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Cross-Border Derivatives Update

Teleconference

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12:00 PM – 1:30 PM EST

Presenters:

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1. **Presentation**

2. **Morrison & Foerster Client Alert – "CFTC Issues Cross-Border Proposal"**

3. **Morrison & Foerster Client Alert – "CFTC Releases Its Final Staff Report on the Swap Dealer *De Minimis* Exception"**

4. **International Financial Law Review – "A Step Closer"**

5. **International Financial Law Review – "Setting the Scene"**

6. **Futures and Derivatives Law Report, Volume 36, Issue 8 – "The Federal Reserve's Proposed Rules for Financial Contracts of Global Systemically Important Banking Organizations and ISDA's Resolution Stay Jurisdictional Modular Protocol"**

7. **Morrison & Foerster Client Alert – "CFTC Issues Final Rules Regarding the Cross-Border Application of its Uncleared Swaps Margin Requirements"**

8. **Morrison & Foerster Client Alert – "SEC Adopts Rule Amendments Addressing Dealing Transactions Between Non-U.S. Persons that are 'Arranged, Negotiated, or Executed' in the United States"**

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Cross-Border Derivatives Update

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Topics to be Covered

- Topics will include the:
  - overall state of play with respect to the treatment of cross-border transactions and the prospects (and need) for further substituted compliance determinations;
  - CFTC's and prudential regulators' treatment of margin in the cross-border context, including in the context of the EU margin rules;
  - CFTC's proposal regarding the cross-border application of registration thresholds and external business conduct standards;
  - SEC's rules relating to cross-border matters; and
  - Fed's and other banking regulators' proposed rules regarding the application of special resolution regimes

Overall State of Play

- More than six years after the enactment of Dodd-Frank, it is still not clear in many cases how exactly regulatory requirements apply to cross-border transactions
- The swap market grew up with very little regulation, so that market participants in numerous jurisdictions could transact with each other, usually without material concern regarding regulation in any particular jurisdiction
- If you were transacting in New York, it did not matter much whether your counterparty was down the street, in London or in Tokyo
- However, starting with a G-20 agreement in 2009, the international community determined to move toward regulation of the swap market

- G-20 agreements provide in general terms for the heart of the Dodd-Frank reforms, including in relation to clearing, trade execution, reporting and margin
- As CFTC Commissioner J. Christopher Giancarlo has noted, the G-20 agreement included a commitment "to take action at the national and international level to raise standards together so that our national authorities implement global standards consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism, and regulatory arbitrage."
- While G-20 agreements have stated in general terms the reforms to be undertaken, those agreements have not prevented different jurisdictions from arriving at materially different rules

- Even in the case of margin -- in connection with which BCBS/IOSCO expended considerable time and resources developing a detailed framework to guide jurisdictions in formulating their margin rules -- there are material differences between the rules of different jurisdictions
- This matters because differing rules in different jurisdictions figure to act as a long-term burden on the cross-border swap market

- The existence of different rules in jurisdictions poses a basic question: when counterparties located in different jurisdictions transact with each other, which jurisdiction's rules apply to their transaction?
- For example: U.S. swap dealer acting through its New York office transacts with German swap dealer acting through its Frankfurt office.
- Do U.S. rules apply, or do EU rules apply?
- Although regulators in numerous jurisdictions have certainly made progress with their own regulations in recent years, they have arguably made markedly less progress in agreeing how their rules will apply in the cross-border context

- The U.S. regulatory scheme – of not only the CFTC but also of the SEC and, in connection with margin, the prudential banking regulators – essentially classifies transactions into three different types:
  - transactions in which U.S. regulatory agencies have a sufficiently great regulatory interest that, from their perspective, U.S. rules must apply
  - transactions in which U.S. regulatory agencies have sufficiently little regulatory interest that, from their perspective, U.S. rules need not apply
  - transactions that fall somewhere in the middle of the spectrum, to which, from the perspective of U.S. regulators, either U.S. rules or non-U.S. rules may apply, so long as the relevant U.S. regulator has determined the relevant non-U.S. rules to be materially comparable to the relevant non U.S. rules by means of a "substituted compliance" or "comparability" determination

- There are a number of potential and practical issues with these classifications
- In relation to certain transactions, the U.S. regulators have staked their claim that the U.S. rules must apply, but non-U.S. regulators are similarly taking the view that their rules must apply
  - Unless the U.S. and the non-U.S. rules are identical or virtually identical, the applicability of two different sets of rules to the same transaction could be a significant issue for the parties to such a transaction and, by extension, for the swaps market as a whole.
- In addition, as a practical matter, to date, the U.S. regulators have made relatively few substituted compliance determinations
- Finally, even where U.S. regulatory authorities have made substituted compliance determinations, or at least, have contemplated them, the method for making such determinations may appear to be overly focused on the details of the non-U.S. rules, which may be a recipe for partial or confusing determinations

- In thinking about the cross-border regulation of derivatives, one must consider a changed and uncertain political context
- Difficult to know how the Trump administration will approach these matters, but, based on the Republican proposal to substantially amend Dodd-Frank, it seems a good bet that an emphasis going forward will be on more expeditious substituted compliance determinations and greater harmonization of different rule sets
- It appears that such an emphasis would be consistent with the views of Commissioner Giancarlo, who is reportedly the frontrunner to become the next Chairman of the CFTC

Brexit: Additional Cross-Border Complexity?

- In a speech this week in London, CFTC Chairman Massad mentioned additional complications that could arise from Brexit
- Chairman Massad noted that it has been reported that the U.K. plans to repeal the European Union financial regulation rules and then adopt equivalent measures as UK law
- That would mean that the UK would continue to have laws and regulations equivalent to those in the EU

- However, complexities could still arise
  - With respect to clearinghouse recognition, under current law, the process for deciding whether to grant equivalence would not start until after the UK exits
  - As a result, there would need to be a change in the process to avoid a gap between exit and recognition
  - Negotiators will apparently be faced with whether they can agree to a process or relationship for the post-Brexit world during the actual exit negotiations
  - In addition, if the EU determined to move the clearing of euro-denominated products from London to continental Europe, that would be a further issue, and could also call into question the clearing of such products in the U.S.

Financial CHOICE Act of 2016

- This is the name of the Republican bill intended to substantially revise Dodd-Frank, which passed the House of Representatives Financial Services Committee in September of last year
- Still at an early stage but, if enacted, would institute major changes to Dodd-Frank:
  - so-called "off-ramp" for certain banking institutions deemed to be well capitalized and well managed, exempting them from many Dodd-Frank capital and liquidity requirements;
  - abolition of Volcker Rule; and
  - elimination of orderly liquidation authority for financial companies contained in Title II of Dodd-Frank
- Interestingly though, with respect to substantive derivatives regulation, the Act's most significant provision concerns cross-border matters

- This seems to indicate that the Republicans do not have much interest in rolling back the substantive requirements of Title VII of Dodd-Frank
- Section 468 of the Act would require the CFTC to issue a cross-border rule addressing
  - the nature of the connections to the U.S. that require a non-U.S. person to register as a swap dealer or a major swap participant;
  - which of the U.S. swaps requirements apply to the swap activities of non-U.S. persons and U.S. persons and their branches, agencies, subsidiaries, and affiliates outside of the U.S., and the extent to which the requirements apply; and
  - the circumstances under which a U.S. person or non-U.S. person in compliance with the swaps regulatory requirements of a foreign jurisdiction will be exempt from U.S. swaps requirements

- Section 468 of the Act would also require the CFTC to establish criteria for determining that one or more categories of the swaps regulatory requirements of a foreign jurisdiction are comparable to and as comprehensive as United States swaps requirements
- In that rule, the CFTC would be required to
  - provide that any non-U.S. person or any transaction between two non-U.S. persons shall be exempt from U.S. swaps requirements if the person or transaction is in compliance with the swaps regulatory requirements of a foreign jurisdiction which the CFTC has determined to be comparable to and as comprehensive as U.S. swaps requirements; and
  - set forth the circumstances in which a U.S. person or a transaction between a U.S. person and a non-U.S. person will be exempt from U.S. swaps requirements if the person or transaction is in compliance with the swaps regulatory requirements of a foreign jurisdiction which the CFTC has determined to be comparable to and as comprehensive as U.S. swaps requirements.

- Section 468 of the Act would also require the CFTC to establish criteria for determining that one or more categories of the swaps regulatory requirements of a foreign jurisdiction are comparable to and as comprehensive as United States swaps requirements
- In developing and applying the criteria, the CFTC would be required to emphasize the results and outcomes of, rather than the design and construction of, foreign swaps regulatory requirements
- The rule could not take into account, for purposes of determining the applicability of U.S. swaps requirements, the location of personnel that arrange, negotiate, or execute swaps
- Beginning 18 months after the Act's enactment, any of the eight largest jurisdictions (by notional amount, calculated over a 12-month period) for which the CFTC had not examined for comparability would be deemed to have rules comparable to and as comprehensive as the U.S. swaps requirements

- Provisions similar to those contained in Section 468 of the CHOICE Act are also contained in H.R. 238, the Commodity End-User Relief Act
- H.R. 238, among other things, also provides for CFTC re-authorization
- The House's consideration of the bill could occur as early as this week.

Margin – Cross-Border Issues

- The difficulty of cross-border questions is arising now in connection with margin
- A big date will be March 1 of this year
- That is scheduled to be the compliance date for variation margin requirements under the rules of both the prudential banking regulators and the CFTC for all but the very largest financial institutions (for which variation margin has already gone into effect)
- In addition, that is scheduled to be the general compliance date for variation margin under the EU's margin rules
- In part because of cross-border issues, market participants are currently scrambling to be in a position to comply with margin requirements by March 1
- Possible the March 1 date may be pushed back

- The current situation with margin seems to show, in high relief, some of the difficulties that may occur when more than one regulator, each claiming jurisdiction over the same transactions or parties, attempts to phase in complex regulations
  - Differing rules
  - Confusion over how to apply differing rules
  - Confusion over how to amend contractual arrangements in order to comply with differing rules

- The U.S. margin rules and EU margin rules differ in significant respects
- FX swaps are subject to variation margin requirements under the EU rules but not under the U.S. rules
- The situation with FX forwards is similar
  - The EU is working toward a definition to distinguish FX forwards from spot transactions; after that definition is agreed, FX forwards are expected to become subject to variation margin under the EU margin rules
  - However, under the U.S. rules, FX forwards are exempted from variation margin requirements

- What has the market done to facilitate compliance in advance of the March 1 deadline?
- ISDA has published a robust "Regulatory Margin Self-Disclosure Letter"
- The self-disclosure letter is intended to permit market participants to disclose information about themselves that will permit compliance with the margin rules of the U.S., the EU, Canada, Japan and Switzerland
- There are also recent supplements intended to facilitate compliance under the margin rules of Australia, Singapore and Hong Kong
- ISDA has also undertaken a variation margin protocol which, similar to previous ISDA protocols, is intended to permit market participants to amend their contractual documentation in line with regulatory requirements
- ISDA has also published a CSA applicable to variation margin only (the "ISDA 2016 Credit Support Annex for Variation Margin (VM)")

- The feedback that we have heard regarding the ISDA documentation is that many market participants find it difficult to understand and complex to complete
- Different possible approaches to variation margin, both as a commercial matter and with respect to documentation
  - Possible to fold all transactions under the same compliant CSA, but also possible to split books into pre- and post-compliance date
  - Possible to amend CSAs with a light touch, simply to reflect bottom line regulatory requirements (transfer timing, limited eligible collateral, etc.) but also possible to incorporate new language from ISDA VM CSA (treatment of legally ineligible Credit Support, effect of negative interest rates, etc.)
  - Possible to amend CSAs by means of the ISDA variation margin protocol or bilaterally

- This adds up to a fair amount of confusion in the market
- Reports of similarly situated parties receiving differing legal advice
- Moreover, even once a market participant manages to document its new arrangement for the exchange of collateral, the ISDA documentation does not give guidance as to what regulatory regime actually applies to each counterparty or transaction, or what is to be done when the requirements of different regulatory regimes differ materially from each other
- So far, our advice has generally been a “greater of” approach entailing compliance to the greatest degree required by any applicable set of rules

- However, there is a real issue with inconsistent regulations that require this “greater of” approach: by requiring compliance in addition to that which might be required in connection with a transaction that takes place in a single jurisdiction, they disfavor cross-border transactions
- Liquidity concerns? Market fragmentation?
- This seems unlikely to have been what the G-20 countries had in mind when they agreed on their fundamental swap market reforms

Pru Regs – Cross-Border Margin

- Prudential Regulators' final margin rules contain provisions governing the cross-border application of the margin rules
- Under Prudential Regulators margin rules, margin rules do not apply to any foreign non-cleared swap or foreign non-cleared security-based swap of a foreign covered swap entity
- A foreign covered swap entity is any covered swap entity that is not:
  - an entity organized under the laws of the United States or any State, including a U.S. branch, agency, or subsidiary of a foreign bank;
  - a branch or office of an entity organized under the laws of the United States or any State; or
  - an entity that is a subsidiary of an entity that is organized under the laws of the United States or any State.

- A foreign non-cleared swap (or security-based swap) is any transaction in which neither the counterparty to the foreign covered swap entity nor any party that provides a guarantee of either party's obligations under the non-cleared swap or non-cleared security-based swap is:
  - an entity organized under the laws of the United States or any State (including a U.S. branch, agency, or subsidiary of a foreign bank) or a natural person who is a resident of the United States;
  - a branch or office of an entity organized under the laws of the United States or any State; or
  - a swap entity that is a subsidiary of an entity that is organized under the laws of the United States or any State

- Substituted compliance may apply only if
  - the covered swap entity's obligations under the non-cleared swap or non-cleared security-based swap do not have a guarantee from:
    - an entity organized under the laws of the United States or any State (other than a U.S. branch or agency of a foreign bank) or a natural person who is a resident of the United States; or
    - a branch or office of an entity organized under the laws of the United States or any State; and
  - the covered swap entity is:
    - a foreign covered swap entity;
    - a U.S. branch or agency of a foreign bank; or
    - an entity that is not organized under the laws of the United States or any State and is a subsidiary of a depository institution, Edge corporation, or agreement corporation.

- In determining whether to make a substituted compliance determination, the prudential regulators will consider whether the requirements of such foreign regulatory framework for non-cleared swaps applicable to such covered swap entities are
  - comparable to the otherwise applicable requirements of the prudential regulators margin rules and
  - appropriate for the safe and sound operation of the covered swap entity, taking into account the risks associated with non-cleared swaps and non-cleared security-based swaps

- A covered swap entity satisfies its requirement to post initial margin by posting to its counterparty initial margin in accordance with the initial margin that its counterparty is required to collect under a foreign regulatory framework, provided the prudential regulators have made a substituted compliance determination for that framework, and the counterparty's obligations under the non-cleared swap or non-cleared security-based swap do not have a guarantee from:
  - an entity organized under the laws of the United States or any State (including a U.S. branch, agency, or subsidiary of a foreign bank) or a natural person who is a resident of the United States or
  - a branch or office of an entity organized under the laws of the United States or any State.

