Introduction and Overview

• With almost six years having passed since the enactment of Dodd-Frank, the derivatives market is still grappling with the requirements of Title VII
  • Margin requirements not yet phased in – may change economics significantly
  • Timing differences between CFTC regulations (for swaps) and SEC regulations (for security-based swaps)
  • Differences, both in timing and in substance, between the U.S. regulations and foreign rules
Introduction and Overview

• Today we will discuss some recent regulatory developments connected to these themes:
  • Margin rules for uncleared swaps
  • Cross-border developments and their effects on U.S. counterparties
    • Status of U.S. cross-border rules
    • EU-U.S. “Common Approach” to CCPs
    • ISDA 2015 Universal Resolution Stay Protocol and related matters
  • Status of SEC rules for security-based swaps and what’s ahead
Background Regarding Margin

• Margin for uncleared swaps was not one of the derivatives markets reforms required by the 2009 Pittsburgh G-20 agreement.

• Dodd-Frank required regulators to draft rules requiring margin for bilateral swaps that will not be cleared at a clearinghouse (cleared swaps, in contrast, are subject to margin requirements imposed by clearinghouses and their members).

• Margin was added to the agreed G-20 reforms in 2011, when the G-20 requested the Basel Committee on Banking Supervision (BCBS) and International Organization of Securities Commissions (IOSCO) to develop, for consultation, consistent global standards for margin requirements.

• As with the other G-20 reforms, margin requirements, though mandated by international agreement, are being implemented at the level of individual jurisdictions.
Background Regarding Margin

• Margin is a significant economic issue that the swap market will need to address in accordance with rules that have only recently become final.
• Based on the BCBS/IOSCO framework, U.S. regulators have finalized rules for swaps that draw heavily on traditional margin practices in the futures market.
• Most significantly, the regulations will require many parties (though not commercial end-users) to provide initial margin, which is intended to account for potential future exposure -- 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, when required, will be segregated and not subject to rehypothecation or other use – a significant new cost for swap dealers and certain other financial entities.
• It remains to be seen how the market will respond to the margin requirements, and the extent to which products other than OTC swaps (for example, futures) may increasingly be used in place of OTC swaps.
Status of Margin Rules – U.S.

- Last October, the Prudential Regulators issued final rules for swap entities subject to their supervision (essentially swap dealers, major swap participants, security-based swap dealers and major security-based swap participants that are banks).
- In addition, last December, the CFTC adopted final rules to impose margin requirements on uncleared swaps entered into by swap dealers and major swap participants subject to CFTC regulation, referred to as “Covered Swap Entities” or “CSEs”.
- The CFTC also adopted an interim final rule to exclude from margin requirements most uncleared swaps that swap entities enter into with commercial end users, financial institutions with $10 billion or less in total assets, and certain other entities.
Status of Margin Rules – U.S. (cont.)

• Both sets of rules become effective on April 1, 2016, with a phased-in compliance schedule beginning in September 2016

• Even though the September date applies only to the largest institutions, it is not clear the market is going to be able to meet the stated timing
Overview of the Final U.S. Rules

• In general, the CFTC’s and Prudential Regulators’ Rules will:
  • Require swap entities, subject to a $50 million threshold, to bilaterally exchange “initial margin” with other swap entities and with a broad range of “financial end users” whose use of uncleared swaps meet a notional amount-based threshold (“material swaps exposure”), all such initial margin to be segregated with a custodian (not affiliated with either counterparty) and generally not subject to rehypothecation or other use by the custodian;
  • Permit the calculation of initial margin by means of either a model-based method or a table-based method;
Overview of the Final U.S. Rules

• Impose a significantly higher initial margin requirement on uncleared swaps as compared with cleared swaps by requiring that initial margin models use a 10 business day closeout horizon for most uncleared swaps as opposed to a 5 business day horizon for most cleared swaps in order to “incentivize clearing”; and

• Require swap entities to exchange “variation margin” with swap entities and with a broad range of financial end users (without regard to the existence of material swaps exposure) without any threshold
Scope of the Final U.S. Rules

