensus around the policy framework for margin stated in a series of papers released by the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions, the last of which was published in September, 2013 (the "BCBS/IOSCO Framework").7 With some significant exceptions, which we note below, the Proposals are broadly consistent both with the BCBS/IOSCO Framework and with each other.

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1 The five prudential regulators include the Office of the Comptroller of the Currency, the Board of Governors of The Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Authority.
4 The CFTC Proposal refers to swaps that are not centrally cleared as "uncleared swaps," while the Prudential Regulators Proposal refers to such swaps as "non-cleared swaps." For consistency, we refer to them as "uncleared swaps."
7 Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, Margin requirements for non-centrally cleared derivatives (September 2013).
I. OVERVIEW OF PROPOSALS AND ISSUES ARISING FROM THEM

Although the Proposals by their terms apply directly to "covered swap entities" (each, a "CSE"), the measures that they would require of CSEs would significantly change the economics of the uncleared swaps market not only for CSEs, but also for many of their financial counterparties. Among other things, the Proposals would:

- require CSEs to bilaterally exchange initial margin with other CSEs and with a broad range of financial end users whose use of swaps met a notional amount-based threshold ("material swaps exposure"), all such initial margin to be segregated and not subject to rehypothecation or other use;
- require CSEs to exchange variation margin with CSEs and with a broad array of financial end users (without regard to the existence of material swaps exposure);
- permit the calculation of initial margin by means of either a model-based method or a table-based method;
- permit offsets in relation to either initial margin calculations or variation margin calculations when (among other things) the offsets related to swaps that were subject to the same "eligible master netting agreement";
- require the use of cash as variation margin; and
- provide for staggered compliance dates ending in 2019 for initial margin, and apply to swaps transacted prior to a relevant compliance date if such swaps were subject to the same eligible master netting agreement as swaps transacted after such compliance date.

Among the issues for market participants that arise under the Proposals are the following:

- The Proposals would set the definition of "material swaps exposure," the aggregate notional amount at which initial margin requirements would become effective for financial end users, considerably lower than that suggested by the BCBS/IOSCO Framework. As a result, U.S. parties to swaps may be disadvantaged in comparison with non-U.S. market participants. See Part II.A.2 below.
- Several of the provisions contained in the Proposals would require CSEs to aggregate notional amounts with their affiliates. The aggregation requirement would affect not only the key "material swaps exposure" definition, but also the definition of "initial margin threshold" (the amount of initial margin below which no transfer of initial margin is required), and the phase-in schedule for initial margin. Affiliation for these purposes would be defined to be as little as 25 percent ownership or control. Aggregation of notional amounts exposures across diverse entities would be difficult to accomplish and would likely require the implementation of new systems. See Parts II.A.2, II.A.3 and VI.A below.
- The manner in which initial margin is proposed to be calculated may lead to misleadingly high calculations. The Proposals would require calculations based on an assumed close-out period of 10 business days, an assumed period expressly intended to disfavor uncleared swaps, and more prolonged than the period that most closeouts of uncleared swaps actually require. Further, the

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8 The Prudential Regulators Proposal, if finalized, would apply to “covered swap entities” including swap dealers (each, an “SD”), major swap participants (each, an “MSP”), security-based swap dealers and major security-based swap participants, in each case that is regulated by one of the Prudential Regulators. Prudential Regulators Proposal at 57350. The CFTC Proposal, if finalized, would apply to SDs and MSPs for which there is no Prudential Regulator. CFTC Proposal at 59902. We refer to “covered swap entities” as “CSEs” unless the context requires differentiation between CSEs for purposes of the CFTC Proposal and CSEs for purposes of the Prudential Regulators Proposal, in which case we refer to the CSEs covered by the Prudential Regulators Proposal as “Prudential Regulator CSEs” and to the CSEs covered by the CFTC Proposal as “CFTC CSEs.”
Proposals restrict the nature of the offsets available in initial margin calculations by requiring each
swap to be placed in one category and not permitting offsets even of truly like exposures across
such categories. See Part II.B.1 below.

- The important definition of “eligible master netting agreement” contained in the Proposals, as well
as the Proposals’ requirement for custodial agreements for initial margin, would require CSEs to
meet a poorly defined, but apparently heavy, due diligence burden. See Part II.B.3 below.

- The Proposals’ requirement that variation margin be provided in the form of cash could help push
swaps market liquidity into other jurisdictions and require investment managers to liquidate
securities, thus causing tracking errors. See Part III.C below.

- The manner in which the Proposals may apply to pre-compliance date swaps would incentivize
parties to negotiate new master netting agreements for new swaps and, thus, could increase risk
rather than reduce it. See Part VI.B below.

II. INITIAL MARGIN REQUIREMENTS

Initial margin is intended to secure potential future exposure, that is, adverse changes in value that may
arise during the period of time when a swap or group of swaps is being closed out. Initial margin is to be
provided within one business day after a swap is transacted and is to augment the variation margin
securing the current mark-to-market value of a swap or set of swaps. Outside of areas notable for their
volatility (such as FX transactions, and especially exotic FX transactions), dealers have typically been
hesitant to seek to impose on clients of demonstrable creditworthiness requirements for financial
collateral beyond that reflecting current mark-to-market value. Under typical existing documentation for
uncleared swaps published by the International Swaps and Derivatives Association, Inc. (“ISDA”), a
requirement for collateral in excess of current mark-to-market value would likely be expressed as an
“Independent Amount.”

The Proposals, in a significant break from historical practices for uncleared swaps, but in accordance with
the BCBS/IOSCO Framework and clearinghouse practices for cleared swaps, would require CSEs to
both collect initial margin from and provide initial margin to many financial counterparties. Specifically,
the Proposals would require the exchange of initial margin when (i) the notional amount of the swaps of a
non-CSE financial counterparty and its affiliates reached a specified threshold (“material swaps
exposure”), (ii) the initial margin calculation for swaps between the parties and their affiliates exceeded a
separate threshold (the “initial margin threshold amount”), and (iii) a transfer was required with a value
exceeding a specified minimum transfer amount. The mathematical basis upon which the Proposals
would require CSEs to calculate initial margin is expressly intended to disfavor uncleared swaps. Unlike
Independent Amounts under the ISDA Credit Support Annex, which typically form part of a calculation of
a single value for which one party must provide collateral to the other, initial margin for each applicable
swap under the Proposals would be provided by each party to the other and segregated with an
unaffiliated custodian.

A. When Initial Margin is Required

Subject to an exposure threshold (the “initial margin threshold amount”) and a minimum transfer amount,
the CFTC Proposal would require each party to provide initial margin to the other party when the relevant
swap was between (i) a CFTC CSE, and (ii) either a CSE or a “financial end user” with “material swaps
exposure.”

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9 See, e.g., CFTC Proposal at 59901.
10 CFTC Proposed Rule 23.152; Prudential Regulators Proposed Rule ___.3(c).
11 See the preprinted form of Credit Support Annex, published in 1994 by ISDA (the “ISDA Credit Support Annex”), at paragraph 12
defining “Independent Amount”) and paragraph 3 (stating how Independent Amounts are to be used in calculations of collateral
required to be exchanged).
12 BCBS/IOSCO Framework at 4, 18-21.
13 See ISDA Credit Support Annex at paragraph 3.
exposure.” Similarly, subject to the same exposure threshold and minimum transfer amount, the Prudential Regulators Proposal would require each party to provide initial margin to the other party when the relevant swap or security-based swap was between (i) a Prudential Regulator CSE, and (ii) either a CSE or a “financial end user” with “material swaps exposure.” Accordingly, the only time when initial margin is not mandated is when a party to a swap with a CSE is either (i) an end user that is not a “financial end user” or (ii) a financial end user that does not have “material swaps exposure.”

1. Definition of “Financial End User”

The Proposals define “financial end user” as a party that is not a CSE, but which does fall within one of the 13 categories of entities engaged primarily in financial activities. The categories are virtually identical in the CFTC Proposal and the Prudential Regulators Proposal. While the definition makes for notably dense reading, the categories can be summarized as follows:

- a wide variety of banks and bank-like institutions, both domestic and foreign;
- an entity that is state-licensed or registered as a credit or lending entity (other than entities registered or licensed solely on account of financing the entity’s direct sales of goods or services to customers) or as a money services business;
- a securities holding company, broker or dealer, investment adviser or registered investment company;
- a private fund and certain investment company-like entities;
- a commodity pool, a commodity pool operator, a commodity trading advisor, or futures commission merchant;
- many employee benefit plans;
- an insurance company;
- an entity that is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in loans, securities, swaps, funds or other assets for resale or other disposition or otherwise trading in loans, securities, swaps, funds or other assets;
- a foreign entity that would constitute a financial end user if it were organized under the laws of the United States or any State thereof; and
- any other entity that a relevant regulator determines should be treated as a financial end user.