CFTC Cross-Border Margin – U.S. CSEs

- The general rule is that (i) CSEs that are U.S. persons and (ii) non-U.S. CSEs whose obligations under a swap are guaranteed by a U.S. person must comply with the CFTC's margin rules
- However, a U.S. CSE, or a non-U.S. CSE whose obligations are guaranteed by a U.S. person, may in certain circumstances satisfy its obligation to post initial margin to certain counterparties in accordance with comparable non-U.S. rules
- Specifically, a U.S. CSE, or a non-U.S. CSE whose obligations are guaranteed by a U.S. person, may satisfy its obligation requirement to post initial margin by posting initial margin that its counterparty is required to collect in accordance with a foreign jurisdiction's margin requirements, but only if, among other things
  - The counterparty is neither a U.S. person nor a non-U.S. person whose obligations under the relevant swap are guaranteed by a U.S. person; and
  - The CFTC has made a substituted compliance determination with respect to such foreign jurisdiction's requirements regarding the posting of initial margin

CFTC Cross-Border Margin – Non-U.S. CSEs

- With respect to non-U.S. CSEs, the CFTC's rules provide an exclusion under which a non-U.S. CSE is not required to comply with the CFTC's margin rules
- Under that exclusion, with respect to each uncleared swap entered into by a non-U.S. CSE whose obligations under the relevant swap are not guaranteed by a U.S. person, such non-U.S. CSE is <u>not</u> required to comply with CFTC's margin rules if:
  - The non-U.S. CSE is not a U.S. branch of a non-U.S. CSE;
  - The non-U.S. CSE is not a "Foreign Consolidated Subsidiary" (that is, a non-U.S. CSE whose ultimate parent is a U.S. person that consolidates the non-U.S. CSE for accounting purposes); and
  - The counterparty to the uncleared swap is a non-U.S. person (other than a Foreign Consolidated Subsidiary or the U.S. branch of a non-U.S. CSE), whose obligations under the relevant swap are not guaranteed by a U.S. person

- However, the exclusion does not apply to certain circumstances in which the non-U.S. CSE enters into a swap with an U.S. affiliate that transfers to the affiliate risk arising out of the relevant uncleared swap
- If the exclusion does not apply with respect to an uncleared swap, then substituted compliance may apply
- In relation to an uncleared swap between
  - A non-U.S. CSE whose obligations under the relevant swap are not guaranteed by a U.S. person and
  - A counterparty that is <u>not</u> a U.S. CSE or a non-U.S. CSE whose obligations under the relevant swap are guaranteed by a U.S. person,

substituted compliance may apply, and thus the non-U.S. CSE may satisfy margin requirements by complying with the margin requirements of a foreign jurisdiction to which such non-U.S. CSE is subject if the CFTC has issued a comparability determination with respect to that foreign jurisdiction

CFTC Cross-Border Margin – Non-U.S. CSEs, cont'd

- This differs from the CFTC's general cross-border guidance, which would generally apply the CFTC's margin requirements to swaps between non-U.S. swap dealers and all U.S. persons, with substituted compliance available only for swaps between a non-U.S. swap dealer and a foreign branch of a U.S. swap dealer.
- In addition, in relation to an uncleared swap between
  - A non-U.S. CSE whose obligations under the relevant swap are not guaranteed by a U.S. person and
  - A counterparty that is a U.S. CSE or a non-U.S. CSE whose obligations under the relevant swap are guaranteed by a U.S. person,

  the non-U.S. CSE may satisfy its requirement to collect initial margin by collecting initial margin in accordance with a relevant foreign jurisdiction's margin requirements if the CFTC has issued a comparability determination with respect to such foreign jurisdiction's margin requirements

CFTC Cross-Border Margin – Non-U.S. CSEs, cont'd

CFTC Margin – Comparability Determinations

- With respect to substituted compliance determinations, the CFTC will review foreign margin requirements on an element-by-element basis
- In order to request a comparability determination, a CSE or a foreign regulatory authority must provide the CFTC with, among other things, information regarding numerous elements of the relevant non-U.S. margin rules
- Under the rules, the CFTC may make substituted compliance determinations for certain elements of a non-U.S. margin regime and not others, in which case market participants may be required to comply with certain aspects of the U.S. rules and certain aspects of the non-U.S. rules

- To request a comparability determination, a CSE or a foreign regulatory authority must provide the CFTC with information regarding the following elements of the relevant non-U.S. rules:
  - The products subject to the foreign jurisdiction's margin requirements;
  - The entities subject to the foreign jurisdiction's margin requirements;
  - The treatment of inter-affiliate derivative transactions;
  - The methodologies for calculating the amounts of initial and variation margin;
  - The process and standards for approving models for calculating initial and variation margin models.
  - The timing and manner in which initial and variation margin must be collected and/or paid;
  - Any threshold levels or amounts;

CFTC Margin – Comparability Determinations, cont'd

- Risk management controls for the calculation of initial and variation margin;
- Eligible collateral for initial and variation margin;
- The requirements of custodial arrangements, including segregation of margin and rehypothecation;
- Margin documentation requirements; and
- The cross-border application of the foreign jurisdiction's margin regime.

CFTC Margin – Comparability Determinations, cont'd

- Commissioner Giancarlo was roundly critical of the CFTC's approach to comparability in the margin context and, especially if he becomes the new CFTC Chairman, it is very possible that the CFTC's approach to substituted compliance could change
- In his dissent from the CFTC's cross-border margin rules, Commissioner Giancarlo wrote that the CFTC's approach to substituted compliance was "overly complex, unduly narrow and operationally impractical"
- He noted that the "element-by-element" approach could subject a transaction to "a patchwork of U.S. and foreign regulation"
- He further wrote: "In effect, the Commission's approach is somewhat principles-based, except when it is rules-based and somewhat objective, except when it is subjective. Today's muddled methodology invites foreign regulators to respond in kind."

CFTC Margin – Comparability Determinations, cont'd

CFTC Issues Comparability Determination for Japan

- On September 8, 2016, the CFTC issued its first comparability determination with respect to the uncleared swaps margin requirements under Japanese rules, finding that the Japanese rules were, for the most part, comparable to CFTC rules.
- The determination generally permits CSEs that are subject to both the CFTC's and Japan Financial Services Agency's ("JFSA's") uncleared swaps margin rules to comply with the CFTC's rules through substituted compliance with Japan's uncleared swaps margin rules that have been found comparable, as provided for under the Cross-Border Margin Rules.
- As of today, the CFTC has made no comparability determinations regarding margin, other than with respect to Japan
- Further, as Commissioner Bowen noted in her dissent from the Japan comparability determination, the Prudential Regulators have not issued a parallel comparability determination with respect to their margin rules

Japan Comparability Determination

- The CFTC did not find Japanese rules comparable with respect to margin for uncleared inter-affiliate swaps because the JFSA does not have any margin requirements for inter-affiliate swaps, while CFTC rules require exchange of VM and, in some cases, IM with respect to such swaps.
- Accordingly, a CSE entering into an uncleared swap with an affiliate will have to comply with CFTC rules.
- For the requirements that the CFTC found comparable, it did not insist that Japanese requirements be identical to its requirements.
- Rather, it adopted a more outcomes-based approach, assessing whether JFSA requirements were comparable to the CFTC's in purpose and effect.

- Thus, for example, under CFTC rules, all IM posted or collected by a CSE must be held by an independent third-party custodian.
- While not a requirement under JFSA rules, JFSA rules do require that IM must be held in a trust structure, which the CFTC found comparable because property deposited to a trust account under Japanese law is recognized as segregated from the property of the trustor, property of the trust bank, and other trust property.
- Similarly, although JFSA rules do not have as high a haircut for certain equities posted as collateral that are not contained in the S&P 500, they have a higher haircut (and thus are more stringent) for corporate bonds than the CFTC's rules.
- Commissioner Bowen dissented from these and certain other comparability determinations, arguing that third party custodianship is an important safeguard in the event of bankruptcy.

Japan Comparability Determination, cont'd.

- Another concern she raised was that the Prudential Regulators have not issued a comparability determination, so, for example, Japanese swap dealers registered with the CFTC that are subject to the Prudential Regulators' rules will not be able to substitute compliance with Japanese rules in the same way as those Japanese swap dealers that are subject to the CFTC's rules.
- Despite these concerns, the CFTC's approach appears to be a pragmatic one, recognizing that some flexibility is need if an international framework is to be implemented, and that, other than with respect to inter-affiliate swaps for which the JFSA has no rule, its other rules achieve comparable outcomes to CFTC rules.
- The determination became effective on September 15, 2016.

Japan Comparability Determination, cont'd

CFTC Cross-Border Proposal

- On October 11, 2016, the CFTC issued proposed rules to address certain cross-border issues.
- Specifically, the proposed rules define key terms for purposes of applying the CEA on a cross-border basis, including definitions of U.S. person and foreign consolidated subsidiary.
- The proposal also includes an interpretation regarding transactions "arranged, negotiated or executed" in the United States.
- In addition, the proposal addresses the cross-border application of swap dealer and major swap participant registration thresholds and the cross-border applicability of the external business conduct standards, including the extent to which they would apply to swap transactions that are arranged, negotiated, or executed using personnel located in the United States. These rules, if adopted, would supersede the CFTC's Cross-Border Guidance.
- Comment period for the proposal closed on December 19, 2016.

CFTC Proposal – Definitions

- The proposed rules would define the terms “U.S. Person” and “Foreign Consolidated Subsidiary” (“FCS”) in line with the definitions in the cross-border uncleared swaps margin rules.
- These definitions would be used for purposes of the other rules contained in the proposal, and for purposes of any subsequent rulemakings addressing the cross-border application of Dodd-Frank requirements.

Proposed Interpretation

- The proposal contains an interpretation regarding the scope of transactions that are "arranged, negotiated, or executed" in the United States ("ANE") that would be subject to Dodd-Frank.
- The proposed interpretation of ANE is substantively identical with the interpretation adopted by the SEC defining these terms last year in connection with cross border security-based swap dealing.
- The interpretation provides that the terms "arrange" and "negotiate" refer to market-facing activity normally associated with sales and trading, as opposed to internal, back-office activities, such as ministerial or clerical tasks, performed by personnel not involved in the actual sale or trading of the relevant swap. The terms would not encompass activities such as swap processing, preparation of the underlying swap documentation (including negotiation of a master agreement and related documentation), or the mere provision of research information to sales and trading personnel located outside the United States.
- The term "executed" would refer to the market-facing act of becoming legally and irrevocably bound to the terms of a swap under applicable law.

Cross-Border Application of Swap Dealer Registration Thresholds

Under the proposed rule, in making its swap dealer de minimis calculation:

- A U.S. person would include all of its swap dealing transactions.
- A non-U.S. person would include all swap dealing transactions with respect to which it is a "U.S. Guaranteed Entity." For purposes of the proposed rules, "guarantee" has the same meaning as in the cross-border margin rules.
- An FCS would include all of its swap dealing transactions.
- A non-U.S. person that is neither an FCS nor a U.S. Guaranteed Entity ("Other Non-U.S. Person") would include all of its swap dealing transactions with counterparties that are U.S. persons, U.S. Guaranteed Entities, or FCSs, unless the swap is executed anonymously on a designated contract market, swap execution facility, or foreign board of trade and cleared.
- Other Non-U.S. Persons would not, however, include any of their swap dealing transactions with Other Non-U.S. Persons, even if they constitute ANE transactions.
- This differs from the SEC approach, which requires that ANE transactions be included in a Non-U.S. person's security-based swap dealing de minimis calculation.

- Notably, the treatment of FCSs is different under the proposal from how they are treated under the Cross-Border Guidance.
- An FCS is defined as a non-U.S. person in which an ultimate U.S. person parent entity has a controlling financial interest such that the U.S. parent entity includes the non-U.S. person's operating results in its consolidated financial statements in accordance with U.S. GAAP
- Currently under the Cross-Border Guidance, only U.S. persons, guaranteed affiliates of U.S. persons, and conduit affiliates of U.S. persons are required to count all of their dealing swap transactions, whether with U.S. or non-U.S. counterparties.
- FCSs, which by definition are non-U.S. persons and are not guaranteed affiliates of U.S. persons, and unless they meet the requirements for conduit affiliates would not be such affiliates either, would not be required to count all of their swaps under the Cross-Border Guidance.

Cross-Border Application of Swap Dealer Registration Thresholds, cont'd

- Such FCSs would be required, however, to count all of their swaps, whether with U.S. or non-U.S. persons, toward the de minimis threshold under the proposed rules.
- In addition, Other Non-U.S. persons would be required to count their swaps with FCSs, which they are not required to do under the Cross-Border Guidance.
- Other non-U.S. persons also would be required to count swaps with non-U.S. branches of U.S. persons, which is not required under the Cross-Border Guidance.
- This could have the effect of non-U.S. persons avoiding FCSs or non-U.S. branches of U.S. persons as counterparties in order to not trip up CFTC registration requirements.

Cross-Border Application of Swap Dealer Registration Thresholds, cont'd

- The Proposal does not address "conduit affiliates," which, under the Cross-Border Guidance, are required to count all of their swaps transactions toward the *de minimis* threshold, although it includes a series of questions requesting comment regarding conduits.
- Consistent with the approach taken in the Cross-Border Guidance, the proposed rules provide that potential swap dealers, whether U.S. or non-U.S. persons, would aggregate their swap dealing transactions with those of persons controlling, controlled by, or under common control with the potential swap dealer to the extent that those affiliates are themselves required to include those swaps in their own *de minimis* thresholds, unless the affiliated person is a registered swap dealer.

Cross-Border Application of Swap Dealer Registration Thresholds, cont'd

Cross-Border Application of Major Swap Participant Registration Thresholds

- An entity that is not a swap dealer would count swap positions toward the major swap participant threshold calculations to the same extent as potential swap dealers count swap dealing transactions toward the swap dealer de minimis calculation, with the exception of the aggregation requirement.
- In addition, all swap positions that are subject to recourse would be attributed to a guarantor, whether it is a U.S. person or a non-U.S. person, unless the guarantor, the guaranteed entity, and its counterparty are "Other Non-U.S. Persons."

Cross-Border Application of External Business Conduct Standards

- The proposed rules would apply the CFTC's external business conduct ("EBC") standards to cross-border transactions as follows:
- U.S. swap dealers and major swap participants (SD/MSPs) would comply with applicable EBC standards, without substituted compliance, except with respect to transactions conducted through a foreign branch of the U.S. SD/MSP.
- Non-U.S. SD/MSPs and foreign branches of U.S. SD/MSPs would comply with applicable EBC standards, without substituted compliance, if the counterparty is a U.S. person (other than a foreign branch of a U.S. SD/MSP).
- Non-U.S. SD/MSPs and foreign branches of U.S. SD/MSPs would not be subject to EBC standards for their swaps with non-U.S. persons and foreign branches of a U.S. SD/MSP, except that non-U.S. SDs and foreign branches of U.S. SDs that enter into transactions ANE would be required to comply with CFTC Reg. 23.410 (Prohibition on Fraud, Manipulation, and other Abusive Practices) and 23.433 (Fair Dealing), without substituted compliance.

CFTC vs. SEC

- 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
- In May of last year, the CFTC issued final rules regarding cross-border application of its uncleared swaps margin rules
- On October 11, 2016, the CFTC proposed new rules regarding cross-border issues
- SEC has <u>not</u> issued comprehensive final rules or guidance
  - In general, the SEC is far behind the CFTC in finalizing its rules
  - However, the SEC has provided targeted cross-border rules with respect to each substantive rule as it gets finalized (e.g., rules for counting cross-border SBS toward the de minimis threshold, Reg. SBSR, external business conduct standards), and thus appears to be taking a rule-by-rule rather than a comprehensive approach.

- SEC may not be issuing further Dodd-Frank rules (cross-border or otherwise) in the near future
- SEC Commissioner Michael Piwowar has stated that, if he becomes acting chairman (as is likely) after the Trump inauguration, the SEC will not prioritize Dodd-Frank rules
- He has been quoted as saying that he does not want to move forward with something that is likely to be repealed or changed after the SEC has a permanent chairman
- The CHOICE Act, if enacted, would require the CFTC and the SEC to issue new rules to resolve inconsistencies between the CFTC's rules for swaps and the SEC's rules for security-based swaps
- Accordingly, the CHOICE Act could have the effect of pushing SEC rules closer to CFTC rules

SEC Cross-Border Rules

- SEC issued targeted cross-border rules to three rulemakings last year: (i) rules for counting cross-border security-based swaps toward the de minimis threshold, (ii) amendments to Reg. SBSR, and (iii) business conduct standards.
- On February 10, 2016, SEC finalized its counting rules addressing how the security-based swap dealer definition and the de minimis threshold applies to security-based swap transactions between non-U.S. persons that are "arranged, negotiated, or executed" ("ANE') in the United States.
- Practical impact of these rules is deferred until security-based swap dealer registration is required, which is dependent on the finalization of 4 other rules (one of which is final and three others have been proposed).

- SEC approach is to require that a security-based swap dealing transaction entered into by a non-U.S. person generally will count toward the non-U.S. person's de minimis exception threshold from registration, 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 agent (whether affiliated or unaffiliated) of such non-U.S. person located in the United States.
- Interpretive guidance provided in the final rule release regarding the terms "arranged, negotiated, or executed," is substantively the same as the CFTC's guidance contained in its cross-border proposal.
- The final rules exempt security-based swaps arranged, negotiated, or executed in the United States by certain international organizations (e.g., multilateral development banks) as defined in SEC rules.
- Final rules do <u>not</u> exempt security-based swaps that are 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 United States.