• Under both sets of rules, a CSE will not be required to collect or post specified amounts of initial or variation margin for swaps with counterparties that are not Swap Entities or “financial end users” — essentially commercial end-users

• The final rules contains a “financial end user” definition that lists numerous types of entities, including banks, broker-dealers, investment companies, insurance companies, commodity pools and ERISA plans

• Expressly excluded from the financial end user definition are sovereign entities (central governments or an agency or department thereof) and multilateral development banks
Financial End Users with Material Swaps Exposure

- The threshold for determining whether a financial end user has “material swaps exposure” has been increased (as compared with previously proposed rules) under the CFTC’s and Prudential Regulators’ final rules from $3 billion to $8 billion of average daily aggregate notional amount of swaps activity over a 3-month period (determined by reference to the swaps activity of the financial end user and its affiliate(s))
- The higher number is aligned with the BCBS-IOSCO Framework
- This change will reduce the number of entities from which swap entities must post and collect initial margin
- It will also level the playing field between swap entities subject to U.S. rules and those subject to rules of foreign jurisdictions, such as the European Union and Japan, which have also followed the BCBS-IOSCO Framework
Eligible Collateral

- The CFTC’s and Prudential Regulators’ final rules also expand the types of eligible collateral for initial and variation margin in comparison with previous proposals.
- Under the final rules, eligible collateral types for Initial Margin include U.S. Treasuries, GSE securities, securities issued by BIS, ECB, IMF and MDBs, publicly traded debt (other than asset-backed securities), publicly-traded equities in certain indices and gold, but not securities issued by the pledgor or its affiliate or banks and similar entities.
Eligible Collateral

- Variation Margin may include major currencies (defined in the final rules) in addition to U.S. dollars and the currency of settlement.
- In addition, for swaps between a covered swap entity and a financial end user (but not for swaps between swap entities), the final rules permit non-cash collateral eligible to be used for initial margin to serve as variation margin.
- This change from previous proposals is significant for certain financial entities, such as insurance companies, that hold significant reserves of bonds and other securities and commented that the restriction to cash-only variation margin would reduce their investment returns.
Approval of Initial Margin Models

• Both sets of U.S. final rules impose stringent regulatory requirements on initial margin models, including:
  • Written approval of the relevant regulator for use of initial margin models,
  • Demonstration on an ongoing basis that the model satisfies all of the requirements under the rules, and
  • Prior notice to the relevant regulator before making changes to the model or its assumptions.
Eligible Master Netting Agreements (EMNAs)

- The CFTC’s and Prudential Regulators’ final rules permit counterparties to document pre- and post-compliance date swaps as separate portfolios for netting purposes under the same EMNA covered by separate credit support annexes.
- Accordingly, netting portfolios that contain only uncleared swaps entered before the applicable compliance date are not subject to the final rules.
- EMNAs, as under the previous proposals, are subject to a requirement that a swap entity conduct sufficient legal review to conclude with a well-founded basis that among other things, the contract would be found legal, binding, and enforceable under the law of the relevant jurisdiction.
- Although unqualified legal opinions are not required, the legal review must be in writing.
Phased-in Compliance

• The final rules adopt the delayed phase-in schedule announced by BCBS/IOSCO in March 2015, which delays the beginning of implementation of initial margin and variation margin requirements until September 1, 2016

• Variation margin:
  • scheduled phase-in on September 1, 2016 where both the covered swap entity combined with all its affiliates and its counterparty combined with all its affiliates have an average daily aggregate notional amount that exceeds $3 trillion
  • scheduled phase-in on March 1, 2017 for variation margin for any other covered swap entity with respect to covered swaps with any other counterparty

• Initial margin: phased-in implementation depending upon swaps average daily aggregate notional amounts of the covered swap entity and its affiliates, and its counterparties and their affiliates, starting from September 1, 2016 (for entities with the largest average daily aggregate notional amount) through September 1, 2020
Cross-Border Background

• Primary G-20 commitments in relation to swaps, other than margin, derive from the September 2009 meeting in Pittsburgh, at which the G-20 determined that:
  “All standardized OTC derivatives should be traded on exchanges […] cleared through central counterparties […] OTC derivatives contracts should be reported to trade repositories”

• As with margin, for clearing, exchange trading and reporting, the G-20 jurisdictions have been working on parallel, but not identical, reforms that generally resemble each other but differ in their details and timing

• 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 cross-border swaps?