The “financial end user” definition expressly excludes from its scope sovereign entities, multilateral development banks and the Bank for International Settlements, and a subset of financial entities that engage in swaps to hedge or mitigate commercial risks.

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15 CFTC Proposed Rules 23.152 and 23.151 (definition of “Covered counterparty”).
16 Prudential Regulators Proposed Rule ___-3.
17 See discussion of non-financial end users below at Part IV.
19 See id.
20 Sovereign entities are defined in the Proposals as a central government (including the U.S. government) or an agency, department, ministry, or central bank of a central government. See CFTC Proposed Rule 23.151 (definition of “sovereign entity”); Prudential Regulators Proposed Rule ___-2 (definition of “sovereign entity”).
21 The Proposals define the term multilateral development bank as the International Bank for Reconstruction and Development, the Multilateral Investment Guarantee Agency, the International Finance Corporation, the Inter-American Development Bank, the Asian
2. Definition of “Material Swaps Exposure”

Under the Proposals, an entity has “material swaps exposure” when it and its affiliates have an average daily aggregate notional amount of uncleared swap products (including swaps, security-based swaps, foreign exchange forwards and foreign exchange swaps\(^{23}\)), calculated on business days falling in June, July and August of the previous year, that exceeds $3 billion.\(^{24}\)

The regulators’ proposed definition of “material swaps exposure” is proving controversial for several reasons. Equating materiality to an average aggregate notional amount of $3 billion is contrary to the BCBS/IOSCO Framework, which contains a far higher standard for materiality and, thus, would require initial margin for many fewer financial end users. In addition, market participants have expressed concern about the practicability of the requirement that exposure be measured at the corporate group level, across a party and its affiliates, especially in view of the Proposals’ unusually loose definition of “affiliate.” Further, it is not clear why the definition of material swaps exposure should take into account foreign exchange forwards and foreign exchange swaps, simple and often short-dated trades transacted in large quantities, which themselves are not subject to initial margin requirements.

a. Use of $3 Billion as Materiality Standard

The average notional amount that the regulators use to define materiality, $3 billion, is significantly lower than the average notional amount ($68 billion,\(^{25}\) or, at the time at which the Proposals were released, approximately $11 billion\(^{26}\)) by which the BCBS/IOSCO Framework defines materiality. The European regulators, in their draft regulatory technical standards pursuant to the European Market Infrastructure Regulation (the “EMIR RTS”), have also proposed to adopt the $8 billion threshold.\(^{27}\) The U.S. regulators' lower number, if adopted, would require many more financial end users to provide initial margin than would be the case under the BCBS/IOSCO Framework or the EMIR RTS.\(^{28}\)

\(^{23}\) For these purposes, “foreign exchange forward” is defined as a transaction that solely involves the exchange of two different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange, and “foreign exchange swap” is defined as a transaction that solely involves an exchange of two different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange and a reverse exchange of those two currencies at a later date and at a fixed rate that is agreed upon on the inception of the contract covering the exchange. See Commodity Exchange Act, 7 U.S.C. 1, et seq., at Section 1a(24) and 1a(25). See also CFTC Proposed Rule 23.151 (definition of “Foreign exchange forward and foreign exchange swap”); Prudential Regulator Proposed Rule ___2 (definition of “Foreign exchange forward and foreign exchange swap”). Because they settle by means of cross-exchanges of currencies rather than a single settlement payment from one party to another, foreign exchange forwards and foreign exchange swaps are also known as “physically settled” foreign exchange forwards and foreign exchange swaps.


\(^{25}\) BCBS/IOSCO Framework at 8, 24.

\(^{26}\) See CFTC Proposal at 59905. However, at current exchange rates $6 billion is equal to approximately $9 billion, not $11 billion. Both the initial margin threshold amount ($65 million in the Proposals and $50 million in the BCBS/IOSCO Framework) and the minimum transfer amount ($650,000 in the Proposals and $500,000 million in the BCBS/IOSCO Framework) are based on an assumed exchange rate of 1.30 U.S. dollars to 1 Euro. However, at current exchange rates, the dollar equivalents of the initial margin threshold amount and minimum transfer amount stated in the BCBS/IOSCO are significantly lower than $65 million and $650,000. In the Proposals, the regulators request comment on whether and how fluctuations resulting from exchange rate movements should be addressed. See CFTC Proposal at 59901; Prudential Regulator Proposal at 57353.


\(^{28}\) Another disparity between the approach of non-U.S. regulators and that of the CFTC and Prudential Regulators relates to the days on which the calculation for “materials swaps exposure” takes place. Under both of the Proposals, the existence of “material swaps exposure” is to be determined based on the average notional amounts calculated on business days falling in June, July and August of the previous year. See CFTC Proposed Rule 23.151 (definition of “Material swaps exposure”); Prudential Regulator Proposed Rule ____2 (definition of “Material swaps exposure”). In contrast, under the BCBS/IOSCO Framework, notional amounts
The CFTC and the Prudential Regulators explain the substantial disparity between $3 billion and $11 billion by reference to what they believe to be the intention of international regulators. They state that the intent of the BCBS/IOSCO Framework is to require collection of initial margin when the amount exceeds the initial margin threshold amount ($65 million in the Proposals); and, based on a review of data for cleared swaps, which the regulators deem to entail less risk than bilateral swaps, the regulators believe that there are many "cases in which a financial end user would have a material swaps exposure level below $11 billion but would have a swap portfolio with an initial margin collection amount that significantly exceeds the proposed permitted initial margin threshold amount of $65 million." The $3 billion number, multiplied by what the regulators claim to be the average initial margin rate in the cleared swaps market of 2.1 percent of gross notional amount, equals $63 million, just short of the proposed $65 million initial margin threshold. Accordingly, the U.S. regulators took the "preliminary view" that $3 billion is an appropriate threshold to determine when a financial end user's swaps exposure is material and should require the exchange of initial margin.

That the U.S. regulators have correctly ascertained the intent of the BCBS/IOSCO Framework is by no means clear. The BCBS/IOSCO Framework states both that (i) "[a]ll covered entities must exchange, on a bilateral basis, initial margin with a threshold not to exceed €50 million," and (ii) "there will be a minimum level of non-centrally cleared OTC derivatives activity (€8 billion in gross notional outstanding amounts) necessary for covered entities to be subject to initial margin requirements described in this paper." The framework does not appear to recognize any tension that might exist between these two statements, and indeed appears to state them as independent requirements. In fact, it seems plain that the BCBS/IOSCO Framework adopted the $65 million initial margin threshold amount to alleviate liquidity concerns arising from initial margin requirements, not to determine which parties should be subject to initial margin requirements.

In any event, many market participants see peril in the possibility of a $3 billion materiality threshold for initial margin. Some have noted that, if the U.S. regulators were to adopt a different standard for "material swaps exposure" than is adopted in other countries, U.S. companies and their affiliates could be hamstrung in comparison with companies with no ties to the U.S. Similarly, others view a common threshold for "material swaps exposure" as necessary for international harmonization, and warn that a disparity between U.S. and non-U.S. definitions could contribute to further swaps market fragmentation.

b. Aggregating Exposures Among Affiliates

The Proposals define "material swaps exposure" as the aggregate notional amount of swaps not only of a particular entity, but also of its affiliates. As a result, under the Proposals, in order to determine whether "material swaps exposure" exists, financial end users would be required to determine the overall notional amount of both their swaps and those of their affiliates. In this regard, the definition is aligned with both the BCBS/IOSCO Framework and the EMIR RTS.
However, market participants have expressed significant concerns regarding the potential necessity of aggregating their notional amounts with those of their affiliates. Calculations of aggregated swaps exposures could prove difficult for financial end users and their affiliates to implement and could require expensive new reporting and tracking systems. Further, requiring financial end users to aggregate transactions of their non-financial affiliates could potentially penalize financial end users with relatively little swaps trading activity.

The difficulties that enterprises might have in tracking notional amounts across entities would likely be exacerbated by the unusually low level of “control” that the Proposals would require for an affiliation to exist. The “control” necessary for a company to be an “affiliate” of another company is defined loosely, as (a) only 25 percent (not 50 percent or more) of the ownership or control, directly or indirectly, of (i) a class of voting securities or (ii) the total equity, directly or indirectly, or (b) control in any manner of the election of a majority of the directors or trustees of the company. This definition of “control” means that entities with relatively low levels of affiliation would, under the Proposals, be required to work together to determine the notional amounts of their swaps.