SEC Cross-Border Rules, cont'd

- SEC adopted rule amendments to Regulation SBSR on July 13, 2016 that address the applicability of the reporting and public dissemination requirements for security-based swaps that are "arranged, negotiated, or executed" by non-U.S. persons within the United States.
- The rule amendments also address the assignment of reporting responsibilities in certain cross-border situations not provided for in Regulation SBSR as adopted in 2015.
- When it was adopted in 2015, Regulation SBSR provided for regulatory reporting and public dissemination of any SBS transaction that (1) has a direct or indirect counterparty that is a U.S. person on either or both sides of the transaction or (2) is accepted by a clearing agency having its principal place of business in the U.S.
- Regulation SBSR also required regulatory reporting (but not public dissemination) of uncleared SBSs of registered non-U.S. SBS dealers and major SBS participants when there is no U.S. person on either side.

SEC Cross-Border Rules, cont'd

- Under the Final Rules and Guidance, SBSs in connection with a non-U.S. person's SBS dealing activity that are "arranged, negotiated, or executed" by personnel of such non-U.S. person located in a U.S. branch or office, or by personnel of its agent located in a U.S. branch or office, are required to be reported and publicly disseminated.
- The Final Rules and Guidance do not subject additional transactions involving registered SBS dealers to Regulation SBSR's regulatory *reporting* requirements because registered SBS dealers, whether US or non-U.S., are already subject to regulatory reporting requirements with respect to *all* of their counterparties, whether U.S. or non-U.S., under Regulation SBSR as originally adopted.
- However, this provision of the Final Rules and Guidance would require that transactions of non-U.S. SBS dealers that are "arranged, negotiated, or executed" in the U.S. be *publicly disseminated*.

- In addition, the Final Rules and Guidance assign reporting responsibility for SBSs in situations involving non-registrants.
- Specifically, they provide that, for SBSs between two non-U.S. persons engaged in SBS dealing activity that is "arranged, negotiated, or executed" in the U.S., or between one such non-U.S. person and a U.S. person, the parties shall select the reporting side.
- For SBSs between a non-U.S. person who is not engaged in SBS dealing activity "arranged, negotiated, or executed" in the United States, and a non-U.S. person who is engaged in such activity in the United States or a U.S. person, the Final Rules and Guidance provide that the latter is the reporting side.
- If the SBS is between two non-U.S. persons who are not engaged in SBS dealing activity "arranged, negotiated, or executed" in the U.S., Regulation SBSR does not apply, unless the SBS is effected by or through a registered broker-dealer, including a registered SBS execution facility, in which case the registered broker-dealer reports.

SEC Cross-Border Rules, cont'd

Summary of Reporting Responsibilities under Regulation SBSR

Party B Party A	SBSD	Non-SBSD, U.S. person	Non-SBSD, non-U.S. person, security-based swap dealing ANE	Non-SBSD, non-U.S. person, not ANE
SBSD	Parties select	Party A	Party A	Party A
Non-SBSD, U.S. Person	Party B	Parties select	Parties select	Party A
Non-SBSD, non-U.S. person, security-based swap dealing, ANE	Party B	Parties select	Parties select	Party A
Non-SBSD, non-U.S. person, not ANE	Party B	Party B	Party B	N/A, except if effected by or through a registered broker-dealer, in which case the broker-dealer reports

SEC Cross-Border Rules, cont'd

- Substituted compliance with a foreign jurisdiction's reporting and public dissemination rules would potentially be available under Reg. SBSR if at least one of the direct counterparties to the security-based swap is either a non-U.S. person or a foreign branch.
- Substituted compliance eligibility is not conditioned on where a particular transaction was arranged, negotiated, or executed.
- Thus, a security-based swap between a U.S. person and the New York branch of a foreign bank (i.e, a non-U.S. person utilizing U.S.-located personnel) potentially to be eligible for substituted compliance, if the transaction is also subject to the rules of a foreign jurisdiction that is the subject of an SEC substituted compliance order.
- The procedure and standards for issuing substituted compliance orders under Reg. SBSR are contained in Rule 908(c).

SEC Cross-Border Rules, cont'd

- A number of commenters requested that the SEC defer compliance with Regulation SBSR until the SEC has made substituted compliance determinations with respect to regulatory reporting and public dissemination of SBS transactions for certain foreign jurisdictions, which would allow market participants to comply with the foreign jurisdictions' rules in place of SEC rules.
- This approach has been taken by the CFTC through staff no-action letters, which have delayed regulatory reporting of swaps for certain registered non-U.S. swap dealers based in Australia, Canada, the EU, Japan or Switzerland with non-U.S. counterparties that are not guaranteed by a U.S. person, until the earlier of 30 days after a comparability determination issued by the CFTC (which has not yet been issued for these jurisdictions) or December 1, 2017 .
- However, the SEC declined to provide for such a delay, noting that it had not received any substituted compliance applications and that other jurisdictions were still in the process of promulgating reporting rules, which could lead to a significant delay in Regulation SBSR implementation.

SEC Cross-Border Rules, cont'd

- SEC's Business Conduct Rules adopted in April 2016 provide for their cross-border application.
- For registered security-based swap dealers (SBSDs), the SEC Conduct Rules will generally not apply to "foreign business."
- For SBSDs that are U.S. persons, "foreign business" is effectively defined as an SBS that is conducted through such SBSD's foreign branch with either (i) a non-U.S. person or (ii) a U.S.-person counterparty acting through a foreign branch.
- For SBSDs that are not U.S. persons, "foreign business" is effectively defined as an SBS transaction that is not (i) with a U.S. person (other than a transaction conducted through a foreign branch of that person) or (ii) arranged, negotiated, or executed by personnel of the foreign SBSD swap dealer (or its agent) located in a U.S. branch or office.

SEC Cross-Border Rules, cont'd

- The SEC Conduct Rules also state the circumstances in which the SEC may make substituted compliance determinations, to the effect that compliance with particular requirements under a foreign financial regulatory system may satisfy the corresponding requirements under the SEC Conduct Rules.
- In order to make such a determination, the SEC must, among other things, determine that the relevant foreign requirements are comparable to its own otherwise applicable requirements and enter into a memorandum of understanding or other arrangement with the relevant foreign financial regulatory authority.
- Certain provisions are not eligible for substituted compliance (e.g., prohibition on fraudulent activities by SBSDs).
- SEC states that substituted compliance may be granted with regard to some business conduct requirements but not others.
- Substituted compliance not available for U.S. SBSDs and major security-based swap participants.

SEC Cross-Border Rules, cont'd

Proposed Rules for Financial Contracts

- On May 11, 2016, the Board of Governors of the Federal Reserve System (the "Board") published in the Federal Register proposed new rules intended to reduce the potential risks posed to the U.S. financial system by too-big-to-fail banks
- On August 19, 2016, the Office of the Comptroller of the Currency ("OCC") published in the Federal Register proposed rules, substantively identical to the Board's proposed rules, for entities that the OCC supervises
- On October 26, 2016, the Federal Deposit Insurance Corporation ("FDIC") also published in the Federal Register proposed rules, substantively identical to the Board's proposed rules, for entities that the FDIC supervises

- The proposed rules have two primary goals, both aimed at facilitating the orderly liquidations of systemically important financial institutions, including under the orderly liquidation process created by the Dodd-Frank Act
- The first goal is to assure the cross-border application of U.S. special resolution regimes to certain transactions between a counterparty outside of the U.S. and a banking entity covered by the proposed regulations
- While it is clear that existing U.S. special resolution regimes provide the U.S. regulatory agencies with the powers to prevent counterparties from exercising contractual termination rights in certain circumstances, it is not entirely clear what might happen if a court outside of the U.S. were to disregard such powers.
- The proposed rules, if adopted, will require parties to add to their contracts provisions to make clear that the U.S. special resolution regimes will apply to cross-border transactions and will thus bind authorities and parties outside of the U.S.

Proposed Rules for Financial Contracts, cont'd

- The second goal is to facilitate the resolution of a covered banking entity under a "single point of entry" strategy, in which only the top-tier holding company would enter into a resolution proceeding while its subsidiaries would continue to operate and meet their financial obligations
- The regulatory agencies take the view that, to facilitate such a resolution, they must ensure that operating subsidiaries of a covered entity are not parties to contracts containing cross-default rights that their counterparties could exercise based on the entry into resolution of an affiliate of such operating subsidiaries
- The proposed rules designate both the Federal Deposit Insurance Act and the "Orderly Liquidation Authority" or "OLA" provisions contained in Title II of Dodd-Frank as "U.S. special resolution regimes"

Proposed Rules for Financial Contracts, cont'd

- Both of the U.S. special resolution regimes in certain circumstances limit the contractual rights of counterparties facing certain bank entities to terminate contracts with those banks
- In addition, under both its OLA authority and the FDI Act, the Federal Deposit Insurance Corporation ("FDIC") has the right, among other things, to transfer certain contracts to a bridge financial company, which, as contemplated by the special resolution regimes, will be capable of performing under the transferred contracts.
- After such a transfer, the bank's counterparty no longer has the right to terminate based on events that occurred prior to the transfer
- These provisions of the U.S. special resolution regimes are in accordance with recommendations of the Financial Stability Board ("FSB").

Proposed Rules for Financial Contracts, cont'd

- After the financial crisis of 2007-09, the FSB recommended that countries put in place special resolution regimes to address failing financial institutions, especially those whose collapse could have systemic consequences
- Many countries that are members of the G20 group of nations have adopted or are in the process of adopting similar resolution regimes
- The proposed rules apply to "covered QFCs," that is, contracts that constitute "qualified financial contracts" to which a "covered entity" is a party
- The primary differences among the Board's proposed rules, the OCC's proposed rules and FDIC's proposed rules relate to the entities defined as covered entities, to which the proposed rules would apply

Proposed Rules for Financial Contracts, cont'd

- "Covered entities," for purposes of the Board's proposed rules, include:
  - Any U.S. bank holding company that is identified as a global systemically important bank holding company under the Board's rule establishing risk-based capital surcharges for global systemically important banking organizations (GSIBs);
  - Any subsidiary of a U.S. GSIB described in the preceding bullet point that is not a national bank, federal savings association, federal branch or federal agency; and
  - A U.S. subsidiary, U.S. branch, or U.S. agency of a non-U.S. GSIB (other than entities subject to regulation by the OCC, such as national banks, federal savings associations, federal branches or federal agencies)
- "Covered entities," for purposes of the OCC's proposed rules, include national banks, federal savings associations, federal branches or federal agencies that are subject to regulation by the OCC
- "Covered entities," for purposes of the FDIC's rules, include certain state savings associations and state-chartered banks that are not members of the Federal Reserve System for which the FDIC is the primary federal regulator

Proposed Rules for Financial Contracts, cont'd

- The proposed rules define the term "qualified financial contracts" broadly, in accordance with section 210(c)(8)(D) of the Dodd-Frank Act
- Accordingly, QFCs include many swaps, repurchase (and reverse repurchase) transactions, forward contracts, commodity contracts and securities sale, lending and borrowing transactions
- However, the proposed rules expressly exclude centrally cleared QFCs from their scope
- The "QFC" definition generally includes any master agreement that governs QFCs between parties
- The proposed rules would require covered entities to add two distinct provisions to their QFCs
- One such provision would limit the exercise of default rights under Covered QFCs
- The other provision would permit transfers of QFCs to bridge entities as contemplated by the special resolution regimes

Proposed Rules for Financial Contracts, cont'd

- To clarify the cross-border application of the U.S. special resolution regimes, the proposed rules would require each covered QFC to expressly provide that default rights under such covered QFC "that may be exercised against the covered entity are permitted to be exercised to no greater extent than the default rights could be exercised under the U.S. special resolution regimes," assuming U.S. law applied and the covered entity were under a U.S. special resolution regime
- Such a provision, if and when inserted into covered QFCs, will make clear that the covered entity's counterparty, regardless of its jurisdiction, will have no right to terminate a covered QFC to the extent it would not have such right under the applicable U.S. special resolution regime

Proposed Rules for Financial Contracts, cont'd

- The proposed rules would also require each covered QFC to support the U.S. special resolution regimes by permitting transfers of such QFCs to bridge entities as contemplated by the special resolution regimes
- Specifically, the proposed rules would require covered QFCs expressly to provide that the transfer of the covered QFC (and any interest in, or property securing, the covered QFC) from the covered entity will be effective to the same extent as the transfer would be effective under the U.S. special resolution regimes, assuming U.S. law applied and the covered entity were under a U.S. special resolution regime
- The proposed rules also contain provisions intended to support "single point of entry" resolutions of banking organizations, in which only a single legal entity, the top-tier bank holding company, is to enter into a resolution proceeding

Proposed Rules for Financial Contracts, cont'd

- The agencies contemplates that a banking institution may enter into QFCs through operating subsidiaries, and, to the extent that such QFCs cause losses, those losses will be passed up from the operating subsidiaries that incurred them to the holding company, where, by means of the resolution process, the losses will be imposed on the holding company's equity holders and unsecured creditors
- The "single point of entry" strategy is intended to ensure that the operating subsidiaries will remain adequately capitalized and able to meet their financial obligations without defaulting or entering resolution
- To facilitate this resolution strategy, the agencies believe that they must prevent counterparties facing operating subsidiaries of banking institutions from exercising default rights based on the entry into resolution or insolvency proceedings of the operating subsidiaries' affiliates

Proposed Rules for Financial Contracts, cont'd

- Accordingly, the proposed rules would provide that a covered QFC may not permit the exercise of any default right with respect to the covered QFC that is related, directly or indirectly, to an affiliate of a covered entity becoming subject to a receivership, insolvency, liquidation, resolution, or similar proceeding
- However, a covered QFC could permit the exercise of default rights based on
  - A covered entity itself becoming subject to receivership, insolvency, liquidation, resolution, or similar proceeding, other than under a special resolution regime, or
  - A party to a QFC, or an affiliated credit support provider, failing to meet a payment or delivery obligation under the covered QFC

Proposed Rules for Financial Contracts, cont'd

ISDA Resolution Stay Protocols

- Contemporaneously with the Board's release of its proposed rules, ISDA released its Resolution Stay Jurisdictional Modular Protocol (the "JM Protocol"), which is intended to permit market participants to comply with the provisions of the proposed rules (when adopted in their final form) and similar rules of foreign jurisdictions
- By adhering to the protocol, parties agree that their contracts with other adhering parties are amended in accordance with the terms of the relevant protocol
- The heart of the JM Protocol consists of the country-specific modules, a large majority of which ISDA has not yet published

- Market participants other than systemically important banks, such as asset managers, have been concerned about the possibility of breaching their fiduciary duties if they were to expressly relinquish default rights under numerous jurisdictions in the absence of any legal requirement to do so
- The JM Protocol differs from the Universal Stay Protocol and the Resolution Stay Protocol in that, by means of the JM Protocol's country-specific modules, parties will be able to specify exactly which special resolution regime modules they will opt in to
- So far, the only jurisdictional modules that ISDA has published are the modules for Germany and the UK
- ISDA has also circulated a draft of the jurisdictional module for Japan
- Presumably the U.S. jurisdictional module will not be published until after the Board or the OCC finalizes its proposed rules

ISDA Resolution Stay Protocols, cont'd

Questions?

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Client Alert

November 10, 2016

CFTC Issues Cross-Border Proposal

By Julian Hammar

On October 11, 2016, the U.S. Commodity Futures Trading Commission ("CFTC") issued proposed rules to address certain issues related to the cross-border application of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), the comprehensive framework for swaps regulation enacted by Congress in 2010. If adopted, the proposed rules would supersede the CFTC's Cross-Border Guidance, the interpretative statement adopted by the CFTC in 2013 to address cross-border application of Dodd-Frank, with respect to these issues.[1]

Among other things, the proposed rules would:

- provide definitions of "U.S. person" and "foreign consolidated subsidiary," which would apply for purposes of subsequent rulemakings addressing cross-border application of Dodd-Frank;
- clarify in certain respects the treatment of transactions that are "arranged, negotiated, or executed" in the United States by non-U.S. persons; and
- address the cross-border application of swap dealer and major swap participant registration thresholds and the cross-border applicability of the external business conduct standards.