• Also: whose rules should apply to market utilities, such as clearinghouses and trading facilities, who may provide services to clients in multiple jurisdictions?
EU-U.S. “Common Approach” to CCPs

- With respect to cleared swaps, there has been significant progress with respect to international harmonization.
- Last month, European Commissioner for Financial Stability, Financial Services and Capital Markets Union, Jonathan Hill, and CFTC Chairman Timothy Massad announced a “common approach” regarding requirements for central clearing counterparties (CCPs).
- The common approach to CCPs should help the cleared swaps market to be unfragmented over the longer run.
- The EU made positive “equivalence” decisions for the regulatory regimes of CCPs in Australia, Hong Kong, Japan and Singapore, Mexico, Canada, South Africa, Switzerland and the Republic of Korea before reaching the agreement with the U.S. on the “common approach.”
EU-U.S. “Common Approach” to CCPs

• The EU has postponed several times its deadline for the recognition of U.S. equivalence in respect of CCPs
• If the EU were to fail to recognize U.S. CCPs, there would come a parade of horribles:
  • U.S. CCPs would not constitute “Qualifying CCPs” for purposes of Basel III risk-weighting
  • European banks would 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
EU-U.S. “Common Approach” to CCPs

- Under the common approach, the European Commission intends to adopt in the near future an equivalence decision with respect to CFTC requirements for U.S. CCPs, which will allow the EU to recognize U.S. CCPs as soon as practicable.
- Once recognized by ESMA, U.S. CCPs will continue to provide services in the EU, while complying with CFTC requirements.
- With respect to the U.S. rules and substituted compliance, the CFTC staff will propose a determination of comparability with respect to EU requirements.
- This means that the CFTC will propose to find EU requirements comparable to its own and thus that compliance with those requirements will suffice for the CFTC’s purposes.
- This will permit EU CCPs to provide services to U.S. clearing members and clients while complying with certain corresponding EU requirements.
EU-U.S. “Common Approach” to CCPs

• The European Commission’s proposed determination of equivalence is based on the condition that CFTC-registered U.S. CCPs seeking recognition in the EU confirm that their internal rules and procedures ensure:
  • for clearing members' proprietary positions in exchange traded derivatives, the collection of initial margins that are sufficient to take into account a two day liquidation period;
  • that initial margin models include measures to mitigate the risk of procyclicality; and
  • the maintenance of 'cover 2' default resources, that is, enough loss absorption capacity to cover a simultaneous failure of a CCP’s two largest members
EU-U.S. “Common Approach” to CCPs

- These conditions will not apply with respect to U.S. agricultural commodity derivatives traded and cleared domestically within the U.S.
- This carve out is intended to recognize the nexus of these U.S. contracts with the U.S. economy, the importance of these contracts to U.S. farmers and ranchers and the low degree of systemic interconnectedness of these markets with the rest of the financial system.
- In addition, the European Commission will soon propose the adoption of an equivalence decision under EMIR to determine that U.S. trading venues are equivalent to regulated markets in the EU, providing a level playing field between EU and U.S. trading venues for the purposes of the MIFID I framework.
EU-U.S. “Common Approach” to CCPs

• Before an equivalence decision is adopted by the European Commission, Member State authorities must vote in the European Securities Committee.

• Once a decision is adopted, ESMA will proceed to complete the process for recognizing applicant U.S. CCPs, including the execution of a cooperation arrangement with the CFTC, providing for the ongoing sharing of information.