Implementing the aggregation of notional amounts across affiliates, as so defined, could pose particular difficulties in the context of investment vehicles and asset management. For example, a large institutional investor such as a pension plan might own more than 25 percent of an investment vehicle and, thus, be required to aggregate the positions of the investment vehicle with its own swaps to determine overall swaps exposure. Moreover, aggregation of all of an investor’s swaps appears to be incongruent with the typical practice, in the asset management context, of separating assets into different pools managed by different managers, with recourse of any counterparty limited to the particular assets in relation to which the manager has entered into a swap. Accordingly, some have argued, investment funds and certain other investment vehicles should be exempted from any aggregation requirement.

c. Inclusion of FX Transactions in Determination of “Material Swaps Exposure”

The notional amounts used to calculate whether a party has “material swaps exposure” include the notional amounts of simple foreign exchange transactions—foreign exchange forwards and foreign exchange swaps—that do not qualify as “swaps” for many purposes and for which no initial margin is required. The inclusion of such forwards and swaps in such calculation is in accordance with the BCBS/IOSCO Framework.

However, market participants have commented that requiring foreign exchange forwards and foreign exchange swaps to be aggregated for purposes of determining the existence of material swaps exposure would unduly increase costs for counterparties who use such products heavily, but use other derivatives only sparingly. It is not wholly clear why such products, which are often short-dated, and which do not themselves require any initial margin, should be aggregated for purposes of determining whether material swaps exposure exists.

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30 SIFMA letter at 7.
32 See CFTC Proposed Rule 23.151 (definitions of “Affiliate” and “Control”); Prudential Regulators Proposed Rule ___2 (definitions of “Affiliate” and “Control”).
33 See CIEBA Letter at 6; SIFMA letter at 7.
34 SIFMA Letter at 7.
35 SIFMA letter at 8.
36 See also ICI Letter at 9-10.
37 See note 23 above.
38 The Proposals do not contain margin requirements for foreign exchange forwards and foreign exchange swaps, in keeping with the Secretary of the Treasury’s determination to exempt such transactions from most provisions of the Commodity Exchange Act, including margin requirements. See Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 77 Fed. Reg. 69694 (November 20, 2012). See also Part III.D below.
39 BCBS/IOSCO Framework at 24.
41 See CIEBA Letter at 13.
3. Initial Margin Threshold Amount and Minimum Transfer Amount

The posting of initial margin is subject to an “initial margin threshold amount” of $65 million, which, in accordance with the BCBS/IOSCO Framework, is to apply on a consolidated entity level, across each party and its affiliates in respect of all uncleared swaps and security-based swaps. The initial margin threshold amount reduces any initial margin that is required to be posted by a party. If the initial margin requirement is less than the initial margin threshold amount, then there is no requirement to post initial margin.

The application of the threshold amount across each party and its affiliates raises similar concerns as does the aggregation of swaps exposures across affiliates for purposes of “material swaps exposure” (see Part II.A.2.b above). Especially in view of the low 25 percent requirement for affiliation, the application of the initial margin threshold amount across all affiliates would, in practice, likely prove difficult and costly to implement.

Under both Proposals a CSE is not required to collect or post any amount below the minimum transfer amount of USD $650,000.

B. Calculation of Initial Margin

Under both Proposals, a CSE must calculate the required amount of initial margin daily, on the basis of either a risk-based model or a table-based method. The regulatory requirements for risk-based models are significant.

In relation to risk-based models, market participants have noted several aspects of the calculation of initial margin in the Proposals that could prove disadvantageous or problematic. The Proposals would require models to calculate initial margin amounts on the basis of a 10-day close-out period, a hypothetical period that is expressly intended to disfavor uncleared transactions and is longer than the period that actual close-outs typically require under standard documentation for uncleared swaps. In addition, the Proposals would limit, arguably artificially, the extent to which initial margin models would be permitted to reflect offsetting exposures.

Of relevance to both risk-based models and the table-based method is the regulators’ definition of “eligible master netting agreement,” which would place an ill-defined, but potentially heavy, burden of due diligence on CSEs, who would be required to verify the treatment of netting agreements under all relevant insolvency regimes.

1. Risk-Based Model

The regulators’ requirements for risk-based models include the following.

   a. Ten Business Day Close-Out Period

Under both Proposals, a risk-based model used by a CSE would generally calculate initial margin based on the assumption of a “holding period” of 10 business days. This is the period for which the initial margin required by the Proposals would be intended to mitigate risk, which, in theory, at least, should correspond to the period when a swap or set of swaps is in the process of being closed out. The amount

50 See BCBS IOSCO Framework at 9.
51 See CFTC Proposed Rule 23.151 (definition of “Initial margin threshold amount”); Prudential Regulators Proposed Rule ___2 (definition of “Initial margin threshold amount”).
52 See CFTC Proposed Rule 23.154(a); Prudential Regulators Proposed Rule ___3(a).
53 SIFMA Letter at 7.
55 See CFTC Proposed Rule 23.154(a); Prudential Regulators Proposed Rule ___3 and Proposed Rule ___2 (definition of “Initial margin collection amount”).
56 CFTC Proposal at 23.154(b)(3)(i); Prudential Regulators Proposal at ___8(d)(1).
of initial margin would be calculated as an amount equal to an estimate, for that period, “of the one-tailed 99 percent confidence interval for an increase in the value... due to an instantaneous price shock that is equivalent to a movement in all material underlying risk factors, including prices, rates, and spreads."\(^{57}\) A model-based method would be required to use “risk factors sufficient to measure all material price risks inherent in the transactions for which initial margin is being calculated.”\(^{58}\) The data used to calibrate the model would be based on an equally weighted historical observation period of at least one year and not more than five years and would incorporate a period of significant financial stress for each broad asset class related to the relevant swaps.\(^{59}\)

The assumed length of the close-out period is of critical importance to the calculation of initial margin; the longer the assumed close-out period, the greater the initial margin amount. The regulators' proposed ten-business-day liquidation horizon, which is longer than the 10-day horizon (apparently calendar days, not business days) contemplated by the BCBS/IOSCO Framework,\(^{60}\) is expressly intended to disfavor uncleared swaps relative to cleared swaps. According to the CFTC Proposal, by requiring “ten day initial margins for uncleared swaps and only five day margin for cleared swaps,” the Proposals “make cleared swaps relatively more attractive.”\(^{61}\) This explanation, however, understates the extent of the regulators’ favoritism of cleared swaps. Many cleared swaps, namely those on agricultural commodities, energy commodities, and metals, are permitted minimum liquidation times of only one day.\(^{62}\) Further, for cleared swaps, market participants can request,\(^{63}\) and have requested,\(^{64}\) that assumed close out periods be reduced.

A ten-business-day close-out period, moreover, appears to be materially longer than the usual close-out period for most uncleared swaps. A typical close-out period under an ISDA Master Agreement, the most-used master netting agreement in the uncleared swaps market, might reasonably be expected to require approximately four to six business days, a period that takes into account of the cure period, typically of one or three business days,\(^{65}\) to cure a failure to pay or deliver, as well as the time required to deliver notices and value outstanding transactions. One CFTC Commissioner, in requesting a “considered analysis” of the effects of a ten-business-day period, stated that he was “troubled by recent press reports of remarks by unnamed Fed officials that the coverage period may be intentionally ‘punitive’ in order to move the majority of trades into a cleared environment.”\(^{66}\) Market participants have contended that the proposed ten-business-day liquidation time is too long for purposes of determining initial margin amounts, and should be shortened to closer to five days\(^{67}\) or even shorter.\(^{68}\)

b. Restrictions on Use of Offsets in Calculations of Initial Margin

The Proposals restrict the extent to which a risk-based model may reflect offsetting exposures that would reduce the required amount of initial margin. A risk-based model for initial margin would be permitted to recognize an offsetting exposure for a swap only in relation to another swap that falls within the same category, and not in relation to another swap that falls within another category.\(^{69}\)

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\(^{57}\) CFTC Proposal at 23.154(b)(3)(i); Prudential Regulators Proposal at ___8(d)(1).

\(^{58}\) CFTC Proposal at 23.154(b)(3)(iii); Prudential Regulators Proposal at ___8(d)(3).

\(^{59}\) CFTC Proposal at 23.154(b)(3)(ii); Prudential Regulators Proposal at ___8(d)(2).

\(^{60}\) BCBS/IOSCO Framework at 11.

\(^{61}\) CFTC Proposal at 59924.