The proposal will be open for public comment until **December 19, 2016**, and is available here.[2]

DEFINITIONS

The proposed rules would define the terms "U.S. Person" and "Foreign Consolidated Subsidiary" ("FCS") in line with the definitions contained in the cross-border uncleared swaps margin rules adopted by the CFTC last May.[3] The proposed definition of the term U.S. person would, as under the cross-border uncleared swaps margin rules, eliminate the "including, but not limited to" language contained in the U.S. person definition in the Cross-Border Guidance, which created legal uncertainty for market participants as to who is and who is not a U.S. person. Also eliminated is the prong for commodity pools, investment funds, or other collective investment vehicles majority-owned by U.S. persons, which was included in the U.S. person definition contained in the Cross-Border Guidance, but which created difficulties in identifying and tracking fund ownership. The prong for a legal entity

[1] See Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45,292 (July 26, 2013) ("Cross-Border Guidance").

[2] Cross-Border Application of the Registration Thresholds and External Business Conduct Standards Applicable to Swap Dealers and Major Swap Participants, 81 Fed. Reg. 71,946 (Oct. 18, 2016).

[3] See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants—Cross-Border Application of the Margin Requirements, 81 Fed. Reg. 34,818 (May 31, 2016). For more information on the cross-border uncleared swaps margin rules, please see our client alert here.

owned by one or more U.S. persons bearing unlimited responsibility for such entity's obligations and liabilities, which under the Cross-Border Guidance applied to such entities majority-owned by U.S. persons, has also been modified to remove the majority-U.S. person ownership requirement.[4]

The proposed definition of the term FCS, like the definition under the cross-border uncleared swaps margin rules, would denote a non-U.S. person in which an ultimate parent entity that is a U.S. person has a controlling financial interest, and as a result of that controlling interest the ultimate parent includes the non-U.S. person's operating results, financial position and statement of cash flows in the ultimate parent's consolidated financial statements in accordance with U.S. Generally Accepted Accounting Principles.

These definitions would be used for purposes of the other rules contained in the proposal, and for purposes of any subsequent rulemakings addressing the cross-border application of Dodd-Frank requirements.

INTERPRETATION REGARDING TRANSACTIONS THAT ARE "ARRANGED, NEGOTIATED, OR EXECUTED" IN THE UNITED STATES

In addition to these definitions, the proposal contains an interpretation regarding the scope of transactions between non-U.S. persons that are "arranged, negotiated, or executed" in the United States ("ANE") that would be subject to Dodd-Frank.[5] CFTC staff in 2013, in its Advisory 13-69, took the position that non-U.S. swap dealers registered with the CFTC had to comply with the Transaction-Level Requirements for transactions with non-U.S. persons that were ANE.[6] The staff subsequently issued a series of no-action letters delaying compliance with the terms of Advisory 13-69 pending CFTC consideration, after the CFTC had issued a request for comment, of whether the advisory should be adopted as Commission policy.

The proposed interpretation adopts the view that ANE transactions between non-U.S. persons implicate regulatory concerns intended to be addressed by Dodd-Frank and that applying specific Dodd-Frank swap requirements to such transactions may be appropriate. The proposed rules discussed below address whether such transactions would count toward the swap dealer and major swap participant thresholds, as well as how the CFTC's external business conduct standards would apply to such transactions.

In addition, the proposed interpretation would provide guidance regarding the meaning of the terms "arranged," "negotiated," and "executed," terms not defined in Advisory 13-69. The interpretive guidance regarding these terms is substantively identical to the interpretation adopted by the Securities and Exchange Commission ("SEC") defining these terms earlier this year in connection with cross-border security-based swap dealing.[7]

Specifically, the proposed interpretation provides that the terms "arrange" and "negotiate" refer to market-facing activity normally associated with sales and trading, as opposed to internal, back-office activities, such as

[4] See generally Proposed Reg. 1.3(aaaaa) for these definitions.

[5] See generally 81 Fed. Reg. at 71,952-54.

[6] See CFTC Staff Advisory No. 13-69, Applicability of Transaction-Level Requirements to Activity in the United States (Nov. 13, 2013).

[7] See Security-Based Swap Transactions Connected With a Non-U.S. Person's Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office or in a U.S. Branch or Office of an Agent; Security-Based Swap Dealer De Minimis Exception, 81 Fed. Reg. 8,597 (Feb. 19, 2016).

ministerial or clerical tasks, performed by personnel not involved in the actual sale or trading of the relevant swap. The terms would not encompass activities such as swap processing, preparation of the underlying swap documentation (including negotiation of a master agreement and related documentation), or the mere provision of research information to sales and trading personnel located outside the United States. The term "executed" would refer to the market-facing act of becoming legally and irrevocably bound to the terms of a swap under applicable law.

COUNTING SWAPS TOWARD SWAP DEALER AND MAJOR SWAP PARTICIPANT THRESHOLDS

The proposal includes rules for counting dealing swaps, in the cross-border context, toward the swap dealer de minimis thresholds, as well as counting cross-border swaps toward the major swap participant thresholds. These proposed rules, if adopted, would supersede the counting rules contained in the Cross-Border Guidance.

Swap Dealer De Minimis Thresholds

In general, a market participant is exempt from registration as a swap dealer if its aggregate gross notional value of swap dealing over the prior 12-month period does not exceed the de minimis threshold, which currently is set at $8 billion (except for certain special entities, where the threshold is $25 million) and will be reduced to $3 billion on December 31, 2018 (recently extended from December 2017),[8] absent further CFTC action. The proposed rules address, based on a counterparty's status as either a U.S. person, U.S. Guaranteed Entity, FCS, or a non-U.S. person that is neither an FCS nor a U.S. Guaranteed Entity ("Other Non-U.S. Person"), which swaps in the cross-border context count toward the de minimis thresholds.

Under the proposed rules, in making its swap dealer de minimis calculation:

- A U.S. person would include all of its swap dealing transactions.
- A non-U.S. person would include all swap dealing transactions with respect to which it is a "U.S. Guaranteed Entity." For purposes of the proposed rules, the proposal notes in a footnote that "guarantee" has the same meaning as in the cross-border margin rules, except that application of the term would not be limited to uncleared swaps.
- An FCS would include all of its swap dealing transactions.
- An Other Non-U.S. Person would include all of its swap dealing transactions with counterparties that are U.S. persons (including their non-U.S. branches), U.S. Guaranteed Entities, or FCSs, unless the swap is executed anonymously on a designated contract market, swap execution facility, or foreign board of trade and cleared.[9]

Other Non-U.S. Persons would not, however, include any of their swap dealing transactions with Other Non-U.S. Persons, even if they constitute ANE transactions. This approach differs from the SEC's, which generally requires that ANE transactions be included in a non-U.S. person's security-based swap dealing de minimis calculation. The SEC also does not exclude ANE transactions that are executed anonymously on an exchange or

[8] See Order Establishing De Minimis Threshold Phase-In Termination Date, 81 Fed. Reg. 71,605 (Oct. 18, 2016).

[9] See Proposed Reg. 1.3(ggg)(7).

swap execution facility from the security-based swap dealing de minimis calculation, but such transactions would not be required to be counted under the CFTC's proposed rules.[10]

Notably, the proposal does not address "conduit affiliates," which, under the Cross-Border Guidance, are required to count all of their swap transactions toward the de minimis threshold, although it includes a series of questions requesting comment regarding conduits. Another notable difference is the treatment of FCSs, which were not a recognized category under the Cross-Border Guidance. Currently under the Cross-Border Guidance, only U.S. persons, guaranteed affiliates of U.S. persons, and conduit affiliates of U.S. persons are required to count all of their dealing swap transactions, whether with U.S. or non-U.S. counterparties. FCSs, which by definition are non-U.S. persons and are not guaranteed affiliates of U.S. persons, and unless they meet the requirements for conduit affiliates would not be such affiliates either, would not be required to count all of their swaps under the Cross-Border Guidance. Such FCSs would be required, however, to count all of their swaps under the proposed rules. Another change to the counting rules from the Cross-Border Guidance, about which the CFTC requests comment, is that under the proposed rules, Other Non-U.S. Persons would be required to count swaps with non-U.S. branches of U.S. persons, which is not required under the Cross-Border Guidance.

Consistent with the approach taken in the Cross-Border Guidance, the proposed rules provide that potential swap dealers, whether U.S. or non-U.S. persons, would aggregate their swap dealing transactions with those of persons controlling, controlled by, or under common control with the potential swap dealer to the extent that those affiliates are themselves required to include those swaps in their own de minimis thresholds, unless the affiliated person is a registered swap dealer.

Major Swap Participant Thresholds

An entity that is not a swap dealer would count swap positions toward the major swap participant threshold calculations to the same extent as potential swap dealers count swap dealing transactions toward the swap dealer de minimis calculation discussed above, with the exception of the aggregation requirement. In addition, all swap positions that are subject to recourse would be attributed to a guarantor, whether it is a U.S. person or a non-U.S. person, unless the guarantor, the guaranteed entity, and its counterparty are Other Non-U.S. Persons.[11]

EXTERNAL BUSINESS CONDUCT STANDARDS

The proposed rules would apply the CFTC's external business conduct ("EBC") standards to cross-border transactions, as follows:

- U.S. swap dealers and major swap participants (SD/MSPs) would comply with applicable EBC standards, without substituted compliance, except with respect to transactions conducted through a foreign branch of the U.S. SD/MSP.

[10] For more information about the SEC's rules, see our client alert here.

[11] See Proposed Reg. 1.3(nnn).

- Non-U.S. SD/MSPs and foreign branches of U.S. SD/MSPs would comply with applicable EBC standards, without substituted compliance, if the counterparty is a U.S. person (other than a foreign branch of a U.S. SD/MSP).
- Non-U.S. SD/MSPs and foreign branches of U.S. SD/MSPs would not be subject to EBC standards for their swaps with non-U.S. persons and foreign branches of a U.S. SD/MSP, except that non-U.S. SDs and foreign branches of U.S. SDs that enter into transactions ANE would be required to comply with CFTC Reg. 23.410 (Prohibition on Fraud, Manipulation, and other Abusive Practices) and 23.433 (Fair Dealing), without substituted compliance.[12]

CONCLUSION

The proposal represents a first step toward addressing the cross-border issues raised by Advisory 13-69 and transactions that are ANE. However, it is only a first step, because the proposal is silent about whether additional Dodd-Frank requirements will apply to ANE transactions, stating that the application of other Dodd-Frank requirements will be considered in subsequent rulemakings as necessary and appropriate. It also represents a first step toward codification of the Cross-Border Guidance with respect to the counting rules and applicability of the external business conduct standards, but does not codify other requirements. Nonetheless, market participants may welcome certain aspects of the proposal, including the proposed codification of the U.S. person definition that promotes legal certainty, as well as the interpretive guidance providing greater clarity regarding ANE transactions. Market participants may, however, question the treatment of FCSs for purposes of the counting rules, which appears to mark a significant change from the Cross-Border Guidance that could impact many U.S. companies that consolidate their foreign subsidiaries on their financial statements. It is also unclear whether existing no-action relief from Advisory 13-69 will be extended as the CFTC considers whether to apply additional Dodd-Frank requirements to ANE transactions.[13] Treatment of conduit affiliates, while not included in the proposed counting rules, remains a subject about which the CFTC has requested comment, as well as whether the CFTC should conform to the SEC's approach toward ANE transactions for purposes of the counting rules. Market participants may wish to file comments during the comment period to assist the CFTC in its consideration of these issues.

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[12] See Proposed Reg. 23.452.

[13] Currently, under CFTC Staff Letter 16-64 (Aug. 4, 2016), that relief is set to expire on September 30, 2017.

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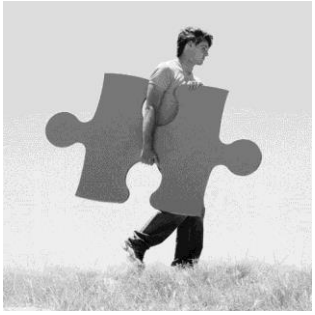
Client Alert

September 7, 2016



CFTC Releases Its Final Staff Report on the Swap Dealer *De Minimis* Exception

Last month the Commodity Futures Trading Commission ("CFTC") released the final report of its staff (the "Staff") on the *de minimis* exception to the CFTC's definition of "swap dealer" (the "Final Report").[1] That exception, which permits a market participant not to register with the CFTC as a swap dealer if it conducts dealing activity in swaps below a specified notional amount threshold, is a key to many market participants' determinations that they need not register as a swap dealer. Although based on problematic data and limited in its conclusions, the Final Report is part of the process, important to unregistered swap market participants, by which the CFTC will determine whether or not to modify the scheduled implementation of a lower *de minimis* threshold level. If the *de minimis* threshold is reduced, as contemplated by CFTC regulations, additional market participants will likely become subject to the swap dealer registration requirement and to the substantial body of CFTC regulations that apply to swap dealers.

CFTC regulations provide for a *de minimis* threshold of $3 billion in notional amount of dealing activity in swaps over a 12-month period, subject to an initial phase-in period, still ongoing, during which the *de minimis* threshold is $8 billion in notional amount over a 12-month period.[2] However, those regulations also require the Staff to draft a report such as the Final Report, and provide that nine months after publication of such report, and after giving due consideration to that report and associated public comment, the CFTC may either terminate the phase-in period, thus reducing the *de minimis* threshold to $3 billion, or determine that it is in the public interest to propose an alternative to the $3 billion *de minimis* threshold amount.[3] Accordingly, absent CFTC action amending the regulations' timeframe, the market will likely[4] know on or about May 15, 2017, nine months after the Final Report's publication, how the CFTC will treat the *de minimis* threshold.

The Final Report updates the analysis contained in a preliminary report prepared by the Staff (the "Preliminary Report"),[5] sets out final findings, and discusses alternatives in approaches to the *de minimis* threshold in light of additional data and comments received on the Preliminary Report. As required by CFTC rules,[6] the Final Report examines topics relating to the *de minimis* threshold and the definition of "swap dealer," including, among other things, the potential impact of modifying the *de minimis* threshold.

The Final Report, like the Preliminary Report before it, notes numerous and significant difficulties with its underlying data. The Staff based both reports on analyses of transaction data that market participants reported to

[1] Swap Dealer *De Minimis* Exception Final Staff Report, a Report by Staff of the U.S. Commodity Futures Trading Commission Pursuant to Regulation 1.3(ggg), August 15, 2016, available here.
[2] CFTC Regulation 1.3(ggg)(4)(i)(A).
[3] CFTC Regulation 1.3(ggg)(4)(ii)(B) and (C).
[4] If the CFTC does not either terminate the phase-in period or propose an alternative to the $3 billion *de minimis* threshold amount, then the phase-in period will terminate on December 31, 2017. See Final Report at 1; CFTC Regulation 1.3(ggg)(4)(ii)(D).
[5] See Swap Dealer *De Minimis* Exception Preliminary Report, a Report by Staff of the U.S. Commodity Futures Trading Commission Pursuant to Regulation 1.3(ggg), November 18, 2015, available here.
[6] See CFTC Regulation 1.3(ggg)(4)(ii)(B).

swap data repositories. While the Final Report analyzes a calendar year of swap data in addition to the data analyzed in the Preliminary Report, and while the Final Report notes improvements in the CFTC's analytical tools, the Final Report makes clear that its underlying data nonetheless remained problematic. That data lacked, among other things, detail regarding which swaps constitute dealing activity and, for certain swaps, reliable notional amount data or information regarding the identities of the counterparties.[7] Such issues with data quality forced the Staff to make numerous assumptions to interpret the data, and limited the Staff's ability to assess with precision the potential results of changes to the *de minimis* threshold.