• During the recognition process, CFTC-registered U.S. CCPs will continue to benefit from any transitional relief under the Capital Requirements Regulation including any extensions that are granted.
EU-U.S. “Common Approach” to CCPs

• On the U.S. side, the CFTC staff will propose a determination of comparability, concluding that a majority of EU requirements are comparable to CFTC requirements
• This determination will provide a basis for both EU CCPs already registered with the CFTC as derivatives clearing organizations, and those seeking registration, to meet certain CFTC requirements by complying with the corresponding requirements as set forth in EMIR
• In addition, the CFTC staff will propose to streamline the registration process for EU CCPs wishing to register with it, reflecting these similar requirements
• This process will be completed within the same timeframe as the process for EU equivalence and recognition of CFTC-registered US CCPs
EU-U.S. “Common Approach” to CCPs

• The steps required to implement the common approach are expected to be put into place as soon as practicable and in a coordinated manner
• The EU recognizes that EU market participants may wish to use CFTC-registered U.S. CCPs to satisfy their upcoming central clearing obligations under EMIR
• The first phase of clearing obligations for certain interest rate derivative contracts is scheduled to take effect in Europe on June 21, 2016
• Market participants may continue to clear these contracts in non-recognized CFTC-registered US CCPs until that date
• The European Commission Services and the CFTC anticipate that CFTC registered CCPs will be in a position to be recognized by that date and the CFTC will work closely with ESMA to facilitate this process
EU-U.S. “Common Approach” to CCPs

- ESMA has recently consulted on the possibility for EU CCPs to apply an alternative standard for client margining
- This would allow EU CCPs to comply with standards similar to CFTC requirements regarding client margining
- Such a change would reduce the possibility for regulatory arbitrage across jurisdictions
Status of U.S. Cross-Border Rules

• CFTC issued cross-border “guidance” in July of 2013
  • Addresses which substantive rules apply to which swaps and which counterparties
  • “Guidance,” not rules, but generally treated as rules
• SEC has not yet issued comprehensive final rules or guidance
  • In general, the SEC is far behind the CFTC in finalizing and implementing its rules
  • The SEC has not yet finalized its proposed rules regarding which substantive rules apply to swaps involving which counterparties
  • However, the SEC has provided certain targeted cross-border rules
Status of U.S. Cross-Border Rules

• Particular rules regarding margin:
  • Prudential banking regulators have provided final rules regarding margin for cross-border transactions
    • Prudential regulators include the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency
    • Prudential regulators’ margin rules govern swap dealers that are banks subject to U.S. regulation
  • CFTC has proposed rules regarding margin for cross-border transactions but has not yet finalized them
  • No final SEC margin rules yet, or rules regarding the cross-border application of margin rules
CFTC Cross-Border Guidance

• Divides substantive CFTC regulatory requirements into “Transaction-Level” and “Entity-Level” requirements
• Entity-Level requirements include capital adequacy, chief compliance officer, risk management, and most swap data recordkeeping and swap data repository reporting
• In relation to Entity-Level Requirements, for non-U.S. swap dealers, the CFTC has generally shown broad deference (through substituted compliance determinations) to rules of other jurisdictions
• Transaction-Level Requirements consist of Category A Transaction-Level Requirements (which include clearing, trade execution, swap trading relationship documentation, and real-time public reporting) and Category B Transaction-Level Requirements (the CFTC’s external business conduct standards)
CFTC Cross-Border Guidance

• Transaction-Level requirements – like a continuum:
  • At one end of the spectrum, Transaction-Level requirements apply to swaps involving
    • a CFTC-registered swap dealer (whether or not a U.S. Person) acting through a U.S. branch or
    • a U.S. Person other than a swap dealer.
  • At the other end of the spectrum, Transaction-Level requirements do not apply (unless one party is a swap dealer acting through a U.S. branch or a U.S. Person) to swaps involving a party that is not a U.S. Person and not otherwise linked to the U.S. as a “guaranteed affiliate” or an “affiliate conduit”
  • With respect to swaps that do not fall at either end of the spectrum, such as swaps involving a CFTC-registered swap dealer acting through a non-U.S. branch, a substituted compliance determination is possible in relation to many Transaction-Level requirements
CFTC Cross-Border Guidance

- 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.
- In order for a market participant to comply with non-U.S. rules instead of U.S. rules, the relevant U.S. regulator must determine that the analogous foreign rules are sufficiently comprehensive and comparable to its own rules.
- Tension between a requirement-by-requirement approach to substituted compliance and a “holistic” or “outcome based approach.”
SEC Cross-Border Rules

• The SEC released proposed (and not yet finalized) rules regarding the cross-border application of its substantive rules in May, 2013
  • Although the details are different, there is a similar pattern, or continuum, as in the CFTC’s cross-border guidance
• In addition, in May, 2014, the SEC released final rules regarding which security-based swaps count toward the security-based swap dealer de minimis registration thresholds
  • Rules include definition of U.S. Person
• In February of this year, the SEC also recently released additional set of final rules clarifying that certain SBS arranged, negotiated or executed by personnel within the U.S. will count toward the de minimis thresholds
Harmonization and the CFTC’s Guidance

- 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.)