\(^{63}\) See CFTC Rule 39.13(g)(2)(ii)(D).

\(^{64}\) See, e.g., letter to CFTC of Javelin SEF, LLC, dated December 3, 2014, requesting that the minimum liquidation time for certain interest rate swaps be shortened from five days to one day.

\(^{65}\) The 2002 version of the ISDA Master Agreement provides a one-business-day cure period for an event of default based on a failure to make a required payment or delivery. See ISDA 2002 Master Agreement at Section 5(a)(i). The 1992 version of the ISDA Master Agreement provides a three-business-day cure period for an event of default based on a failure to make a required payment or delivery. See ISDA Master Agreement (Multicurrency—Cross-Border) at Section 5(a)(i). The parties to such an agreement may agree to amend any applicable cure period.

\(^{66}\) CFTC Proposal at 59934-35 (Appendix 3—Statement of Commissioner J. Christopher Giancarlo).

\(^{67}\) SIFMA Letter at 28.

\(^{68}\) CIEBA Letter at 14.

\(^{69}\) CFTC Proposal at 23.154(b)(3)(v); Prudential Regulators Proposal at ___8(d)(5).
The categories of swaps within which offsets are permitted include agriculture, credit, energy, equity, foreign exchange/interest rate, metals, and other. Under the Proposals, even truly like exposures could not be offset across such categories. For example, CSEs would not be able to offset interest rate exposures arising from interest rate swaps against interest rate exposures arising either from the financing legs of equity swaps or the fixed rate side of credit default swaps. Although the regulators’ unwillingness to permit risk offsets across different asset classes is consistent with the BCBS/IOSCO Framework, some market participants have commented that broader risk offsets should be permitted if there is a sound basis and empirical support for them. For each party to an eligible master netting agreement, under the Proposals the overall amount of initial margin required would be calculated based on the sum of the initial margin amounts for swaps in each of the seven categories.

c. Regulatory Approvals and Required Internal Processes for Models

Each risk-based model used to calculate initial margin would be subject to regulatory approval. A CSE would be required to obtain the written approval of the relevant regulator in order to use a risk-based model to calculate initial margin, and to demonstrate, on an ongoing basis, that the model satisfies all of the regulators’ requirements. Before making any material change to its risk-based model or its assumptions, or extending the use of an approved initial margin model to any additional products, a CSE would be required to give 60 days’ prior notice to the relevant regulator. The relevant regulator could rescind its approval of any initial margin model, or impose additional conditions or requirements, if the regulator were to determine that the model was no longer fully compliant.

The Proposals would require each CSE to have a rigorous and well-defined process to re-evaluate and update its internal models to ensure continued applicability and relevance, and to review and, as necessary, revise the data used to calibrate the model at least monthly, or more often if warranted by market conditions. At least annually, each CSE would be required to review its model in light of developments in financial markets and modeling technologies, and to enhance the model as appropriate to ensure that it continues to meet the regulatory requirements. Each CSE’s risk control unit would be required to validate the CSE’s model prior to implementation and on an ongoing basis. The Proposals would require CSEs to notify the relevant regulator of any problems that their validation process might uncover, and to document all material aspects of their risk-based models.

2. Table-Based Method

In accordance with the BCBS/IOSCO Framework, under the Proposals, CSEs have the option to employ a table-based method for calculating initial margin rather than a risk-based model.

The Prudential Regulators state that Prudential Regulator CSEs should not choose between a risk-based model and the table-based method by “cherry picking” the approach that requires the lower initial margin level. Rather, they state, the choice of one method over the other “should be based on fundamental considerations,” and, absent a significant change in swap activities, they do not consider that it should be necessary for Prudential Regulator CSEs to switch between using a risk-based model and a table-based method.
method. The CFTC Proposal contains no such statement, but it does note the BCBS/IOSCO Framework’s statement that covered entities should not “cherry pick” between methods.

The tables forming the basis of the table-based method are included in the Proposals. The charts in the CFTC Proposal and the Prudential Regulators Proposal are aligned, with the initial margin requirements ranging from 1 percent of notional amount (for short-dated interest rate swaps and cross-currency swaps) to as high as 15 percent of notional amount (for commodity swaps, equity swaps, and swaps in the “other” category).

For multiple uncleared swaps subject to the same eligible master netting agreement, the initial margin amount is to be computed according to a formula that relies, in part, on the net current replacement cost of all relevant swaps and, thus, partially reflects the degree to which such uncleared swaps offset each other.

3. Eligible Master Netting Agreements

Both the formula employed in the table-based method and the approach of the risk-based model to reflect offsetting exposures require that offsets be reflected only for swaps that are subject to the same “qualifying master netting agreement.” This term is defined in a manner that would impose on CSEs a sketchily defined, but apparently heavy, burden of due diligence.

The Proposals define an “eligible master netting agreement” as a written, legally enforceable agreement, that, among other things:

- creates a single legal obligation for all individual transactions covered by the agreement upon an event of default, including an insolvency-related event of default;
- provides the CSE with the right to accelerate, terminate, and close out on a net basis all transactions under the agreement and to liquidate or set off collateral promptly upon an event of default of the counterparty, subject to applicable law relating to the close-out of transactions against banks and systemically important institutions;
- does not contain a “walkaway clause” permitting a non-defaulting counterparty to make a lower payment than it otherwise would make under the agreement, or no payment at all, to a defaulting party; and
- has been subject to sufficient legal review by the CSE (which is required to establish and maintain written procedures to ensure that the agreement continues to satisfy the regulators’ requirements) that the CSE may conclude with a well-founded basis that the agreement

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82 Prudential Regulators Proposal at 57378.
83 CFTC Proposal at 59900.
84 See CFTC Proposed Rule 23.154(c), and Prudential Regulators Proposed Rule ____8(a) (definition of “Initial margin collection amount” and Appendix A, Table A.
85 The formula is as follows:

**Standardized Initial Margin** = 0.4 × **Gross Initial Margin** + 0.6 × **NGR** × **Gross Initial Margin**

Where:

**Gross Initial Margin** = the sum of the notional value multiplied by the appropriate initial margin requirement percentage from the table contained in the Proposals for each uncleared swap subject to the relevant eligible master netting agreement; and

**NGR** = net-to-gross ratio, which compares (i) in the numerator, the net current replacement cost of the entire uncleared portfolio subject to an eligible master netting agreement with (ii) in the denominator, the gross current replacement cost of only swaps contained in the uncleared portfolio subject to an eligible master netting agreement that have a positive replacement cost.

See Prudential Regulators Proposal at 57377 and 57396 (Table A); CFTC Proposal at 59911-12 and Proposed Rule 23.154(c).
86 See CFTC Proposal at 59911 and note 82.
constitutes an eligible master netting agreement and, in the event of a legal challenge, including an insolvency-related proceeding, would be ruled to be legal, valid, binding, and enforceable under the law of the relevant jurisdictions. 87

It is the last of these requirements, the legal review with respect to enforceability, including insolvency, that has raised the most concern. In some cases it may not be wholly clear which jurisdictions are “relevant” for purposes of such legal review. 88 And then there is the further question of what type of legal review qualifies as “sufficient”; if a “sufficient legal review” in practice means obtaining an opinion of counsel, then the requirement could, in practice, adversely affect costs for dealers and, ultimately, for their counterparties. 89 Further questions would arise concerning the assumptions and qualifications that would be permissible in such opinions. Moreover, for certain counterparty types, such as ERISA funds, it may be impossible to obtain a strong opinion of counsel because the extent to which close-out netting applies to such counterparties may be unclear. 90 Rather than requiring a legal review of uncertain scope, some market participants have suggested, the regulators should require disclosure of insolvency-related risks, or require only that a reasonable basis exists to conclude that agreements will be enforceable. 91

C. Forms of Initial Margin

Unlike with variation margin (see discussion at Part III.C below), a wide variety of assets may be posted as initial margin. Indeed, the list of assets eligible to be posted as initial margin is more inclusive than has been the typical practice in the uncleared swaps market. Both Proposals would permit the following assets as initial margin:

- U.S. dollars, numerous other major currencies, and a currency in which payments under the relevant swap are required to be made;
- a security issued by, or unconditionally guaranteed by, the U.S. Department of the Treasury or another U.S. government agency whose obligations are fully guaranteed by the full faith and credit of the United States government;
- a publicly traded debt security issued by, or an asset-backed security fully guaranteed by, a U.S. Government-sponsored enterprise operating with direct financial assistance received from the U.S. government enabling the repayments of the U.S. Government-sponsored enterprise’s eligible securities;
- a security issued by, or fully guaranteed by, the European Central Bank or certain sovereign entities;
- a security issued by, or fully guaranteed by, the Bank for International Settlements, the International Monetary Fund, or a multilateral development bank;
- publicly traded common equity that is included in either (i) the S&P Composite 1500 Index or any other similar index of liquid and readily marketable equity securities as determined by the relevant regulator, or (ii) an index that a CSE’s supervisor in a foreign jurisdiction recognizes for purposes of initial margin; and
- gold. 92