Significantly, however, notwithstanding these difficulties with data quality, the Final Report reaffirms the Preliminary Report's finding that only a very material increase or decrease in the *de minimis* threshold would have a significant impact on the amount of interest rate and credit default swap activity covered by swap dealer regulation, whether measured by number of transactions, number of counterparties, or notional amount. The Final Report interprets the data to indicate that, if the *de minimis* threshold were lowered to $3 billion, as currently contemplated, approximately 84 additional entities trading in interest rate swaps and credit default swaps might be required to register as swap dealers. However, as compared with the current $8 billion *de minimis* threshold, with a $3 billion threshold "less than 1% of additional notional activity and swap transactions and less than 4% of additional unique counterparties would potentially be covered by swap dealer regulation," and thus "additional regulatory coverage" would be "insignificant."[8] Similarly, if the *de minimis* threshold were raised to $15 billion, while approximately 34 fewer entities trading in interest rates and credit might be subject to registration as swap dealers, overall coverage would decrease by less than 1%, whether measured by notional amounts, number of transactions or unique counterparties.[9]

While these numbers appear to provide a ready justification for keeping the *de minimis* threshold at its current $8 billion level, the Final Report gives little indication of how the CFTC will ultimately address the *de minimis* exception. Indeed, apart from its finding that only a large change in the *de minimis* threshold would have a material impact on the amount of interest rate and credit default swap activity covered by swap dealer regulation, the Final Report seems somewhat perfunctory and its findings less than revelatory. In its discussion of alternatives to the current *de minimis* exception and its inventory of key issues, the Final Report suggests the CFTC may wish to consider, among other things, whether to:

- keep the *de minimis* notional threshold at its current $8 billion level, allow it to drop to $3 billion as scheduled, or delay its reduction while the CFTC continues its efforts to improve data quality;
- exclude from the *de minimis* threshold, after further study, as the Staff did not have sufficient time to study the matter, swaps that are traded on a swap execution facility or designated contract market, or cleared;
- maintain a single *de minimis* threshold based on notional amounts, rather than a threshold based on additional factors, such as counterparty or transaction counts;
- maintain the current single gross notional *de minimis* exception rather than adopting an asset class-specific approach; and
- request the Staff to obtain further information to continue to assess the insured depository institution ("IDI") exclusion, which allows an IDI to exclude from its *de minimis* calculations certain swaps that it enters into with its borrowing customers, to determine whether the conditions of that exclusion are overly restrictive.[10]

Even if the Final Report's finding regarding the limited impact of changes in the *de minimis* threshold were the report's only finding, however, that finding in itself would justify the Staff's efforts in assembling the report. That said, it needs no surfeit of cynicism to consider that the Final Report may be a mere technical preliminary to the

[7] See Final Report at 4-5, 18-19.
[8] Final Report at 21.
[9] *Id*.
[10] *Id*. at 25-27.

political, or at least politics-tinged, debate over the *de minimis* threshold, and no abundance of imagination to think that, notwithstanding the Final Report's central finding, the CFTC may become concerned about the optics of backing off of its view that, all things being equal, over time more entities should become subject to regulation as swap dealers. So let the real games begin. In any case, the swap market should know sooner rather than later whether the CFTC will seek to impose its swap dealer regulations on a broader range of market participants.

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A step closer

The SEC still has some work to do to finalise its framework for SBS dealer registration but firms are already expected to set compliance plans in motion

More than six years after the enactment of the Dodd-Frank Act, and more than three years after the US Commodity Futures Trading Commission (CTFC) required swap dealers to register in accordance with Title VII of that Act, it remains unclear when exactly the US Securities and Exchange Commission (SEC) will require the registration of security-based swap (SBS) dealers. But while the timing for registration is unclear, SBS dealing entities can now begin to take steps to facilitate their SEC registration.

Despite the SEC's progress in recent months in finalising its rules for SBS dealers – it has, among other things, recently issued amendments to its Regulation SBSR and finalised its business conduct rules for SBS dealers – several more dominoes need to fall before SBS dealer registration will be required. Of particular note, the SEC's SBS dealer registration rules provide that registration will not be required until at least six months after the publication in the Federal Register of the SEC's final margin rules for SBS dealers. The SEC proposed those rules in 2012 but, after that proposal, the Basel Committee on Banking Supervision and the International Organization of Securities Commissions released their widely influential international framework for margin for uncleared derivatives. As a result, it seems likely, though perhaps not inevitable, that the SEC will re-propose its margin rules. In view of that likely re-proposal, the required six-month waiting period after the final margin rules' publication, and SEC Chair Mary Jo White's recent statement at an open meeting that the SEC's goal is to complete its regulations for SBS dealers by the end of 2016, an SBS dealer registration compliance date toward the middle or end of 2017 seems likely.

Even if registration will not be required this year, the SBS rules that the SEC has created to date give a helpful if still somewhat inexact roadmap for registration by SBS dealers. What follows is a quick and non-exclusive list of action items for SBS dealing entities.

SBS dealers should consider their internal division of labour for SBS processes and compliance. The bifurcated US regulatory scheme for derivatives means that dealers will need to run many processes in parallel. Those parallel processes, for CFTC-regulated swaps on the one hand, and for SEC-regulated SBS on the other, will in many cases be quite similar, but they will generally not be identical. Accordingly, a first-order question for dealers is to what extent they can and should use the same personnel and the same systems to comply with the parallel CFTC and SEC regulatory requirements.

Because SBS dealer registration is only required after an SBS dealing entity's trading activity exceeds an applicable *de minimis* threshold, many financial institutions that deal in SBS will wish to put in place processes to monitor the level of their SBS trading activity. SBS dealing institutions that do not intend to register as an SBS dealer should put in place processes to monitor the amount of their SBS dealing activity that counts toward the applicable *de minimis* thresholds, and should limit their trading activity so that it remains below those thresholds. Similarly, some institutions will likely wish to monitor their SBS dealing activity to determine when that activity exceeds a relevant threshold and requires SEC registration. Here, as in other areas, the CFTC and SEC rules are similar but not identical. One difference: although the SEC's phase-in *de minimis* threshold level for SBS that are credit default swaps is set at $8 billion in notional amount over a 12-month period, the same as the CFTC's phase-in *de minimis* threshold level for swaps, the SEC's rules, unlike the CFTC's rules, also contain a separate *de minimis* threshold set at $400 million, for SBS that are not credit default swaps.

Registration

SBS dealing entities that intend to register with the SEC should begin preparations to provide the certifications that the SEC requires for registration. In one of those certifications, a senior officer of the applicant must certify that the applicant has developed and implemented written policies and procedures reasonably designed to prevent violation of the federal securities laws and rules thereunder, and has documented the process by which they reached such determination. Accordingly, an SBS dealing entity should consider not only the range of the securities laws to which it is subject – apparently including laws that do not apply directly to SBS or SBS dealing activity – but also how it will document the process supporting the senior officer's certification that the applicant has implemented all required policies and procedures.

SBS dealers will also need to develop the policies and procedures, reasonably designed to prevent violation of the securities laws, as to which the senior officer will certify. Because of the many similarities between the SEC and CFTC rules, SBS dealers should in many cases be able to use their CFTC swap dealer policies as models for their SEC SBS dealer policies. At the same time, because the SEC and CFTC rules differ in many details, the new SBS dealer policies must be drafted carefully to reflect faithfully the SEC's requirements.

Additional considerations apply for non-resident SBS dealers, those that are incorporated, or have their principal place of business, outside of the United States. The SEC requires that such SBS dealers certify that they will, and that they provide an opinion of counsel stating that as a matter of law they can, provide the SEC with prompt access to books and records and submit to onsite SEC inspection and examination. Certain non-resident SBS dealers may find these requirements problematic under the laws of their home jurisdictions. In its registration rules release, the SEC goes so far as to suggest that certain SBS dealers may wish to consider restructuring their businesses to permit them to give this certification.

As the SEC continues to finalise its requirements for SBS dealers, additional considerations will undoubtedly arise. In the meantime, however, regardless of the exact timing for SBS dealer registration, there is no shortage of preparation that SBS dealing entities may begin to undertake.

By Morrison & Foerster of counsel James Schwartz in New York

Setting the scene

Final SEC guidance on cross-border SBSs is likely to ease concerns surrounding reporting duties and compliance with the SEC's Regulation SBSR

On July 13 2016, the US Securities and Exchange Commission (SEC) adopted amendments and guidance (Final Rules and Guidance) related to its rules on the regulatory reporting and public dissemination of security-based swaps (SBSs), known as Regulation SBSR. Two key issues addressed by the Final Rules and Guidance that may interest market participants involved in the cross-border SBS market are the compliance date for when SBS reporting begins and the applicability of Regulation SBSR to certain cross-border situations.

With regard to the compliance date, the Final Rules and Guidance make a significant modification to the compliance schedule as proposed that links the reporting compliance date to the compliance date for registration of SBS dealers and major SBS participants. This should alleviate certain compliance challenges in the cross-border context. Concerning the cross-border applicability of Regulation SBSR, the Final Rules and Guidance continue the SEC's policy of applying Dodd-Frank Act requirements to certain SBS transactions between non-US persons, where such transactions are "arranged, negotiated, or executed" within the US.

Regulation SBSR, which was adopted in February 2015, sets forth the information that must be reported and publicly disseminated for each SBS, assigns reporting duties for many SBSs, and requires registered SBS data repositories (SDRs) to establish and maintain policies and procedures for carrying out their responsibilities under Regulation SBSR. It also addresses the application of Regulation SBSR to certain cross-border SBS transactions.

At the same time that Regulation SBSR was adopted, the SEC proposed additional provisions of Regulation SBSR to address issues not covered in the Regulation SBSR adopting release. The companion proposing release (Companion Proposal) included a proposed compliance schedule establishing when SBS must be reported under Regulation SBSR, as well as provisions for reporting platform-executed SBS that will be submitted for clearing and for SBS resulting from the clearing process. Separately, in April 2015, the SEC proposed rules addressing the application of Regulation SBSR to SBS activity of non-US persons within the US (US Activity Release). The Final Rules and Guidance adopted by the SEC in its July release address the open issues from the Companion Proposal and the US Activity Release.

> **There is no date certain for when security-based entity registration will be required, and thus no date certain when SBS reporting will commence**

Compliance date challenges

Perhaps most important for market participants is that the Final Rules and Guidance establish the much anticipated compliance schedule for reporting under Regulation SBSR. Market participants have been waiting for the commencement of SBS reporting, as reporting for swaps has been in place for some time in the US under rules of the Commodity Futures Trading Commission (CFTC), which has had jurisdiction over swaps based on interest rates, foreign exchange, commodities and broad-based security indexes. Under the Companion Proposal, the compliance date for newly executed SBS reporting would have been six months after the first registered SDR that could accept reports of SBS in a particular asset class commences operations as a registered SDR.

Commentators voiced a number of concerns about requiring compliance before SBS dealer registration is required, noting that, during any interim period after the commencement of reporting of SBS but before SBS dealer or major SBS participant registration is required, there would be no registered SBS dealers or major SBS participants to occupy the highest rungs of the reporting hierarchy in Regulation SBSR.

As under the CFTC's reporting rules for swaps, Regulation SBSR establishes a reporting hierarchy under which only one counterparty reports a SBS to an SDR based on a counterparty's regulatory status, with registered SBS dealers and major SBS participants (except in SBSs with each other) as the reporting counterparty with respect to uncleared SBSs with all other counterparties. Without any registered SBS dealers or major SBS participants, a number of challenges in negotiating and carrying out reporting duties would result, including particular challenges with ascertaining reporting duties under the rules for cross-border transactions, especially for buy-side US. persons. Any interim solutions to assign reporting obligations negotiated between counterparties would not be useful for the period after SBS entities registration is required, when, by rule, SBS dealers or major SBS participants would be the reporting party.

Recognising these challenges, the SEC changed the compliance date for reporting newly-executed SBSs in a particular asset class under the Final Rules and Guidance. The compliance date, described as Compliance Date 1 in the Final Rules and Guidance release, is now the first Monday that is the later of: (1) six months after the date on which the first SDR that can accept transaction reports in that asset class registers with the SEC or (2) one month after the SBS entities registration compliance date. The one-month period after the SBS entities registration compliance date according to the SEC is designed to allow market participants to become familiar with which firms have registered as SBS dealers, and for registered SBS dealers to ensure that they have systems, policies, and procedures in place to commence their reporting duties under Regulation SBSR. Two additional compliance dates are provided for in the Final Rules and Guidance, one for when SDRs must commence public dissemination of SBS data – or Compliance Date 2 – which is the first Monday that is three months after Compliance Date 1, and the other for the reporting of historical SBS – or Compliance Date 3 – which is two

Reporting responsibilities under regulation SBSR as modified by the Final Rules and Guidance

Party A \ Party B	SBSD	Non-SBSD, U.S. person	Non-SBSD, non-US person, SBS dealing ANE	Non-SBSD, non-US person, not ANE
SBSD	Parties select	Party A	Party A	Party A
Non-SBSD, US Person	Party B	Parties select	Parties select	Party A
Non-SBSD, non-US person, SBS dealing, ANE	Party B	Parties select	Parties select	Party A
Non-SBSD, non-US person, not ANE	Party B	Party B	Party B	N/A, except if effected by or through a registered broker-dealer, in which case the broker-dealer reports

Key: SBSD = SBS dealer
ANE = Arranged, negotiated, or executed by personnel of such non-US person located in a US branch or office, or by personnel of its agent located in a US branch or office

months after Compliance Date 2.

With regard to Compliance Date 1, the SBS entities registration compliance date, to which SBS reporting is now linked under the Final Rules and Guidance, is separately provided for in the SEC's final SBS dealer and major SBS participant registration rules and, admittedly, is not definite (see *James Schwartz's swap registration article on page XX*). The registration rules provide that the compliance date 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. In any event, in light of these contingencies, there is no date certain under the SBS entities registration rules for when security-based entity registration will be required, and thus no date certain for when SBS reporting will commence.

A number of commentators also requested that the SEC defer compliance with Regulation SBSR until the SEC has made substituted compliance determinations with respect to regulatory reporting and public dissemination of SBS transactions for certain foreign jurisdictions, which would allow market participants to comply with the foreign jurisdictions' rules in place of SEC rules. This approach was taken by the CFTC through staff no-action letters, which have delayed regulatory reporting of swaps for certain registered non-US swap dealers based in Australia, Canada, the EU, Japan or Switzerland with non-US counterparties that are not guaranteed by a US person, until the earlier of 30 days after a comparability determination issued by the CFTC (which has not yet been issued for these jurisdictions) or December 1 2016. However, the SEC declined to provide for such a delay, noting that it had not received any substituted compliance applications and that other jurisdictions were still in the process of promulgating reporting rules, which could lead to a significant delay in Regulation SBSR implementation.

Nonetheless, despite the lack of a date certain for when SBS reporting is to commence and no provision for a delay for substituted compliance determinations to be made, market participants will likely welcome the new compliance date in the Final Rules and Guidance for reporting under Regulation SBSR and its linkage to the compliance date for the SBS entities registration rules because of the challenges and inefficiencies that it avoids.

Cross-border SBSR applicability

Another important issue for international market participants is the cross-border applicability of Regulation SBSR as provided for in the Final Rules and Guidance. In particular, the Final Rules and Guidance address the applicability of SBSR to certain SBS transactions that are "arranged, negotiated, or executed" by non-US persons within the US, and the assignment of reporting responsibilities in certain cross-border situations not provided for in Regulation SBSR as adopted in 2015.

When it was adopted in 2015, Regulation SBSR provided for regulatory reporting and public dissemination of any SBS transaction that (1) has a direct or indirect counterparty that is a US person on either or both sides of the transaction or (2) is accepted by a clearing agency having its principal place of business in the US. Regulation SBSR also required regulatory reporting (but not public dissemination) of uncleared SBSs of registered non-US SBS dealers and major SBS participants when there is no US person on either side. It did not address reporting and public dissemination of transactions that are "arranged, negotiated, or executed" in the US. It also did not assign the reporting responsibility for SBSs between two unregistered non-US persons and between an unregistered US person and an unregistered non-US person. These issues were taken up in the US Activity Proposal, and in turn have been finalised under the Final Rules and Guidance.

Under the Final Rules and Guidance, SBSs in connection with a non-US person's SBS dealing activity that are "arranged, negotiated, or executed" by personnel of such non-US person located in a US branch or office, or by personnel of its agent located in a US branch or office, are required to be reported and publicly disseminated. The Final Rules and Guidance do not subject additional transactions involving registered SBS dealers to Regulation SBSR's regulatory reporting requirements because registered SBS dealers, whether US or non-US, are already subject to regulatory reporting requirements with respect to *all* of their counterparties, whether US or non-US, under Regulation SBSR as previously adopted. However, this provision of the Final Rules and Guidance would require that transactions of non-US SBS dealers that are "arranged, negotiated, or executed" in the US be publicly disseminated.