• 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 apply 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.)

- Another feature of the CFTC’s cross-border guidance 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 has 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.
Harmonization and the CFTC’s Guidance (cont.)

- 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.
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.)

- However, a series of no-action letters have granted relief, currently extended until September 30, 2016 (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 any 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”.
- Recent comments by CFTC Chairman Massad appear to indicate that the CFTC is determining how to amend the advisory.
CFTC Substituted Compliance Determinations

• CFTC has announced few substituted compliance determinations to date, and none since the end of 2013:
  • 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
Margin – Cross-Border Application

- Prudential Regulators’ final rules contain provisions governing the cross-border application of the margin rules, while the CFTC has proposed a separate rulemaking, not yet finalized, to address cross-border application.
- Prudential Regulators’ final rules exempt from margin requirements swaps between foreign swap entities (but not their U.S. branches or offices) and other non-U.S. entities (but not their U.S. offices or branches).
- Exemption is not available where either party’s obligations are guaranteed by a U.S. entity, a U.S. branch, or a foreign swap entity that is a subsidiary of a U.S. entity.
Margin – Cross-Border Application

• Substituted compliance (i.e., compliance with non-U.S. rules rather than U.S. rules) may be available for a foreign bank, U.S. branch or agency of a foreign bank, or an entity that is a foreign subsidiary of a depository institution

• Substituted compliance would not be available if the swap is guaranteed by a U.S. entity

• Substituted compliance is available only if the Prudential Regulators have made a comparability determination for the other jurisdiction whose rules would apply to the uncleared swap
Margin – Cross-Border Application

- CFTC’s proposed rules for cross-border application of margin rules contain intriguing disparities from the CFTC’s cross-border guidance
  - Increased scope for potential substituted compliance determinations
  - Narrowing definition of “U.S. Person”
  - Narrowing definition of “guarantee”

- These changes may indicate that the CFTC may be willing to step back from certain problematic aspects of its cross-border guidance
Margin – Cross-Border Application

- Increased scope for potential substituted compliance determinations
  - Under CFTC’s cross-border guidance, transactions between a non-U.S. dealer and a U.S. person are subject to the CFTC’s rules (although substituted compliance may apply to transactions between the non-U.S. dealer and the foreign branch of U.S. swap dealer)
  - However, under the proposed cross-border rules applicable to margin requirements, substituted compliance could apply to transactions between a non-U.S. swap dealer and most U.S. persons (other than U.S. swap dealers)
  - The CFTC is proposing to make element-by-element determinations as to comparability, and could make substituted compliance determinations for some, but not all, of a foreign jurisdiction’s margin requirements
Margin – Cross-Border Application

• Narrowed definition of “U.S. Person” for purposes of margin requirements
  • Deletion of “includes, but is not limited to” at beginning of definition
  • Provides greater legal certainty
  • Deletion of investment vehicles majority-owned by U.S. persons

• Narrowed definition of “guarantee”
  • Guarantee is defined specifically as an arrangement in which a party to a swap has a right of recourse against a U.S. person to receive or otherwise collect payments from the U.S. person in connection with the non-U.S. person counterparty’s payment obligations under the swap
  • Narrower definition than in cross-border guidance
ISDA Resolution Stay Protocols

- As of today, there are two such protocols:
  - ISDA 2014 Resolution Stay Protocol; and
  - ISDA 2015 Universal Resolution Stay Protocol
- Primary difference is scope of product coverage – the new “universal” protocol covers not only transactions under ISDA Master Agreements, but also securities financing transactions
  - “Securities financing transactions” include repurchase transactions and securities lending transactions
- New protocol supersedes previous one for parties who adhered to previous protocol
ISDA Resolution Stay Protocols