However, initial margin may not consist of a security that is issued by (i) the party pledging the security of an affiliate of that party; or (ii) a bank holding company, a savings and loan holding company, a foreign

87 CFTC Proposed Rule 23.151(definition of “Eligible master netting agreement”) and Prudential Regulators Proposed Rule ___2 (definition of “Eligible master netting agreement”).
88 ICI Letter at 20.
89 SIFMA Letter at 19; ICI Letter at 20.
90 SIFMA Letter at 19.
91 SIFMA letter at 18-20.
92 CFTC Proposed Rule 23.156(a)(1); Prudential Regulators Proposed Rule ___6(a). The Prudential Regulators Proposal also includes a provision for publicly-traded debt, including a debt security by a U.S. Government-sponsored enterprise (“GSE”) (not otherwise covered by the GSE provision) that has adequate capacity to meet financial commitments (as defined by the appropriate Prudential Regulator) and is not an asset-backed security. See Prudential Regulators Proposal at 57371-72; ___6(a)(2)(vii)(A). The CFTC Proposal includes a provision for publicly-traded debt that has been deemed acceptable as initial margin by a Prudential Regulator. See CFTC Proposed Rule 23.156(a)(1)(ix).
bank, a depository institution, a market intermediary, a company that would be any of the foregoing if it were organized under the laws of the United States or any State, or an affiliate of any of the foregoing institutions.93

Initial margin is subject to proposed standardized haircuts ranging from zero (in the case of cash in the same currency as the related swap) to 25 percent (in the case of certain equities).94

D. Segregation of Initial Margin

Both Proposals require the segregation of initial margin. A CSE that posts or collects initial margin in relation to uncleared swaps must require that such margin be held by one or more custodians that are not affiliates of either the CSE or the counterparty.95 Under both Proposals, the relevant custodial agreement must prohibit the custodian from rehypotecating or otherwise transferring the initial margin held by it. However, a custody agreement may, if all relevant assets remain eligible as initial margin and of sufficient value, permit the posting party to substitute or direct any reinvestment of initial margin held by the custodian.96

The custodial agreement must be legal, valid, binding and enforceable under the laws of all relevant jurisdictions including in the event of bankruptcy, insolvency, or a similar proceeding.97 As with the definition of “eligible master netting agreement” (see Part II.B.3 above), this definition gives rise to concerns that it may be difficult to identify all relevant jurisdictions, that, in order to evidence fulfillment of this requirement, it may be necessary to obtain opinions of counsel, and that, if opinions of counsel are indeed required, the exact parameters of those opinions are unclear.98 In addition, the proposed requirement that custodians not be affiliated with either party also raises concerns for end users, which often have at least one custodian affiliated with a dealer,99 and particularly for pension plans, which often use their trustees, or affiliates of their trustees, as custodians.100

III. VARIATION MARGIN

A. Variation Margin Generally

Subject to the $650,000 minimum transfer amount, the CFTC Proposal would require one party to provide variation margin to the other party when the relevant swap is between (i) a CFTC CSE, and (ii) either a CSE or a financial end user.101 Similarly, subject to the same minimum transfer amount, the Prudential Regulators Proposal would require one party to provide variation margin to the other party when the relevant swap or security-based swap is between (i) a Prudential Regulator CSE, and (ii) either a CSE or a financial end user.102 Accordingly, the only time when variation margin is not mandated103 is when a party to a swap with a CSE is an end user that does not constitute a financial end user. In requiring variation margin for all financial end users, regardless of whether the entity has material swaps exposure, the Proposals are consistent with the BCBS/IOSCO Framework.104

The Proposals permit netting arrangements across swaps for purposes of calculating variation margin amounts only if the relevant swaps are subject to the same “eligible master netting agreement.”105 This raises concerns regarding the definition of such term noted in the discussion at Part II.B.3 above.

93 CFTC Proposed Rule 23.156(a)(2); Prudential Regulators Proposed Rule ____6(c).
94 CFTC Proposed Rule 23.156(a)(3); Prudential Regulators Proposed Rule ____6(b).
95 CFTC Proposed Rule 23.157(a) and (b); Prudential Regulators Proposed Rule ____7(a) and (b).
96 CFTC Proposed Rule 23.157(c); Prudential Regulators Proposed Rule ____7(c)(1) and (d).
97 CFTC Proposed Rule 23.157(c)(3); Prudential Regulators Proposed Rule ____7(c)(2).
98 SIFMA Letter at 19; CIEBA Letter at 10-11.
99 SIFMA Letter at 22.
100 CIEBA Letter at 8-9.
102 Prudential Regulators Proposed Rule ____4(a).
103 See discussion of non-financial end users at Part IV below.
104 BCBS/IOSCO Framework at 9.
105 CFTC Proposed Rule 23.153(c); Prudential Regulators Proposed Rule ____4(d).
B. Calculation of Variation Margin

The CFTC Proposal and the Prudential Regulators Proposal appear to differ from each other in the amounts that they would require to be exchanged as variation margin. It is not clear that this difference is intentional. In any case, there does not appear to exist a compelling reason for which variation margin amounts should differ for Prudential Regulator CSEs and CFTC CSEs.

Under the Prudential Regulators Proposal, variation margin is apparently to be measured from the standpoint of the CSE, that is, at the CSE’s side of the market: a CSE must calculate variation margin as an amount that is at least equal to the increase or decrease (as applicable) in the value to the CSE of the relevant swaps since the previous exchange of variation margin.106 This formulation, intentionally or not, echoes the ISDA Master Agreement’s definition of “Market Quotation,” which is intended to provide for calculations at one party’s side of the market, as the amount that would have the effect of preserving for such party the economic equivalent of a transaction.107 If the Prudential Regulators were to adopt this formulation in their final rulemaking, then counterparties of Prudential Regulator CSEs could be undercollateralized in the event of a Prudential Regulator CSE’s default, because they could be collateralized only at the Prudential Regulator CSE’s side of the market.

The CFTC’s formulation of the required amount of variation margin includes no such requirement, and provides little guidance as to whether, for purposes of variation margin, swaps are to be valued at one party’s side of the market or, in accordance with typical practice in the uncleared market,108 at mid-market. The CFTC would require a CFTC CSE to use a variation margin methodology and inputs that to the maximum extent practicable rely on recently-executed transactions, valuations provided by independent third parties, or other objective criteria, and to have alternative methods available in the event of the unavailability or other failure of any input required to value a swap.109 The CFTC Proposal also contains “control mechanisms” that would require CFTC CSEs to create and maintain documentation setting forth the variation margin methodology with sufficient specificity to allow the CFTC CSE’s counterparty and any applicable regulator to calculate a reasonable approximation of the margin requirement independently.110 CSEs would be required to evaluate the reliability of their data sources at least annually and to make adjustments as appropriate. The CFTC’s proposal also includes a provision authorizing the CFTC to require a CSE at any time to provide further data or analysis concerning the variation margin methodology or data source.111

C. Forms of Variation Margin

Under both Proposals, variation margin must be collected in cash, which may be denominated in U.S. dollars or in the currency in which payment obligations under the swap are required to be settled.112 Because variation margin payments are to be made in cash, the Proposals impose no haircuts on variation margin. The Proposals limit forms of variation margin far more strictly than do the BCBS/IOSCO Framework and the EU Margin RTS, which do not distinguish forms of initial and variation margin, and,

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106 Prudential Regulators Proposed Rule __.2 (definition of “Variation margin amount”). More specifically, under Prudential Regulators Proposed Rule __.2, the variation margin amount to be exchanged is equal to “the cumulative mark-to-market change in value to a covered swap entity of a non-cleared swap or non-cleared security-based swap, as measured from the date it is entered into (or, in the case of a non-cleared swap or non-cleared security-based swap that has a positive or negative value to a covered swap entity on the date it is entered into, such positive or negative value, plus any cumulative mark-to-market change in value to the covered swap entity of a non-cleared swap or non-cleared security-based swap after such date), less the value of all variation margin previously collected, plus the value of all variation margin previously paid with respect to such non-cleared swap or non-cleared security-based swap” (emphasis added).