In addition, the Final Rules and Guidance assign reporting responsibility for SBSs in situations involving non-registrants. Specifically, they provide that, for SBSs between two non-US persons engaged in SBS dealing activity that is "arranged, negotiated, or executed" in the US, or between one such non-US person and a US person, the parties shall select the reporting side. For SBSs between a non-US person who is not engaged in SBS dealing activity "arranged, negotiated, or executed" in the

Another important issue for international market participants is the cross-border applicability of Regulation SBSR as provided for in the Final Rules and Guidance

United States, and a non-US person who is engaged in such activity in the United States or a US person, the Final Rules and Guidance provide that the latter is the reporting side. If the SBS is between two non-US persons who are not engaged in SBS dealing activity "arranged, negotiated, or executed" in the US, Regulation SBSR does not apply, unless the SBS is effected by or through a registered broker dealer, including a registered SBS execution facility, in which case the registered broker-dealer reports. As modified by the Final Rules and Guidance, the reporting responsibility as between two counterparties – Party A and Party B – to a SBS under Regulation SBSR is summarised in the table on the preceding page.

The Final Rules and Guidance thus extend reporting requirements to dealing SBSs between non-US persons that are "arranged, negotiated, or executed" in the United States. This follows rules the SEC adopted in February 2016 that require a foreign dealing entity to count against its *de minimis* threshold (above which registration as a SBS dealer is required) to transactions with non-US persons where the foreign dealing entity is engaged in activity that is "arranged, negotiated, or executed" in the US. The February 2016 release contains detailed guidance about when a SBS is deemed to be "arranged, negotiated, or executed" in the US that may facilitate guidance with the reporting rules. The concept originated with the CFTC in Staff Advisory 13-69 issued in 2013, in which CFTC staff stated that the CFTC's Transaction-Level requirements would apply to a swap transaction between a non-US registered swap dealer and a non-US person, if the transaction is "arranged, negotiated, or executed" in the US.

The Advisory has not been implemented, however, because after its issuance the CFTC requested comment on whether the Advisory should be adopted as CFTC policy and issued no-action relief from the effects of the Advisory. That relief, which has been extended several times and was set to expire on September 30 2016, was extended again by CFTC staff on August 4 2016 until September 30 2017. In conjunction with that relief, CFTC Chairman Timothy Massad said in a statement that he intends to ask the CFTC in the fall of 2016 to consider a proposed rule to address the "arranged, negotiated or executed" issue.

While well behind the CFTC in terms of its implementation of rules for SBSs, the SEC through the February 2016 release and the Final Rules and Guidance has taken the lead with respect to when Dodd-Frank Act requirements apply to a non-US person's dealing activity involving SBSs "arranged, negotiated, or executed" in the US. It remains to be seen whether the CFTC will adopt a similar approach to regulatory requirements under the Dodd-Frank Act with respect to swaps – stay tuned.

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THE FEDERAL RESERVE'S PROPOSED RULES FOR FINANCIAL CONTRACTS OF GLOBAL SYSTEMICALLY IMPORTANT BANKING ORGANIZATIONS AND ISDA'S RESOLUTION STAY JURISDICTIONAL MODULAR PROTOCOL

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On May 11, 2016, the Board of Governors of the Federal Reserve System (the "Board") published in the Federal Register proposed new rules (the "Proposed Rules") intended to reduce the potential risks posed to the U.S. financial system by too-big-to-fail banks.[1] The Proposed Rules would, among other things, require certain systemically important banks to include in their contracts provisions that would significantly limit their counterparties' default rights in over-the-counter swaps, repurchase and reverse repurchase agreements, securities lending and borrowing transactions, commodity contracts, and forward agreements. The Proposed Rules were open to public comment until August 5, 2016.

Contemporaneously with the Board's release of the Proposed Rules, the International Swaps and Derivatives Association, Inc. ("ISDA") released its ISDA Resolution Stay Jurisdictional Modular Protocol (the "JM Protocol"), intended to permit market participants to comply with the Proposed Rules (when adopted in their final form) and similar rules of foreign jurisdictions.

In this article, we examine the Proposed Rules and related ISDA protocols.

Goals of the Proposed Rules

The Proposed Rules have two primary goals, both aimed at facilitating the orderly liquidations of systemically important financial institutions, including under the orderly liquidation process created by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[2]

The first goal is to assure the cross-border application of U.S. special resolution regimes to certain transactions be-

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tween a counterparty outside of the U.S. and a U.S. global systemically important bank ("GSIB") or certain U.S. subsidiaries, branches or agencies of U.S. or non-U.S. GSIBs. While it is clear that existing U.S. special resolution regimes provide the U.S. regulatory agencies with the powers to prevent counterparties from exercising contractual termination rights in certain circumstances, it is not entirely clear what might happen if a court outside of the U.S. were to disregard such powers. The Board intends that the Proposed Rules, if adopted, will require parties to add to their contracts provisions to make clear that the U.S. special resolution regimes will apply to cross-border transactions and will thus bind authorities and parties outside of the U.S.

The Board's second goal is to facilitate the resolution of a GSIB under a "single point of entry" strategy, in which only the top-tier holding company would enter into a resolution proceeding while its subsidiaries would continue to operate and meet their financial obligations. The Board takes the view that, to facilitate such a resolution, it must ensure that operating subsidiaries of a GSIB are not parties to contracts containing cross-default rights that their counterparties could exercise based on the entry into resolution of an affiliate of such operating subsidiaries.

The common thread of these two goals is that, if and when the Proposed Rules are adopted and go into effect, they will likely require parties in many transactions facing certain GSIBs (and certain of their subsidiaries, branches and agencies) expressly to relinquish certain of their contractual rights.

Background: The U.S. Special Resolution Regimes

There are two special resolution regimes whose cross-border application the Proposed Rules seek to assure. The first is Title II of the Dodd-Frank Act (titled "Orderly Liquidation Authority" and known in short as "OLA"), the enactment of which enhanced the federal government's receivership authorities by expanding them to large, interconnected financial companies. OLA provides the Federal Deposit Insurance Corporation ("FDIC") with the authority to serve as receiver for large financial companies whose failure would pose a significant risk to the financial stability of the United States. In addition, even prior to the Dodd-Frank Act, under the Federal Deposit Insurance Act ("FDI Act"),[3] the FDIC had receivership authority with respect to federally insured banks and thrift institutions. The Proposed Rules designate both the FDI Act and the OLA provisions (and related regulations) as "U.S. special resolution regimes."[4]

Both of the U.S. special resolution regimes in certain circumstances limit the contractual rights of counterparties facing certain bank entities. Under the OLA, after a determination is made that a financial company should be placed in receivership, the FDIC takes over as receiver, and the bank's counterparties are prohibited, or "stayed," from terminating certain contracts until 5 p.m. of the business day after the receivership is commenced.[5] Similarly, under the FDI Act, after a resolution is initiated and the FDIC becomes a bank's receiver, the bank's counterparties are prohibited from terminating certain contracts until 5 p.m. of the business day following the day on which the receiver was appointed.[6] Under both its OLA authority and the FDI Act, the FDIC has the right, among other things, to transfer certain contracts to a bridge financial company, which, as contemplated by the special resolution regimes, will be capable of performing under the

transferred contracts. After such a transfer, the counterparty no longer has the right to terminate based on events that occurred prior to the transfer.

These provisions of the U.S. special resolution regimes are in accordance with recommendations of the Financial Stability Board ("FSB"). After the financial crisis of 2007-09, the FSB recommended that countries put in place special resolution regimes to address failing financial institutions, especially those whose collapse could have systemic consequences.[7] Thereafter, the Cross-border Bank Resolution Group of the Basel Committee on Banking Supervision recommended that such resolution regimes include powers to continue needed contracts, terminate unnecessary contracts, and sell assets and transfer liabilities.[8] Many countries that are members of the G20 group of nations have adopted or are in the process of adopting similar resolution regimes.

Provisions of the Proposed Rules

Entities and Contracts Subject to the Proposed Rules

The Proposed Rules apply to "covered QFCs," that is, contracts that constitute "qualified financial contracts" to which a "covered entity" is a party.

For these purposes, "covered entities" include:

- any U.S. bank holding company that is identified as a global systemically important bank holding company under the Board's rule establishing risk-based capital surcharges for GSIBs;
- any subsidiary of a U.S. GSIB described in the preceding bullet point that is not a national bank, federal savings association, federal branch or federal agency; and
- a U.S. subsidiary, U.S. branch, or U.S. agency of a non-U.S. GSIB (other than entities subject to regulation by the OCC,[9] such as national banks, federal savings associations, federal branches or federal agencies).[10]

The Proposed Rules define the term "qualified financial contracts" in accordance with section 210(c)(8)(D) of the Dodd-Frank Act.[11] Accordingly, QFCs include many swaps, repurchase (and reverse repurchase) transactions, forward contracts, commodity contracts and securities sale, lending and borrowing transactions. The "QFC" definition also includes any master agreement that governs QFCs between parties.

The Proposed Rules expressly exclude centrally cleared QFCs from their scope.[12] Although cleared QFCs may pose some of the risks that the Proposed Rules were intended to address, the Board appears to justify the exclusion of cleared QFCs based on its view that the clearing of transactions provides unique benefits to the financial system.[13] The Board has asked for comments regarding the appropriate treatment of cleared QFCs.

Also excluded from the Proposed Rules are certain QFCs entered into under multi-branch master agreements of foreign GSIBs. The definition of QFC generally includes a master agreement that governs QFCs. Many such master agreements permit the parties to trade from multiple branches or offices. For non-U.S. GSIBs, the definition of QFC contained in the Proposed Rules, however, effectively excludes transactions that are not booked at, and for which

no payment or delivery may be made at, a U.S. branch or U.S. agency of the non-U.S. GSIB.[14] The Board invited comment on this point as well.[15]

Provisions Required to be Added to QFCs

The Proposed Rules would require covered entities to add two distinct provisions to their QFCs. One such provision would limit the exercise of default rights under Covered QFCs, and the other would permit transfers of QFCs to bridge entities as contemplated by the special resolution regimes.

Limitations on Default Rights under Covered QFCs

To clarify the cross-border application of the U.S. special resolution regimes, the Proposed Rules would require each covered QFC to expressly provide that "default rights" under such covered QFC "that may be exercised against the covered entity are permitted to be exercised to no greater extent than the default rights could be exercised under the U.S. special resolution regimes," assuming U.S. law applied and the covered entity were under a U.S. special resolution regime.[16] Such a provision, if and when inserted into covered QFCs, will make clear that the covered entity's counterparty, regardless of its jurisdiction, will have no right to terminate a covered QFC to the extent it would not have such right under the applicable U.S. special resolution regime.

The Proposed Rules define broadly the "default rights" to which this mandatory provision applies. "Default rights" include, among other things, a right of a party, whether contractual or otherwise, to liquidate, terminate, cancel, rescind, or accelerate an agreement or transactions thereunder; set off or net amounts owing; exercise remedies in respect of collateral or other credit support or related property; demand payment or delivery, suspend, delay, or defer payment or performance; or modify the obligations of a party. The "default right" definition does not generally prevent, however, the exercise of rights to (i) net same-day payments, (ii) demand delivery of collateral based on a change in the value of relevant transactions or (iii) terminate a contract based on a provision that allows termination at a party's option without the need to show cause.[17]

Transfers of Covered QFCs

The Proposed Rules would also require each covered QFC to support the U.S. special resolution regimes by permitting transfers of such QFCs to bridge entities as contemplated by the special resolution regimes. Specifically, the Proposed Rules would require covered QFCs expressly to provide that the transfer of the covered QFC (and any interest in, or property securing, the covered QFC) from the covered entity will be effective to the same extent as the transfer would be effective under the U.S. special resolution regimes, assuming U.S. law applied and the covered entity were under a U.S. special resolution regime.[18]

Support for "Single Point of Entry" Resolutions

The Proposed Rules also contain provisions intended to support "single point of entry" resolutions of banking organizations, in which only a single legal entity, the GSIB's top-tier bank holding company, is to enter into a resolution proceeding. The Board contemplates that a GSIB may enter into QFCs through operating subsid-

iaries, and, to the extent that such QFCs cause losses, those losses will be passed up from the operating subsidiaries that incurred them to the holding company, where, by means of the resolution process, the losses will be imposed on the holding company's equity holders and unsecured creditors. The "single point of entry" strategy is intended to ensure that the operating subsidiaries will remain adequately capitalized and able to meet their financial obligations without defaulting or entering resolution.[19] To facilitate this resolution strategy, in which operating subsidiaries are expected to remain continuously in operation and out of resolution, the Board believes that it must prevent counterparties facing operating subsidiaries of GSIBs from exercising default rights based on the entry into resolution or insolvency proceedings of the operating subsidiaries' affiliates.

Accordingly, the Proposed Rules, if finalized in their proposed form, would provide that a covered QFC may not permit the exercise of any default right with respect to the covered QFC that is related, directly or indirectly, to an affiliate of a covered entity becoming subject to a receivership, insolvency, liquidation, resolution, or similar proceeding. However, a covered QFC could permit the exercise of default rights based on (i) a covered entity itself becoming subject to receivership, insolvency, liquidation, resolution, or similar proceeding, other than under a special resolution regime, or (ii) a party to a QFC, or an affiliated credit support provider, failing to meet a payment or delivery obligation under the covered QFC.[20]

The Proposed Rules would also generally provide that no covered QFC may prohibit the transfer of a credit enhancement supporting such QFC provided by an affiliate of the covered entity upon an affiliate of the covered entity becoming subject to a receivership, insolvency, liquidation, resolution or similar proceeding.[21]

Proposed Effective Date

Covered entities would be required to comply with the Proposed Rules by the first day of the first calendar quarter that begins at least one year after the issuance of the final rule (such day, the "Effective Date"). If a covered entity were to enter into a new QFC after the Effective Date, such QFC would be required to comply. With respect to pre-existing QFCs, entered into prior to the Effective Date, a covered entity would be required to bring such QFCs into compliance no later than the first date on or after the Effective Date on which the covered entity or certain of its affiliates were to enter into a new covered QFC with the same counterparty to the preexisting QFC or an affiliate of the counterparty.[22]

ISDA's Resolution Stay Protocols

Contemporaneously with the Board's release of the Proposed Rules, ISDA released its JM Protocol,[23] intended to permit market participants to comply with the provisions of the Proposed Rules (when adopted in their final form) and similar rules of foreign jurisdictions. Like other ISDA protocols, the JM Protocol is a mechanism to allow parties to amend numerous agreements in one stroke. By adhering to the protocol, parties agree that their contracts with other adhering parties are amended in accordance with the terms of the relevant protocol. The heart of the JM Protocol consists of the country-specific modules, a large majority of which ISDA has not yet published. Nonetheless, it is not too soon for market participants to begin to consider the JM Protocol.

The JM Protocol is the third ISDA protocol to address compliance with the requirements of special resolution regimes. Prior to publishing the JM Protocol, ISDA published the ISDA 2015 Universal Stay Protocol (the "Universal Stay Protocol") and the ISDA 2014 Resolution Stay Protocol (the "Resolution Stay Protocol"). The Universal Stay Protocol covers a broader range of transactions than does the Resolution Stay Protocol but is otherwise quite similar to the Resolution Stay Protocol. Under the terms of both the Universal Stay Protocol and the Resolution Stay Protocol, adhering parties, among other things, opt in to numerous special resolution regimes of the U.S. and other countries. Within certain limitations, those protocols provide that if one adhering party is subject to a special resolution regime (regardless of the jurisdiction of that 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.

Primarily it has been the largest, systemically important banks and their affiliates that, with the encouragement of their regulators, have adhered to the Universal Stay Protocol and the Resolution Stay Protocol. Other market participants have generally not adhered to those protocols. In particular, asset managers have been concerned about the possibility of breaching their fiduciary duties if they were to expressly relinquish default rights under numerous jurisdictions in the absence of any legal requirement to do so.

The JM Protocol differs from the Universal Stay Protocol and the Resolution Stay Protocol in that, by means of the JM Protocol's country-specific modules, parties will be able to specify exactly which special resolution regime modules they will opt in to. Thus, although the Proposed Rules specifically identify the Universal Stay Protocol as a permitted means for covered parties to amend their QFCs to comply with certain provisions of the Proposed Rules,[24] most market participants will likely prefer to adhere to the JM Protocol in order to comply.

The JM Protocol consists of a main agreement and separate jurisdictional modules, each of which relates to only one jurisdiction. So far, the only jurisdictional modules that ISDA has published are the modules for Germany and the UK. Presumably the U.S. jurisdictional module will not be published until after the Board finalizes the Proposed Rules.