• Protocols are contractual solutions to questions relating to the cross-border application of special resolution regimes
• Protocols are intended to address issue of banks being “too big to fail” and to give regulators time to facilitate an orderly resolution of a troubled bank
• Regulations are widely expected to be proposed in the near future that will apply to a broader range of market participants requirements similar to those contained in the protocols
• Timing for proposed rules: supposed to be this quarter
• Proposed regulations are expected to require regulated institutions to include in their contracts with unregulated counterparties provisions similar to those contained in the protocols
• New regulations (like 2015 protocol) are expected to apply to derivatives, repurchase transactions and securities lending transactions – and may even be broader
ISDA Resolution Stay Protocols

- Both protocols were developed by a group of ISDA member institutions in coordination with the Financial Stability Board
- Address the fundamental concern is that a close-out of derivatives/repo/sec lending transactions by a large institution could destabilize markets and make resolution of the institution difficult
- Apart from the broader product coverage of the 2015 protocol, the substance of the two protocols is largely similar
ISDA Resolution Stay Protocols

• In the U.S., concerns are addressed by Title II of Dodd-Frank (“Orderly Liquidation Authority”), which imposes a limited stay on termination rights against U.S. banks.
• There are similar provisions in other countries to likewise restrict termination rights against banks.
• However, the cross-border application of such special resolution regimes is not wholly clear.
  • What if U.S. bank in resolution faces counterparty in another jurisdiction? Is counterparty bound by Dodd-Frank’s special resolution provisions?
  • Similarly, what if non-U.S. bank faces a counterparty in the U.S? Is U.S. counterparty bound by the bank’s home country resolution procedures?
ISDA 2015 Universal Resolution Stay Protocol

• Under both protocols, adhering parties opt into accepting the special resolution regimes that may apply to their counterparties
  • Such resolution regimes typically stay or override certain default rights that would otherwise arise when a bank enters into insolvency, resolution or similar proceedings
  • In addition, adhering parties opt into contractual stays on certain cross-default rights that would otherwise apply in the context of insolvency proceedings and that are similar to some of the types of stays contained in certain statutory resolution regimes
The Protocol was intended to apply only to the 21 largest banks and their affiliates.

As of this week, there are 210 adhering parties, mainly large banks and their affiliates.

Many market participants (e.g., fiduciaries such as asset managers) would have potential legal issues if they voluntarily gave up or agreed to delays in exercising their termination rights.
ISDA 2015 Universal Resolution Stay Protocol

• Accordingly, regulators will likely impose the contents of the protocol on many market participants by regulation in the near future, by means of requiring banks to add similar provisions to their trading agreements
• Such laws or regulations have already been proposed or adopted in many European countries
• ISDA has stated that it expects to release a protocol to facilitate compliance with the expected regulations
• There will likely be two different forms of the protocol, one for regulated entities and one for buy-side firms
ISDA 2015 Universal Resolution Stay Protocol

• Section 1 – Opt-in to Special Resolution Regimes

• Provides generally that if one adhering party is subject to a special resolution regime, then the other adhering party may exercise default rights under a “Covered Agreement” or related credit support arrangement only to the extent it would be able to do so under such special resolution regime

• Covered Agreements include both ISDA Master Agreements and numerous forms of repurchase and securities lending agreements

• Also provides that transfers of Covered Agreements and related credit support arrangements will be effective to the same extent as such a transfer would be effective under the relevant special resolution regime
ISDA 2015 Universal Resolution Stay Protocol

• Section 1 – Opt-in to Special Resolution Regimes

• Contains similar provisions that may apply if
  • an affiliate of an adhering party (not the adhering party itself) becomes subject to a special resolution regime or
  • a credit support arrangement runs to the benefit of an affiliate of a party to a Covered Agreement
ISDA 2015 Universal Resolution Stay Protocol