107 See ISDA Master Agreement (Multicurrency—Cross-Border) at Section 14 (definition of “Market Quotation”); see also 2002 ISDA Master Agreement at Section 14 (defining “Close-out Amount,” in part, as an amount intended to provide one party with the economic equivalent of a transaction’s material terms).

108 See ISDA Credit Support Annex at Paragraphs 12 (definition of “Exposure”) and 3.


110 See CFTC Proposed Rule 23.155(b).

111 CFTC Proposed Rule 23.156(b); Prudential Regulators Proposed Rule __.6(a). Eligible variation margin “cash” does not include major currencies other than the U.S. dollar, as is the case for initial margin.
thus, contemplate that variation margin may be provided in a variety of highly liquid forms, including high
government or corporate bonds and equities in major stock indices.\textsuperscript{115}

The CFTC justifies restricting variation margin to cash based on its questionable understanding that swap
counterparties generally view exchanges of variation margin as “the daily settlement of their exposure(s) to
one another.”\textsuperscript{114} This justification appears to run contrary to the actual workings of the uncleared
swaps market, in which parties typically transfer highly liquid securities, such as U.S. Treasury
obligations, by way of security for their mark-to-market obligations to each other. The narrower scope of
variation margin in the U.S. could push swaps market liquidity away from the U.S. and into other
markets.\textsuperscript{115} Further, in the case of investment managers whose returns are based on staying fully
invested in securities, the requirement to post only cash as variation margin could require the liquidation
of investments, thus causing tracking errors, and in certain cases could even introduce currency basis
risk.

D. Treatment of Foreign Exchange Swaps and Forwards

By its terms, the BCBS/IOSCO Framework applies to all uncleared derivatives other than foreign
exchange forwards and foreign exchange swaps; with respect to such transactions, the BCBS/IOSCO
Framework states, variation margin standards should be addressed by national supervisors in a manner
consistent with BCBS supervisory guidance recommendations for these products.\textsuperscript{117}

One of the Prudential Regulators, the Board of Governors of The Federal Reserve System, has
implemented such BCBS supervisory guidance by means of a letter applicable to large financial
institutions subject to its supervision.\textsuperscript{118} That letter states its support of the principles contained in the
guidance and, thus, affirms that such institutions should, as stated in the supervisory guidance, exchange
“the full amount of variation margin necessary to fully collateralise the mark-to-market exposure on
physically settling FX swaps and forwards with counterparties that are financial institutions and
systemically important non-financial entities.”\textsuperscript{119}

IV. TREATMENT OF NON-FINANCIAL END USERS

The Proposals differ from each other somewhat in their treatment of non-financial end users.

Under the Prudential Regulators Proposal, a Prudential Regulator CSE would be required to collect from
non-financial end users both initial and variation margin at such times and in such forms and such
amounts, if any, that the relevant Prudential Regulator CSE might determine appropriately addressed the
credit risk posed by the relevant non-financial end user and its uncleared swaps.\textsuperscript{120} However, because of
recently adopted legislation, which provides that margin requirements will not apply to many non-financial
end users,\textsuperscript{121} it seems unlikely that this requirement will become part of the Prudential Regulators’ final
margin regulations.

The CFTC Proposal, unlike the Prudential Regulators Proposal, would require a CFTC CSE, for
transactions with nonfinancial entities with material swaps exposure to such CFTC CSE, each day to
calculate both initial and variation margin amounts, as if the non-financial end user were a CSE. As a risk

\textsuperscript{113} BCBS/IOSCO Framework at 16-17; EU Margin RTS at 32-34.
\textsuperscript{114} CFTC Proposal at 59913.
\textsuperscript{115} SIFMA Letter at 15.
\textsuperscript{116} SIFMA Letter at 16.
\textsuperscript{117} BCBS/IOSCO Framework at 6.
\textsuperscript{119} See SR letter 13–24 “Managing Foreign Exchange Settlement Risks for Physically Settled Transactions” (December 23, 2013) at
1; Basel Committee on Banking Supervision, Supervisory guidance for managing risks associated with the settlement of foreign
\textsuperscript{120} Prudential Regulators Proposed Rules __.3(d) and __.4(c).
management tool, such CFTC CSE would be required to compare such hypothetical amounts to any actual margin requirements for the relevant positions.  

V. DOCUMENTATION REQUIREMENTS

Each of the Prudential Regulators Proposal and the CFTC Proposal would require CSEs to enter into contractual documentation with counterparties containing provisions in accordance with the respective Proposals. The CFTC and the Prudential Regulators both would require documentation with counterparties providing for contractual rights and obligations to exchange margin. Both Proposals would require CSEs to enter into documentation, specifying how swaps would be valued for purposes of determining margin amounts, and how any valuation disputes would be resolved. In addition, the CFTC’s rule would require documentation between a CSE and a non-financial entity to state whether margin is required to be exchanged and, if so, the applicable thresholds below which margin is not required.

VI. IMPLEMENTATION

A. Timing

The Proposals are aligned with each other regarding compliance dates. CFTC Chairman Timothy Massad has recently been quoted as stating that the CFTC may postpone the implementation time frame.

The Proposals provide for different compliance dates for variation margin and initial margin. The compliance date for variation margin would be December 1, 2015 for all CSEs with respect to swaps with any financial end user counterparty.

The timing of the Proposals’ phase-in for initial margin, in contrast, would depend on the aggregate notional amount of the CSE and its affiliates, and the counterparty and its affiliates, of uncleared swaps, uncleared security-based swaps, foreign exchange forwards and foreign exchange swaps (“covered swaps”). Because the phase-in schedule would require market participants to aggregate their notional amounts with those of their affiliates, it appears to raise similar concerns as do the definitions of “material swaps exposure” and the initial margin threshold amount (see Parts II.A.2 and II.A.3 above). In addition, commenters have noted that because, under the proposed phase-in methodology, the timing of implementation would depend in part on the extent of a non-CSE’s swap trading, the Proposals appear to give CSEs a valid reason to gather information from non-CSEs as to the extent of their swaps trading, information that non-CSEs may not wish to share. Given the large number of master netting agreements that may need to be renegotiated or amended, the phase-in period, if not postponed, may not provide ample time, especially with respect to variation margin.

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122 CFTC Proposed Rules 23.154(a)(6) and 23.155(a)(3); CFTC Proposal at 59907.
123 CFTC Proposed Rule 23.158(a); Prudential Regulators Proposed Rule ___.10(a)(1).
124 CFTC Proposed Rule 23.158(b); Prudential Regulators Proposed Rule ___.10(a)(2).
125 CFTC Proposed Rule 23.158(a) and 23.158(b)(4) and (5).
127 CFTC Proposed Rule 23.159(a)(1); Prudential Regulators Proposed Rule ___.1(d)(1).
128 See CFTC Proposed Rule 23.159(a)(2)-(6); Prudential Regulators Proposed Rule ___.1(d)(2)-(6).
129 See CIEBA Letter at 15.
130 ICI Letter at 18; CIEBA Letter at 15.
The Proposals’ proposed compliance dates for initial margin are as follows:

<table>
<thead>
<tr>
<th>Compliance Date</th>
<th>Initial Margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 1, 2015</td>
<td>Initial margin where both the Covered Swap Entity combined with its affiliates and the counterparty combined with its affiliates have an average daily aggregate notional amount of covered swaps for June, July and August of 2015 that exceeds $4 trillion.</td>
</tr>
<tr>
<td>December 1, 2016</td>
<td>Initial margin where both the Covered Swap Entity combined with its affiliates and the counterparty combined with its affiliates have an average daily aggregate notional amount of covered swaps for June, July and August of 2016 that exceeds $3 trillion.</td>
</tr>
<tr>
<td>December 1, 2017</td>
<td>Initial margin where both the Covered Swap Entity combined with its affiliates and the counterparty combined with its affiliates have an average daily aggregate notional amount of covered swaps for June, July and August of 2017 that exceeds $2 trillion.</td>
</tr>
<tr>
<td>December 1, 2018</td>
<td>Initial margin where both the Covered Swap Entity combined with its affiliates and the counterparty combined with its affiliates have an average daily aggregate notional amount of covered swaps for June, July and August of 2018 that exceeds $1 trillion.</td>
</tr>
<tr>
<td>December 1, 2019</td>
<td>Initial margin for any other Covered Swap Entity with respect to covered swaps with any other counterparty.</td>
</tr>
</tbody>
</table>

**B. Scope of Swaps Subject to the Proposals When Implemented**

Under the Proposals, if a master netting agreement were to cover both swaps entered into after an applicable compliance date and swaps entered into before such compliance date, then the requirements of the Proposals with respect to both initial margin and variation margin would apply to all swaps subject to such agreement. In other words, a CSE would need to enter into a new master netting agreement in order to exclude pre-compliance date swaps from the margin rules.