Conclusion

While it may be difficult to like regulations that, if adopted, will require parties expressly to give up their hard won contractual rights, the Proposed Rules do seem well tailored to the Board's aims of first, assuring the cross-border application of U.S. special resolution regimes and second, facilitating the resolution of GSIBs under a "single point of entry" strategy. If the Proposed Rules are adopted in their proposed form, the exercise of default rights in relation to QFCs will be subject to limitations contained in the U.S. special resolution regimes, and parties facing GSIBs and certain of their subsidiaries in covered QFCs will have fewer cross-default rights and thus fewer opportunities to cause multiple GSIB-related entities to enter insolvency or resolution proceedings.

ENDNOTES:

[1]Restrictions on Qualified Financial Con-

tracts of Systemically Important U.S. Banking Organizations and the U.S. Operations of Systemically Important Foreign Banking Organizations; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions, 81 Fed. Reg. 29,169 (May 11, 2016). In addition, on August 19, 2016, the Office of the Comptroller of the Currency ("OCC") published in the Federal Register proposed rules, substantively identical to the Proposed Rules, for entities that the OCC supervises. *See* Mandatory Contractual Stay Requirements for Qualified Financial Contracts, 81 Fed. Reg. 55,381 (Aug. 19, 2016); note 9 *infra* and accompanying text. The comment period on the OCC's proposed rules is scheduled to close on October 18, 2016.

[2]Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 701-74, 124 Stat. 1376, 1641-802 (2010) (codified as amended in scattered sections of titles 7, 12 and 15 U.S.C. (2012)).

[3]12 U.S.C. 1811 et seq.

[4]Proposed Rules at § 252.81, 81 Fed. Reg. at 29,190.

[5]Dodd-Frank Act at § 210(c)(10)(B).

[6]FDI Act at § 11(e)(10)(B).

[7]*See generally*, Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions, October 15, 2014.

[8]Basel Committee on Banking Supervision, Report and Recommendations of the Cross-border Bank Resolution Group, March, 2010, at 23.

[9]The OCC has proposed rules, substantively identical to the Proposed Rules, for entities that the OCC supervises. *See* note 1 supra.

[10]Proposed Rules at § 252.82(a), 81 Fed. Reg. at 29,190.

[11]*Id*. at § 252.81, 81 Fed. Reg. at 29,190.

[12]*Id*. at § 252.88, 81 Fed. Reg. at 29,193.

[13]81 Fed. Reg. at 29,176.

[14]Proposed Rules at § 252.86, 81 Fed. Reg. at 29,192-93.

[15]*See generally* 81 Fed. Reg. at 29,176-77.

[16]Proposed Rules at § 252.83(b)(2), 81 Fed. Reg. at 29,190.

[17]*Id*. at § 252.81, 81 Fed. Reg. at 29,190.

[18]*Id*. at § 252.83(b)(1), 81 Fed. Reg. at 29,190.

[19]81 Fed. Reg. at 29,172.

[20]Proposed Rules at § 252.84(b)(1) and (e), 81 Fed. Reg. at 29,191. In addition, under the Proposed Rules, a covered QFC would be required to provide that, after an affiliate of the covered party has become subject to a receivership, insolvency, liquidation, resolution, or similar proceeding, a party seeking to exercise a default right must prove by clear and convincing evidence or a similar standard that the exercise is permitted under the covered QFC. Proposed Rules at § 252.84(j), 81 Fed. Reg. at 29,192.

[21]Proposed Rules at § 252.84(b)(2), 81 Fed. Reg. at 29,191. The Proposed Rules would also amend certain definitions contained in the Board's capital and liquidity rules to help ensure that the regulatory capital and liquidity treatment of QFCs to which a covered entity is a party is not affected by the proposed restrictions on such QFCs. Specifically, the Proposed Rules would amend the definition of the term "qualifying master netting agreement" contained in the Board's regulatory capital and liquidity rules and would similarly amend the definitions of the terms "collateral agreement," "eligible margin loan," and "repo-style transaction" contained in the Board's regulatory capital rules. *See* 81 Fed. Reg. at 29,185.

[22]*See* 81 Fed. Reg. at 29,184.

[23]JM Protocol documents are available at: http://www2.isda.org/functional-areas/protocol-management/protocol/24.

[24]*See* 81 Fed. Reg. at 29,181; Proposed Rules at § 252.85(a), 81 Fed. Reg. at 29,192.

Client Alert

June 7, 2016

CFTC Issues Final Rules Regarding the Cross-Border Application of its Uncleared Swaps Margin Requirements

By Julian Hammar

On May 24, 2016, the Commodity Futures Trading Commission ("CFTC") in a much anticipated action approved the issuance of final rules ("Final Rules") regarding the cross-border application of its uncleared swaps margin requirements that it adopted on December 16, 2015. The Final Rules are closely aligned with the cross-border rules for uncleared swaps margin that the Prudential Regulators[1] adopted in October of 2015 for swap dealers and major swap participants subject to their supervision.[2] The CFTC's Final Rules, which were published in the Federal Register on May 31, 2016, are scheduled to become effective on August 1, 2016.[3]

I. BACKGROUND

In December of 2015, the CFTC adopted final rules ("December 2015 Final Margin Rules") regarding margin requirements for uncleared swaps for swap dealers and major swap participants that do not have a Prudential Regulator ("Covered Swap Entities" or "CSEs"). The rules that became the December 2015 Final Margin Rules had been re-proposed in October of 2014 (along with those of the Prudential Regulators) to take into account recommendations of the Basel Committee on Bank Supervision ("BCBS") and the Board of the International Organization of Securities Commissions ("IOSCO") (referred to herein as the "BCBS/IOSCO Standards").[4] The CFTC's October 2014 re-proposal did not include proposed rules regarding the cross-border application of these rules; instead, the October 2014 re-proposal included an advance notice of proposed rulemaking requesting comment on three alternative approaches.

Subsequently, in June of 2015, the CFTC separately proposed rules regarding the cross-border application of its uncleared swaps margin rules ("Proposed Rules"). The Proposed Rules by their terms would apply the uncleared swap margin rules at the entity level, meaning that they would apply to CFTC-registered swap dealers or major swap participants—as entities—that do not have a Prudential Regulator. However, certain uncleared swaps would be eligible for substituted compliance or excluded from the CFTC's margin rules entirely under the Proposed Rules based on the counterparties' relationship to the United States relative to other jurisdictions.[5]

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[1] The Prudential Regulators are the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency.

[2] See Margin and Capital Requirements for Covered Swap Entities; Final Rule, 80 Fed. Reg. 74,839 (Nov. 30, 2015).

[3] See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants—Cross-Border Application of the Margin Requirements, 81 Fed. Reg. 34,817 (May 31, 2016), available here.

[4] See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants; Final Rule, 81 Fed. Reg. 635 (Jan. 6. 2016). For more information regarding the CFTC's December 2015 Final Margin Rules, please see our client alert here.

[5] For more information regarding the Proposed Rules, please see our client alert here.

II. FINAL RULES

The Final Rules generally are the same as the Proposed Rules with a few modifications that are described in this client alert. In general, as under the Proposed Rules, the Final Rules provide for the applicability of the CFTC Margin Rules depending upon the location of the counterparties to an uncleared swap and the nexus of the counterparties to the United States. As discussed in greater detail below, where the covered swap entity is a U.S. CSE or a CSE guaranteed by a U.S. person, the uncleared swaps margin rules apply to a greater extent than to a non-U.S. CSE that is not guaranteed by a U.S. person, whose swaps may in certain circumstances be excluded from the rules.

A. Application of the Margin Rules to U.S. CSEs and U.S.-Guaranteed CSEs

Under the Final Rules, the uncleared swaps margin requirements will generally apply to all uncleared swaps of a U.S. CSE and a non-U.S. CSE that is guaranteed by a U.S. person ("U.S. Guaranteed CSE"), without exclusion. Substituted compliance (*i.e.*, compliance with a non-U.S. regulator's rules that the CFTC has determined to be sufficiently comparable to meet the CFTC's uncleared swaps margin requirements, discussed in section C. below) would be available in one circumstance only: with respect to initial margin posted to (but not collected from) any non-U.S. person counterparty (including any non-U.S. CSE) whose obligations are not guaranteed by a U.S. person. The CFTC believes that, with regard to a non-U.S. counterparty whose swap obligations are not guaranteed by a U.S. person, in the interest of comity substituted compliance in these circumstances would be reasonable. The CFTC's rules afford U.S. CSEs and U.S. Guaranteed CSEs the same treatment as under the Prudential Regulators' final uncleared swaps margin rules, which provide for the possibility of substituted compliance for U.S. CSEs and U.S. Guaranteed CSEs with regard to the posting of initial margin to non-U.S. counterparties.[6]

B. Application of Margin Rules to Non-U.S. CSEs that are Not Guaranteed by a U.S. Person

1. Availability of Substituted Compliance

The Final Rules would allow non-U.S. CSEs that are not guaranteed by a U.S. person to avail themselves of substituted compliance with non-U.S. uncleared swaps margin rules for swaps with any counterparty, except for a U.S. CSE or U.S. Guaranteed CSE. Notably, the availability of substituted compliance under the Final Rules is broader than under the CFTC's Cross-Border Guidance issued by the agency in 2013,[7] which would have applied the CFTC's margin requirements to swaps between non-U.S. swap dealers and all U.S. persons, with substituted compliance available only for swaps between a non-U.S. swap dealer and a foreign branch of a U.S. swap dealer.

The availability of substituted compliance under the Final Rules also applies to a non-U.S. CSE not guaranteed by a U.S. person that is consolidated for accounting purposes with an ultimate parent entity that is a U.S. person, described in the rules as a "Foreign Consolidated Subsidiary" ("FCS"). For this purpose, the term "ultimate parent entity" means an entity in a consolidated group in which none of the other entities in the group has a controlling

[6] See 80 Fed. Reg. at 74,885.

[7] See Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations, 78 Fed. Reg. 45,291 (July 26, 2013) ("Cross Border Guidance").

interest in accordance with U.S. Generally Accepted Accounting Principles. While eligible for substituted compliance, FCSs, as well as U.S. branches of non-U.S. CSEs, are not eligible for the exclusion from the uncleared swaps margin rules for non-U.S. CSEs described in section B.2. below.

If the swap obligations of a non-U.S. CSE (including an FCS or U.S. branch of a non-U.S. CSE) are not guaranteed by a U.S. person, and its counterparty is a U.S. CSE or a U.S. Guaranteed CSE (including an FCS or U.S. branch of a non-U.S. CSE the swap obligations of which are guaranteed by a U.S. person), substituted compliance would be available only with respect to initial margin collected from the U.S. CSE or U.S. Guaranteed CSE, and in no other circumstances.

2. Exclusion from Margin Rules

The Final Rules provide for an exclusion from the CFTC's uncleared swaps margin rules with respect to swaps entered into by a non-U.S. CSE with a non-U.S. person, provided that neither the non-U.S. CSE's nor the non-U.S. person's swap obligations are guaranteed by a U.S. person, and neither counterparty is an FCS or a U.S. branch of a non-U.S. CSE.[8] In a new provision not contained in the Proposed Rules, the Final Rules provide, in connection with inter-affiliate swaps that under the December 2015 Final Margin Rules are exempt from the uncleared swaps margin requirements under certain conditions, that this exclusion is not available if (i) the market-facing transaction of the non-U.S. CSE (that is otherwise eligible for the exclusion) is not subject to comparable initial margin collection requirements in the home jurisdiction and (ii) any of the risk associated with the uncleared swap is transferred, directly or indirectly, through inter-affiliate transactions, to a U.S. CSE.[9]

C. Procedures for Substituted Compliance Determinations

The Final Rules will permit a U.S. CSE or a non-U.S. CSE in the circumstances described above that is eligible for substituted compliance to comply with the margin requirements of the relevant foreign jurisdiction in lieu of compliance with the CFTC's margin requirements, only if the CFTC makes a comparability determination to the effect that such jurisdiction's margin requirements are comparable to the CFTC's margin requirements. Persons eligible to request a comparability determination include any CSE that is eligible for substituted compliance and any foreign regulatory authority that has direct supervisory authority over one or more CSEs and that is responsible for administering the relevant foreign jurisdiction's margin requirements. Such persons may request a comparability determination individually or collectively and with respect to some or all of the CFTC's margin requirements; the CFTC advises that eligible CSEs may wish to coordinate with their home regulators and other CSEs to streamline the process.

A comparability determination applicant must submit (i) copies of the relevant foreign jurisdiction's margin requirements, (ii) a description of their objectives, (iii) a description of how they differ from the BCBS/IOSCO standards, and (iv) a description of how they address the elements of the CFTC's margin requirements, as well as any other documentation the CFTC deems relevant.[10] The CFTC will issue a comparability determination to the

[8] See 17 CFR 23.160(b)(2)(ii).

[9] See 17 CFR 23.160(b)(2)(ii)(B).

[10] See 17 CFR 23.160(c)(2).

extent that it determines that some or all of the relevant foreign jurisdiction's margin requirements are comparable to the CFTC's corresponding margin requirements. In making a comparability determination, the Final Rules provide that the CFTC will consider all relevant factors, including: (i) the scope and objectives of the relevant foreign jurisdiction's margin requirements, (ii) whether the relevant foreign jurisdiction's margin requirements achieve comparable outcomes to the Commission's corresponding margin requirements, (iii) the ability of the relevant regulatory authority or authorities to supervise and enforce compliance with the relevant foreign jurisdiction's margin requirements, and (iv) any other facts and circumstances the CFTC deems relevant.[11] The CFTC will also consider the consistency of the margin requirements of the foreign jurisdiction with the BCBS/IOSCO Standards, although the CFTC states that, while a finding of consistency with the BCBS/IOSCO Standards is necessary, it may not be sufficient for a finding of comparability.[12]

The CFTC describes its comparability standard as "outcome-based" with a focus on whether margin requirements in the foreign jurisdiction achieve the same regulatory objectives as margin requirements under the Commodity Exchange Act without regard to whether the foreign jurisdiction has implemented specific rules that are identical to the CFTC's rules. The standard takes the form of an "element-by-element" determination involving 12 elements, where the CFTC may find some elements comparable with its rules, but not others.[13] In a dissenting statement to the Final Rules, CFTC Commissioner J. Christopher Giancarlo expressed the view that this approach is impractical, unnecessary, and contrary to the spirit of the 2009 G-20 Pittsburgh Accords and the BCBS/IOSCO standards, and that a better approach would be to determine whether, in the aggregate, a foreign regulator has adopted the BCBS-IOSCO standards.[14] It remains to be seen how the CFTC will apply its standard in an actual comparability determination.

D. Definition of U.S. Person

As under the Proposed Rules, the Final Rules' definition of U.S. person differs from the U.S. person definition in the CFTC's 2013 Cross-Border Guidance, which is generally applicable to Dodd-Frank Title VII CFTC requirements. While broadly similar in most respects, key differences adopted by the Final Rules include:

- Elimination of the "including, but not limited" language contained in the U.S. person definition in the Cross-Border Guidance. This change provides greater legal certainty for market participants as to who is (and who is not) a U.S. person.

[11] See 17 CFR 23.160(c)(3).

[12] 81 Fed. Reg. at 34,837.

[13] The twelve elements generally are similar to the elements as proposed, except one element, the treatment of inter-affiliate derivative transactions, has been added. The twelve elements are as follows: (A) The products subject to the foreign jurisdiction's margin requirements; (B) The entities subject to the foreign jurisdiction's margin requirements; (C) The treatment of inter-affiliate derivative transactions; (D) The methodologies for calculating the amounts of initial and variation margin; (E) The process and standards for approving models for calculating initial and variation margin models; (F) The timing and manner in which initial and variation margin must be collected and/or paid; (G) Any threshold levels or amounts; (H) Risk management controls for the calculation of initial and variation margin; (I) Eligible collateral for initial and variation margin; (J) The requirements of custodial arrangements, including segregation of margin and rehypothecation; (K) Margin documentation requirements; and (L) The cross-border application of the foreign jurisdiction's margin regime. See 17 CFR 23.160(c)(2)(ii).

[14] See generally 81 Fed. Reg. at 34,853-54.

- Elimination of the U.S. majority ownership prong that was included in the Cross-Border Guidance definition for funds or other collective investment vehicles. Market participants commented that this requirement is burdensome and difficult to comply with.
- Elimination of the requirement that a legal entity owned by one or more U.S. person(s), for which such person(s) bear unlimited responsibility for its obligations and liabilities, be majority owned by one or more U.S. persons.[15]

It is likely that the final definition of U.S. person will be welcomed by market participants, as it eliminates aspects of the Cross-Border Guidance definition that created legal uncertainty and were burdensome to implement. However, it should be noted that, while similar to the Prudential Regulators' rules, the CFTC's definition of U.S. person includes two types of entities that are not mentioned in the Prudential Regulators' rules: (i) an entity with its principal place of business in the United States and (ii) an entity for which a U.S. person bears unlimited responsibility for the entity. This may mean, in practice, that the CFTC's uncleared swaps margin rules will apply in more situations than the Prudential Regulators' rules.