• Definition of “Special Resolution Regime” includes
  • identified resolution regimes of France, Germany, Japan, Switzerland, the UK and the U.S. and
  • “Protocol-eligible Regimes,” which are defined to include:
    • the resolution regimes of states that are members of the FSB (examples: Argentina, Russia and Saudi Arabia), but only if such resolution regimes incorporate certain protections for creditors
      • no discrimination based on nationality, location or domicile of creditors or jurisdiction where they may be paid
      • limitations on length and nature of stay that may restrict creditors’ rights; and
    • any other jurisdiction that is the jurisdiction of organization of the ultimate parent entity within a banking group that has been designated by the Financial Stability Board as a “global systemically important bank”
ISDA 2015 Universal Resolution Stay Protocol

• Section 2 – Limitation on Exercise of Default Rights in U.S. Insolvency Proceedings

• Restricts default rights that would otherwise arise if an affiliate of an adhering party, not the party itself, becomes subject to insolvency proceedings

• Intended to support a “single point of entry”-style resolution of a parent entity of a financial group, a resolution with only the top-tier parent company entering proceedings
Status of SEC Rules

• Few SEC rules are currently both technically in effect and operative
• SEC seems to want to take a less piecemeal approach than the CFTC has taken
• There is a contingent nature to the effectiveness of many rules
  • Many rules will go into effect when other rules are finalized or other events occur
  • Generally, to date, those conditions have not been met
• Broad no-action relief extends to February 2017
Status of SEC Rules

• Among the SEC rules that have been proposed but not yet finalized are the following:
  • Cross-border rules, including rules stating which substantive SEC requirements would apply to which security-based swap transactions and which market participants
  • Business conduct standards for security-based swap dealers and major security-based swap participants
  • Margin rules for uncleared swaps
  • Applications by security-based swap dealers and major security-based swap participants for statutorily disqualified associated persons to be involved in effecting security-based swaps
Status of SEC Rules

• Among the SEC rules that have been finalized are the following:
  • Registration process for security-based swap dealers and major security-based swap participants (most recent – released in August of last year)
  • Certain cross-border rules, relating to, among other things, which security-based swap transactions need to be counted toward the SBSD registration thresholds
  • Security–based swap data repository registration, duties and core principles
  • Reporting and Dissemination of security-based swap information
Status of SEC Rules

• SEC Chair Mary Jo White (speech on February 19):
  • “We will continue in 2016 to complete the remaining mandates. Of particular focus and priority will be to finalize the remaining security-based swap rules required of the SEC by Title VII of the Dodd-Frank Act, a goal supported by all of the Commissioners, so that the new regulatory regime can become operational… Next in line will be to finalize the substantive requirements for security-based swap dealers – in particular, the rules governing their business conduct and the requirements for their capital, margin, and asset segregation.”

• Commissioner Kara M. Stein (speech on February 19):
  • “I think the first order of business is to finish the remaining rules under Title VII of the Dodd-Frank Act of 2010. The security-based swap market is global, with counterparties located around the world… The large market remains largely unregulated until we complete our Title VII rules. We made some progress last year and earlier this year, with the adoption of the final rules regarding the registration of security-based swap dealers and major security-based swap participants. But, many rules remain outstanding… I look forward to the staff’s recommendations in all of these areas. Hopefully, we will have the final rules in place by this time next year.”
SEC Registration Rules for SBSDs

• The SEC’s final rules for the registration of security-based swap dealers (“SBSDs”) set out the formal requirements for SBSD registration

• The compliance date, when the SBSD registration requirement will go into effect, will occur only after the occurrence of several events that, taken together, have not yet occurred, cannot occur for a minimum of six months, and seem relatively unlikely to occur until after significantly more than six months have passed
SEC Registration Rules – Timing

• Specifically, the compliance date will occur on the later of:
  • six months after the date of publication in the Federal Register of a final rule release adopting rules establishing capital, margin and segregation requirements for SBSDs;
  • the compliance date of final rules establishing recordkeeping and reporting requirements for SBSDs;
  • the compliance date of final rules establishing business conduct requirements for SBSDs; or
  • the compliance date for final rules establishing a process for a registered SBSD to make an application to the SEC to allow an associated person who is subject to a statutory disqualification to effect or be involved in effecting security-based swaps on the SBSD’s behalf.
SEC Registration Rules – Timing

• Moreover, market participants are not required to register as SBSDs until after their security-based swap activity exceeds certain de minimis thresholds.