The regulators state that, because of the possibility of excluding pre-compliance date swaps from margin calculations, margin requirements would not be applied retroactively and the unfair and disruptive effects of retroactive application of the margin rules would be avoided. However, market participants, in arguing that the margin rules should not apply to pre-compliance date swaps, have noted that creating an incentive for parties to divide their swap portfolios serves no apparent purpose and indeed could increase systemic risk.

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131 CFTC Proposed Rules 23.153(c) and 23.154(b)(2); Prudential Regulators Proposed Rules _____.4(d) and _____.8(b)(2).
132 Prudential Regulators Proposal at 57370.
133 See CFTC Proposal at 59902; Prudential Regulators Proposal at 57370.
134 SIFMA Letter at 21.
VII. CONCLUSION

Whatever one might think of the Proposals, surely they indicate the daunting complexity that regulators face in imposing margin requirements on uncleared swaps, to say nothing of the challenges of inter-jurisdictional harmonization. Looking at the big picture, absent major and unexpected changes, the Proposals, when finalized, will go a long way toward further de-risking one of the major markets blamed (rightly or wrongly) for exacerbating the financial crisis. One hopes that the U.S. regulators will determine that they can responsibly discharge their duties without imposing on U.S. market participants margin requirements exceeding those imposed by regulators in other jurisdictions—whether by means of the U.S. regulators’ definition of “material swaps exposure,” their unusually low bar for affiliation, or otherwise. Such deviations from the BCBS/IOSCO Framework would likely disadvantage U.S. market participants and further balkanize swaps trading activity.

AUTHORS

James E. Schwartz
New York
(212) 336-4327
JSchwartz@mofo.com

Julian E. Hammar
Washington, D.C.
(202) 887-1679
JHammar@mofo.com

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Relief for Covered Bonds as ESMA refines the Clearing Obligation

On August 16, 2012, the European Market Infrastructure Regulation (“EMIR”) came into force, defining the obligations of in-scope entities, amongst other things, to (1) centrally clear certain over the counter derivatives trades and (2) exchange collateral in respect of any trades that are considered unsuitable for clearing. Recitals 16 and 23 of EMIR, however, specify that European legislators recognise these requirements could potentially have a damaging effect on the functioning of the covered bond market. In particular, Recital 16 states that when preparing its technical rules on the applicability of the clearing obligation to particular classes of derivatives, the European Securities and Markets Authority (“ESMA”) should account for “the specific nature of OTC derivative contracts which are concluded with covered bond issuers or with cover pools for covered bonds”. As highlighted in a July 2013 discussion paper1 relating to the clearing obligation (the “Discussion Paper”), ESMA sees this, not as a requirement to provide a blanket exemption from centrally clearing all covered bond swaps but rather to take into consideration the specific nature of the aforementioned contracts.

Two years after EMIR came into force and, partly as a consequence of a rather lengthy authorisation process for Central Clearing Counterparties (“CCPs”), ESMA is only now beginning to define and clarify which trades it believes should be subject to the clearing obligation. On July 11, 2014, ESMA published two consultation papers2, each setting out its views and requesting market feedback, in respect of preparing regulatory technical standards (“RTS”) governing these issues in the context of (1) interest rate and (2) credit derivatives (the “Consultations”). Similar consultations in respect of other classes of derivatives are likely to be published in the future.

Within the Consultation focused on interest rate derivative products (the “IR Consultation”), ESMA sets out an analysis of the covered bond market and the specificities of covered bond derivatives. This client alert provides some background in respect of the covered bond derivatives market, considers ESMA’s analysis of the applicable clearing-related issues and sets out its conclusions as regards the regulatory status of derivatives entered into in connection with covered bonds.

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3 The RTS are being prepared in accordance with the requirement under Article 5(2) of EMIR, to specify information including which classes of OTC derivatives should be centrally cleared and the dates from which that obligation should take effect.
Covered Bond Derivatives

In the covered bond market, derivatives are used primarily to hedge exposures to underlying volatility in interest rates and foreign exchange. Such exposures might arise, for example, because of mismatches in the rate of interest being paid on (or currency of) the cover pool, as compared with the covered bonds themselves.

There are a number of unique features applicable to covered bond swaps which differ from more standardised trades, which potentially make them unsuitable for central clearing. In particular, covered bond derivatives are in most cases subject to one-way collateralisation, whereby the counterparty is required to post collateral, while the covered bond issuer is not. Indeed, in many cases, the cover pool may not comprise eligible collateral that could be posted to a CCP. Since the covered bond issuer's counterparty usually has a preferential claim on the cover pool and ranks pari passu with the covered bond holders, the need for it to receive collateral is ordinarily removed, on the basis that counterparty risk has already been mitigated.

Other non-standard features may also be present in covered bond swaps. These include circumstances where the notional principal amount adjusts on a periodic basis, such that it matches either the outstanding balance of the cover pool or the outstanding amount of a covered bond, over time (“balance guaranteed swaps”). Some covered bond swaps may also reference non-standard rates, such as the weighted average rate of mortgages contained in a particular cover pool. In addition, since covered bonds are rated, the ratings methodologies can often require the inclusion of ratings-linked thresholds and triggers, the disapplication of insolvency events and ratings-linked collateral volatility buffers.

To further complicate matters, the IR Consultation highlights the potential difficulty that CCPs might face in attempting to distinguish between the derivatives of the cover pool and those of the covered bond issuer. Covered bond derivatives are in most cases designed to survive the insolvency of the issuer. This means that if the issuer were to become insolvent, the source of payment would switch to the cover pool and the swaps would continue to mitigate interest rate and currency risks inherent in the covered bond structure. Indeed, this survival feature is usually mandated by applicable covered bond legislation. To the extent that a covered bond derivative was to be centrally cleared and the issuer was to become insolvent, the default rules of the CCP could result in an automatic close-out of the trade, in contravention of the survival requirement.

The Proposal

Each of the Consultations has been prepared on the basis of what EMIR describes as the ‘bottom-up’ approach. In other words, the classes of derivatives which are to be considered eligible for clearing are those which are currently already being cleared by CCPs that are authorised or recognised under EMIR. In respect of interest rate derivatives, these are proposed to include certain specified product types, such as fixed/ floating interest rate swaps, basis swaps, forward rate agreements, overnight index swaps and interest rate options. Each product type can then be further narrowed down and defined in accordance with specified characteristics, such as the settlement currency or floating reference rate, etc.

In respect of any of these types of derivatives which relate to covered bonds, ESMA accepts that (for reasons including those described in more detail above) in a number of cases, such transactions will not be suitable for clearing. However, it also believes that there may be certain trades which are standard enough to be captured by the interest rate classes identified in the IR Consultation.

In its July 2013 Discussion Paper, ESMA proposed two possible approaches to the central clearing of covered bond derivatives:

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Option A – Define a cover pool as a distinct category of counterparty under EMIR. This category could then be subject to a phase-in of the clearing obligation, therefore providing a temporary exemption in order to develop other solutions. This option garnered very little support from the covered bond industry, not least because of the inherent difficulties in defining the applicable cover pool category. ESMA has therefore confirmed in the IR Consultation that it shall not be taking this approach.

Option B – Consider that covered bond derivatives belong to separate classes of derivatives which should not be subject to the clearing obligation. ESMA generally favours this approach, subject to the applicable covered bond derivatives satisfying certain pre-determined conditions. These conditions are not dissimilar to those contained in the proposed RTS on risk-management techniques for non-centrally cleared derivatives (i.e., collateralisation of transactions)⁵ and are set out further below.

Covered Bond Exemption Conditions

The draft RTS contained in the IR Consultation proposes that OTC derivatives that are associated with covered bond programmes shall not be subject to the clearing requirement, provided that they satisfy the following conditions (each of which either identifies the transaction as a type which, as described above, is unsuitable for clearing, or supports the view that such transaction poses minimal systemic risk):

a) they must not be terminated in circumstances where the covered bond issuer is in default (i.e., the survival feature referred to above must be a component part of the transaction);

b) the derivative counterparty must rank at least pari passu with the covered bond holders;

c) the transactions must be registered in the cover pool of the covered bond programme and in accordance with national covered bond legislation;

d) they must only be used to hedge interest rate or currency mismatches vis-à-vis the cover pool;

e) the covered bond programme they are associated with must meet the requirements of Article 129 of Regulation (EC) No. 575/213 (which focuses on the capital treatment of covered bonds under the Capital Requirements Regulation); and

f) the covered bond programme they are associated with must be subject to a legal collateralisation requirement of at least 102%.