E. Definition of Guarantee

For purposes of the Final Rules, a guarantee is not as broadly defined as it is in the CFTC's Cross-Border Guidance. The Final Rules would define the term "guarantee" as an arrangement, pursuant to which one party to an uncleared swap transaction with a non-U.S. counterparty has rights of recourse against a U.S. person guarantor (whether such guarantor is affiliated with the non-U.S. counterparty or is an unaffiliated third party) with respect to the non-U.S. counterparty's obligations under the swap. A party has rights of recourse against a U.S. guarantor if the party has a conditional or unconditional legally enforceable right, in whole or in part, to receive payments from, or otherwise collect from, the U.S. person in connection with the non-U.S. person's obligations under the swap. The terms of the guarantee need not be included with the swap documentation or reduced to writing so long as legally enforceable rights are created under the laws of the relevant jurisdiction.[16]

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[15] The final definition of the term U.S. person in the Final Rules is as follows:

(i) A natural person who is a resident of the United States;
(ii) An estate of a decedent who was a resident of the United States at the time of death;
(iii) A corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund or any form of entity similar to any of the foregoing (other than an entity described in paragraph (a)(10)(iv) or (v) of this section) (a "legal entity"), in each case that is organized or incorporated under the laws of the United States or having its principal place of business in the United States, including any branch of such legal entity;
(iv) A pension plan for the employees, officers or principals of a legal entity described in paragraph (a)(10)(iii) of this section, unless the pension plan is primarily for foreign employees of such entity;
(v) A trust governed by the laws of a state or other jurisdiction in the United States, if a court within the United States is able to exercise primary supervision over the administration of the trust;
(vi) A legal entity (other than a limited liability company, limited liability partnership or similar entity where all of the owners of the entity have limited liability) that is owned by one or more persons described in paragraphs (a)(10)(i) through (v) of this section and for which such person(s) bears unlimited responsibility for the obligations and liabilities of the legal entity, including any branch of the legal entity; or
(vii) An individual account or joint account (discretionary or not) where the beneficial owner (or one of the beneficial owners in the case of a joint account) is a person described in paragraphs (a)(10)(i) through (vi) of this section.

17 CFR 23.610(a)(10).

[16] See 17 CFR 23.160(a)(2).

The Final Rules add a provision to the definition of the term guarantee not contained in the Proposed Rules, which provides that, in the case of any arrangement pursuant to which the guarantor has a conditional or unconditional legally enforceable right to receive or otherwise collect, in whole or in part, payments from any other guarantor with respect to the counterparty's obligations under the uncleared swap, such arrangement will be deemed a guarantee of the counterparty's obligations under the uncleared swap by the other guarantor. This provision conforms the CFTC's definition of the term guarantee to that of the Prudential Regulators in their final margin rules. Notwithstanding this modification, the Final Rules' definition of the term guarantee is generally narrower than that in the Cross-Border Guidance because it does not include other types of financial arrangements, such as keepwells and liquidity puts, certain types of indemnity agreements, master trust agreements, liability, or loss transfer or sharing agreements.

F. Reliance on Counterparty Representations

The Final Rules expands the circumstances under which market participants may reasonably rely on written representations with respect to the status of their counterparties compared with the Proposed Rules. Under the Final Rules, a market participant may reasonably rely on a counterparty's written representation of its status as a U.S. person, FCS, or a non-U.S. person whose obligations are guaranteed by a U.S. person, unless the market participant has information that would cause a reasonable person to question the accuracy of the representation.[17] By contrast, the Proposed Rules would have permitted reliance on a counterparty's representation only in the case of representing its status as a U.S. person (and not as an FCS or whether the obligations of the counterparty are guaranteed by a U.S. person).

G. Special Provisions for Non-Segregation and Non-Netting Jurisdictions

In order to conform the CFTC's uncleared swaps margin rules to those of the Prudential Regulators, the Final Rules add two provisions similar to the Prudential Regulators' Rules to address non-segregation and non-netting foreign jurisdictions. Specifically, the first provision addresses swaps with counterparties in foreign jurisdictions where limitations in the legal or operational infrastructure of the jurisdiction make it impracticable to comply with the custodial arrangement requirements contained in the December 2015 Final Margin Rules. Subject to conditions, an FCS or a foreign branch of a U.S. CSE transacting with counterparties in such jurisdictions need not comply with either the requirement to post initial margin or the custodial arrangement requirements that pertain to initial margin collected by a CSE under the December 2015 Final Margin Rules.[18] The second provision addresses the situation where a CSE cannot conclude, with a well-founded basis, that a netting agreement with a counterparty in a foreign jurisdiction meets the definition of an "eligible master netting agreement" set forth in the December 2015 Final Margin Rules. The provision provides that a CSE may net uncleared swaps in such

[17] See 81 Fed. Reg. at 34,827.

[18] See 17 CFR 23.160(e). The conditions include that (i) the CSE's counterparty must be a non-U.S. person that is not a CSE, and the counterparty's obligations must not be guaranteed by a U.S. person; (ii) the CSE must collect initial margin in cash on a gross basis and post and collect variation margin in cash in accordance with the December 2015 Final Margin Rules; and (iii) for each broad risk category set out in the December 2015 Final Margin Rules (credit, equity, foreign exchange and interest rates, and commodities), the total outstanding notional value of all uncleared swaps in the broad risk category as to which the CSE is relying upon this relief may not exceed 5% of the CSE's total outstanding notional value for all uncleared swaps in that same broad risk category. In addition, the CSE must have policies and procedures to ensure compliance with the requirements of the exception and maintain books and records documenting that the requirements are satisfied. See 81 Fed. Reg. at 34,833.

circumstances in determining the amount of initial and variation margin that it posts, provided that certain conditions are met.[19]

III. CONCLUSION

Certain aspects of the CFTC's Final Rules may be viewed favorably by market participants, including the greater legal certainty provided for in the U.S. person definition, the expansion (as compared with the CFTC's Cross-Border Guidance) of the scope for potential substituted compliance determinations and the broadened number of situations where counterparty representations may be relied upon. However, much of the Final Rules' impact on market participants may depend upon how the substituted compliance determination process is implemented, which, although labeled an "outcomes-based" approach, may not achieve that objective with its element-by-element determinations in practice. The element-by-element determinations may also result in findings that some foreign margin requirements are comparable, but not others, leading to the potential for a complex patchwork of U.S. and non-U.S. requirements to apply to cross-border swap transactions, which may greatly increase the compliance burden and cost for market participants.

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Because of the generality of this update, 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. Prior results do not guarantee a similar outcome.

[19] See 17 CFR 23.160(d). These conditions are that the CSE must treat uncleared swaps covered by the agreement on a gross basis in determining the amount of initial and variation margin that it must collect and that the CSE have policies and procedures to ensure, and maintain books and records to document, compliance with the requirements of 17 CFR 23.160(d).

Cross-Border Application of Uncleared Swaps Margin Requirements under CFTC Final Rules

Covered Swap Entity ("CSE")	Counterparty	Cross-Border Application of Margin Requirements
• U.S. CSE or • Non-U.S. CSE (including U.S. branch of a non- U.S. CSE or a Foreign Consolidated Subsidiary (''FCS'')) whose obligations under the relevant swap are guaranteed by a U.S. person.	Any (except for a non-U.S. person whose swap obligations are not guaranteed by a U.S. person as noted immediately below).	CFTC Margin Rules apply.
• U.S. CSE or • Non-U.S. CSE (including a U.S. branch of a non-U.S. CSE or an FCS) whose obligations under the relevant swap are guaranteed by a U.S. person.	Non-U.S. person (including a non-U.S. CSE, FCS, or U.S. branch of a non-U.S. CSE) whose swap obligations are not guaranteed by a U.S. person.	• CFTC Margin Rules generally apply • Substituted compliance may be available for the posting of initial margin by the CSE.
Non-U.S. CSE that is not: • an FCS of a U.S. person or • a U.S. branch of a non-U.S. CSE, and whose obligations under the swap are not guaranteed by a U.S. person.	Non-U.S. person counterparty (including a non-U.S. CSE but not: • an FCS or • a U.S. branch of a non-U.S. CSE), and whose obligations under the swap are not guaranteed by a U.S. person	CFTC Margin Rules do not apply (except in connection with certain inter-affiliate swaps).
• Non-U.S. CSE that is not an FCS and whose swaps are not guaranteed by a U.S. person or • Non-U.S. CSE whose obligations under a swap are not guaranteed by a U.S. person, but which is an FCS or a U.S. branch of the non-U.S. CSE.	• U.S. CSE or • Non-U.S. CSE (including U.S. branch of a non-U.S CSE or an FCS) whose swap obligations are guaranteed by a U.S. person).	• CFTC Margin Rules apply. • Substituted compliance may be available for collection of initial margin by the non-U.S. CSE.
• Non-U.S. CSE that is not an FCS and whose swaps are not guaranteed by a U.S. person or • Non-U.S. CSE whose obligations under a swap are not guaranteed by a U.S. person, but which is an FCS or a U.S. branch of the non-U.S. CSE.	• U.S. person (except as noted above for a U.S. CSE). • Non-U.S. person whose swap obligations are guaranteed by a U.S. person (except a non-U.S. CSE, U.S. branch of a non-U.S. CSE, or FCS whose obligations are guaranteed as noted above). • Non-U.S. CSE, U.S. branch of a non-U.S. CSE or foreign consolidated subsidiary whose obligations are not guaranteed by a U.S. person.	Substituted compliance may be available for all requirements.

Client Alert

February 16, 2016

SEC Adopts Rule Amendments Addressing Dealing Transactions Between Non-U.S. Persons that are "Arranged, Negotiated, or Executed" in the United States

By Julian Hammar

On February 10, 2016, the U.S. Securities and Exchange Commission ("SEC") approved final rule amendments to its cross border rules that address how the security-based swap dealer definition applies to security-based swap dealing transactions between non-U.S. persons that are "arranged, negotiated, or executed" in the United States. The final rules will become effective 60 days after publication in the Federal Register, which is forthcoming. Compliance with the final rules will be required after the later of 12 months following such publication or 2 months prior to the compliance date for registration as a security-based swap dealer under the registration rules. The final rules are available here.

SECURITY-BASED SWAPS BETWEEN NON-U.S. PERSONS THAT COUNT TOWARD THE DE MINIMIS THRESHOLD

Under the final rules, a security-based swap dealing transaction that is entered into by a non-U.S. person will count toward the non-U.S. person's de minimis exception threshold from registration as a security-based swap dealer, 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 agent (whether affiliated or unaffiliated) of such non-U.S. person located in the United States.

Accordingly, a non-U.S. person that conducts security-based swap dealing activity through personnel located in the United States will have to register with the SEC if its dealing activity in the United States – including security-based swaps with non-U.S. persons that are "arranged, negotiated, or executed" using U.S. personnel under the final rules – exceeds the relevant de minimis threshold.[1] The non-U.S. person is not required to consider under the final rules 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.

[1] Under SEC rules, the current de minimis threshold for security-based swap dealer registration is $8 billion in aggregate gross notional amount of dealing activity over the preceding 12 months for credit default swaps and $400 million for all other security-based swaps. These phase-in thresholds are temporary and, in the absence of action by the SEC, are set to drop to $3 billion and $150 million, respectively. The threshold for security-based swaps with special entity counterparties (e.g., governments, certain pension plans, and endowments) is $25 million.

"ARRANGED, NEGOTIATED, OR EXECUTED"

Under interpretive guidance contained in the rule release, a security-based swap transaction is considered to be "arranged, negotiated, or executed" in the United States if it is "market-facing activity." In this context, "arrange" and "negotiate" means market-facing activity of sales or trading personnel in connection with a particular transaction, including interactions with counterparties or their agents.[2] "Execute" refers to the market-facing act that, in connection with a particular transaction, causes the person to become irrevocably bound under the security-based swap under applicable law. "Arranging," "negotiating," and "executing" also includes directing other personnel (including non-U.S.-based personnel) to arrange, negotiate, or execute a particular security-based swap. Personnel directing the arrangement, negotiation, or execution of security-based swaps include personnel located in a U.S. branch or office that specify the trading strategy or techniques carried out through algorithmic trading or automated electronic execution of security-based swaps (although not personnel solely engaged in coding the algorithm), even if the related server is located outside the United States.

The release also clarifies the types of activities that are *not* market-facing with respect to a specific transaction (and thus are not arranging, negotiating, or executing the transaction). These activities include:

- Designing security-based swaps (but not communicating regarding the contract in connection with a specific transaction or executing trades in the contract);
- Preparation of underlying documentation for the transaction, including the negotiation of a master agreement and related documents;
- Performing ministerial or clerical tasks in connection with the transaction (as opposed to negotiating with the counterparty the specific economic terms);
- Collateral management activities (e.g., the exchange of margin payments) that may occur in the United States;
- Submission of security-based swap transactions for clearing in the United States; and
- Reporting security-based swap transactions to U.S. security-based 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." The final rule also does not require persons engaged in dealing activity to consider the location of personnel booking the transaction because the ministerial task of entering transactions on a non-U.S. person's books once the transaction has been executed does not constitute market-facing activity.

[2] The SEC explains that it uses the term "arrange" rather than "solicit" in recognition of the fact that a security-based swap dealer, by virtue of being commonly known in the trade as a dealer, may respond to requests by counterparties to enter into dealing transactions, in addition to actively seeking out such counterparties.

"LOCATED IN A U.S. BRANCH OR OFFICE"

In addition, the market-facing activity of arranging, negotiating, or executing a transaction must be conducted by personnel "located in a U.S. branch or office" of the non-U.S. person or its agent in order to be counted toward the de minimis threshold. The SEC expects that a non-U.S. person will include in its de minimis calculation any transactions arranged, negotiated, or executed in the United States by personnel assigned to, on an ongoing or temporary basis, or regularly working in a U.S. branch or office. However, the non-U.S. person would not have to include transactions arranged, negotiated, or executed by personnel assigned to a foreign office if such personnel are only "incidentally" in the United States, such as to attend an education or industry conference.

"PERSONNEL"

In a footnote, the SEC states that "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, irrespective of whether the non-U.S. person or its agent is itself a security-based swap dealer. This definition is not dependent upon whether a natural person is technically an "employee" of the non-U.S. person, and the SEC expects to consider whether the non-U.S. entity is able to control or supervise the actions of an individual when determining whether the individual is "personnel" of a U.S. branch or office or an agent of that entity.

TRANSACTIONS THAT ARE EXEMPT OR NOT EXEMPT FROM THE RULES

The final rule exempts from its requirements security-based swaps arranged, negotiated, or executed in the United States by certain international organizations (e.g., multilateral development banks) as defined in SEC rules. The final rule does *not* exempt security-based swaps that are 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 United States. Such security-based swaps must be counted toward the de minimis total.

ISSUES NOT ADDRESSED BY THE FINAL RULES

The final rule is limited to addressing the calculation of the de minimis threshold by non-U.S. persons of security-based swap dealing activity arranged, negotiated, or executed in the United States. It does not address other issues that were contained in the April 2015 release proposing the rules, including whether external business conduct standards or security-based swap reporting requirements apply to such transactions. The SEC states that these matters will be addressed in subsequent releases.

CFTC APPROACH

The approach taken in the final rules differs from that of the Commodity Futures Trading Commission ("CFTC") in a 2013 staff advisory, in which CFTC staff took the position that, where a swap is between a non-U.S. swap dealer and another non-U.S. person, the CFTC's transaction-level requirements (e.g., mandatory clearing, trade execution, margin for uncleared swaps) would 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. However, under the CFTC's rules for determining which swaps count toward a non-U.S. person's de minimis threshold for purposes of swap dealer registration, such swaps do not count toward that threshold. The CFTC requested comment on whether it

should adopt the staff advisory, and through a series of no-action letters the CFTC staff has granted relief until September 30, 2016 (or any prior date of CFTC action) to non-U.S. swap dealers from complying with the advisory. CFTC action with respect to the staff advisory is pending at this time.

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