• For purposes of complying with registration requirements, entities engaging in security-based swaps activities are not required to begin calculating whether their activities meet or exceed such thresholds until two months prior to the compliance date of the Registration Rules.
Similar to the CFTC’s rules for the registration of Swap Dealers, the SEC Registration Rules provide for an application for conditional registration.

An applicant will be conditionally registered if it timely completes and submits:

- the primary application form applicable to it and
- a certification form

The SEC may deny or grant ongoing registration as a SBSD based on the applicant’s application.

The SEC will grant ongoing registration if it finds that applicable requirements are satisfied, and may institute proceedings to determine whether ongoing registration should be denied.

If information contained in an applicant’s registration materials becomes inaccurate, such applicant must correct such materials.
SEC Registration – Application Forms

• The Registration Rules provide that an applicant must file one of three primary forms as part of its application for registration.

• The forms are annexed to the Registration Rules and form part of the rulemaking. The three forms are:
  • Form SBSE, for entities that are neither registered or registering with the SEC as a broker-dealer nor registered or registering with the CFTC as a swap dealer or major swap participant;
  • Form SBSE-A, for entities that are not registered or registering with the SEC as a broker-dealer but that are registered or registering with the CFTC as a swap dealer or major swap participant; and
  • Form SBSE-BD, for entities that are registered or registering with the SEC as a broker or dealer.

• The SEC’s decision to use three different primary application forms is intended to recognize that, if an applicant is registered with the SEC or the CFTC, the SEC can obtain access to certain information regarding such applicant.
SEC Registration Rules – Certifications

• In addition to a primary application form, an applicant must file a Form SBSE-C, which, like the primary application forms, is annexed to the Registration Rules and forms part of the SEC’s rulemaking.
• Form SBSE-C contains two separate certifications, one by a senior officer of the applicant and the other by the applicant’s chief compliance officer or his or her designee.
SEC Registration Rules – Certifications

• A senior officer of the applicant must certify that such officer has:
  • after due inquiry, reasonably determined that the applicant has developed and implemented written policies and procedures reasonably designed to prevent violation of federal securities laws and the rules thereunder; and
  • documented the process by which he or she reached such determination.

• The term “senior officer” includes only the most senior executives in an organization, such as an applicant’s chief executive officer, chief financial officer, chief legal officer, chief compliance officer, president, or other person at a similar level.

• The development of the written policies and procedures referenced in this certification will likely be among the most time-consuming of the tasks required to register as an SBSD.
SEC Registration Rules – Certifications

- Further, the applicant must certify, by its chief compliance officer or his or her designee, that the applicant:
  - neither knows, nor in the exercise of reasonable care should have known, that any associated person who effects or is involved in effecting security-based swaps on its behalf is subject to a statutory disqualification, unless otherwise specifically provided by SEC rule, regulation or order; and
  - has performed background checks on all of its associated persons who are natural persons and who effect or are involved in effecting security-based swaps on its behalf.
SEC Registration Rules – Certifications

• The chief compliance officer, or his or her designee, must review and sign the questionnaire or application for employment executed by each associated person who is a natural person and who effects or is involved in effecting security based swaps on behalf of such applicant.

• Such questionnaire or application must serve as a basis for a background check of the associated person to verify that such person is not subject to statutory disqualification.
SEC Registration – Associated Persons

- With respect to non-natural persons, when an entity files an application to register as an SBSD, such entity may permit a non-natural person that is associated with such entity that is subject to statutory disqualification to effect or be involved in effecting security-based swaps on its behalf, provided that
  - the statutory disqualification(s) occurred prior to the compliance date of the Registration Rules, and
  - the entity identifies each such associated person on the applicable application form.

- When the SEC issued its final Registration Rules, it also voted to publish in the Federal Register proposed rules that would permit a SBSD to make an application to permit a statutorily disqualified person (including a natural person) to effect or be involved in effecting security-based swaps.
Questions?

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