In our view, it is clear from the detail set out above that a number of issues remain to be determined. In particular, the requirement that transactions be registered in the cover pool of the covered bond programme requires further clarification. What exactly does ‘registered’ mean in this context? If, as in the case of the UK, there are formal legislative requirements to keep a record of each asset contained in the cover pool⁶, would the maintenance of such records be sufficient to constitute registration for this purpose? It remains questionable how the criteria can be satisfied in cases where there is no formal registration requirement. Moreover, does this requirement mean that the clearing exemption only applies to covered bonds issued in accordance with national covered bond legislation? If so, this will make it extremely difficult for structured covered bonds to be issued outside of a legislative framework and result in a stifling of innovation that should not be the objective of the legislation resulting from the IR Consultation.

Implementation

The IR Consultation remained open for comments until August 18, 2014 and a number of responses have now been published.

Following completion of the consultation and further discussions with the European System of Central Banks, in accordance with the procedure set forth in Article (5) of EMIR, the revised draft technical standards shall be submitted to the European Commission for endorsement.

Authors

Peter Green  
London  
44 (20) 79204013  
pgreen@mofo.com

Jeremy C. Jennings-Mares  
London  
44 (20) 79204072  
jjenningsmares@mofo.com

Lewis Lee  
London  
44 (20) 79204071  
lewislee@mofo.com

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New Law Limits the Swaps Pushout Requirement to Apply Only to Certain ABS Swaps

By Julian Hammar

On December 16, 2014, President Barack Obama limited the scope of swaps and security-based swaps subject to the Dodd-Frank Wall Street Reform and Consumer Protection Act’s (“Dodd-Frank Act’s”) pushout requirement to certain asset-backed security swaps when he signed into law the Consolidated and Further Continuing Appropriations Act, 2015. This Act contains an amendment to Section 716 of the Dodd-Frank Act, commonly known as the Lincoln Amendment, or the Swaps Pushout Rule (hereinafter, “Swaps Pushout Rule”). The new amendment also codifies the Federal Reserve Board’s rule that uninsured branches and agencies of foreign banks may receive the same exceptions as insured depository institutions (“IDIs”) from the pushout requirement. A redlined copy of the amendment is available here.

THE ORIGINAL SWAPS PUSHOUT RULE

The Swaps Pushout Rule generally prohibits “federal assistance” to “swaps entities,” defined as swap dealers, major swap participants, security-based swap dealers and major security-based swap participants, that are registered under the Commodity Exchange Act or the Securities Exchange Act of 1934. Federal assistance is defined in the rule to include certain advances from a Federal Reserve credit facility or discount window and Federal Deposit Insurance Corporation (“FDIC”) deposit insurance or guarantees. The Swaps Pushout Rule effectively requires banks that are swaps entities to push out certain swaps activities to a separately capitalized affiliate or cease the activities altogether, unless an exception applies.

Section 716 originally limited exemptions from the Swaps Pushout Rule to IDIs. The Federal Reserve Board issued an interim final rule in June 2013 that clarified that uninsured branches and agencies of foreign banks that were impacted by the prohibition are treated as IDIs for purposes of the Swaps Pushout Rule, including for purposes of the exemptions applicable to IDIs.

The Swaps Pushout Rule was to become effective on July 16, 2013, but many U.S. banks and uninsured U.S. branches of foreign banks were granted a transition period of two years pursuant to Section 716 to continue dealing in swaps otherwise subject to the Swaps Pushout Rule.

SCOPE OF THE ORIGINAL SWAPS PUSHOUT RULE

As originally enacted, the Swaps Pushout Rule required pushout of the following types of instruments, unless they were used to hedge or mitigate risk related to an IDI’s activities:

1 Senator Blanche Lincoln proposed the amendment to the Dodd-Frank Act.

2 The amendment is substantially the same as H.R. 992, the Swaps Regulatory Improvement Act, which passed in the House of Representatives in October 2013 by a vote of 292 to 122, but was not taken up by the Senate.

Uncleared credit default swaps (including swaps and security-based swaps referencing the credit risk of asset-backed securities);

Most equity swaps and total return swaps referencing equity or convertible debt; and

Swaps referencing most physical commodities, other than bullion metals, including swaps based on agricultural or energy commodities.

The original Swaps Pushout Rule contained an exception from the pushout requirement for certain types of swaps and security-based swaps. Prior to the amendment, IDIs were not required to push out:

Swaps or security-based swaps used to hedge or mitigate risk directly related to their activities;

Swaps involving rates or assets that are permissible for investment by a national bank, such as interest rate swaps, foreign exchange swaps, swaps referencing bullion metals and swaps referencing loans or bank eligible debt securities (including asset-backed securities);

Cleared credit default swaps; and

For IDIs granted an extension of the transition period contained in the law, swaps entered into before the end of the transition period.4

AMENDED SWAPS PUSH OUT RULE

Under Section 716 as amended, IDIs, as well as uninsured U.S. branches and agencies of foreign banks, that are swap dealers and security-based swap dealers (“covered depository institutions”), 5 will only be required to push out certain swaps based on an asset-backed security or a group or index primarily comprised of asset-backed securities, defined in the amendment as “structured finance swaps.”6 A covered depository institution may nonetheless enter into structured finance swaps under Section 716 as amended if:

They are undertaken for hedging or risk management purposes; or

Each asset-backed security underlying such structured finance swaps is of a credit quality and of a type or category with respect to which the Prudential Regulators have jointly adopted rules authorizing such swap activity.7

As amended, Section 716 eliminates from the pushout requirement most of the swaps that were subject to pushout under the original rule, other than certain structured finance swaps as described above. For covered depository institutions actively trading equity and commodity derivatives, the amendment is a welcome development since these instruments are

4 According to FDIC Vice Chairman Thomas M. Hoenig, these instruments, which are not subject to pushout, amount to almost 95% of IDIs’ derivatives activities. See Statement available at https://www.fdic.gov/news/news/speeches/spdec1014.html.

5 Section 716 provides that swap entities do not include IDIs that are major swap participants or major security-based swap participants. The amendment clarifies that this exception applies to uninsured U.S. branches and agencies of foreign banks. Thus, covered depository institutions are limited to swap dealers and security-based swap dealers.

6 Asset-backed security is defined by cross-referencing the definition of the term in Section 3(a) of the Securities Exchange Act of 1934.

7 The Prudential Regulators are the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the FDIC, the Farm Credit Administration, and the Federal Housing Finance Agency.
no longer subject to pushout. In some sense, though, the provision’s exemption giveth and taketh away. The amended rule does not, for example, require pushing out commodity swaps that had been subject to pushout under the original rule. However, swaps based on bank eligible asset-backed debt securities (permissible assets for national banks) may be required to be pushed out under the new rule (unless used for risk mitigation or the Prudential Regulators adopt applicable rules), despite not having been subject to pushout under the old rule.

In addition, unless or until the Prudential Regulators adopt the applicable rules permitting swaps based on asset-backed securities, it is unclear what the scope of the pushout will be. The amendment also does not change the transition period provided for in Section 716 for the pushout of instruments subject to the pushout requirement. For those covered depository institutions that received transition period relief, that period expires on July 16, 2015, although the Prudential Regulators may extend the transition period up to one additional year.  

Contact:

**Julian E. Hammar**  
(202) 887-1679  
jhammar@mofo.com  

**David H. Kaufman**  
(212) 468-8237  
dkaufman@mofo.com

**Barbara R. Mendelson**  
(212) 468-8118  
bmendelson@mofo.com

**Daniel A. Nathan**  
(202) 887-1687  
dnathan@mofo.com

**Anna T. Pinedo**  
(212) 468-8179  
apinedo@mofo.com

**Michael R. Sorrell, Jr.**  
(202) 887-8795  
msorrell@mofo.com

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8 The amendment makes one additional change with respect to swaps required to be pushed out. The original Swaps Pushout Rule permitted only IDIs to push out swaps to a swap entity affiliate that does not receive federal assistance, if the IDI were part of a bank holding company or savings and loan holding company supervised by the Federal Reserve Board, and the swap entity affiliate complied with certain requirements. The amendment revises this provision to apply to covered depository institutions, which may be part of a foreign banking organization (as defined under the Federal Reserve Board’s Regulation K, 12 C.F.R. 211.21(o)) in addition to a bank holding company or savings and loan holding company.