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Confusion or Clarity? Cross-Border Regulation of Derivatives

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Topics to be Covered

- Topics will include:
  - Overall state of play with respect to the treatment by U.S. and EU regulators of cross-border transactions and the prospects (and need) for further substituted compliance/equivalence determinations;
  - CFTC's and prudential regulators' treatment of margin in the cross-border context, including in the context of the EU margin rules, CFTC no-action relief, and substituted compliance determinations;
  - New CFTC mandatory clearing determinations;
  - CFTC's proposal regarding the cross-border application of registration thresholds and external business conduct standards;
  - SEC's rules relating to cross-border matters;
  - Impact of Brexit on cross-border issues in particular in the context of EU passporting and equivalence determinations.

Overall State of Play

- More than six years after the enactment of the Dodd-Frank Act and more than four years after EMIR came into force in the EU, 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.

State of Play, cont'd.

- 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.
- In the EU, EMIR (and other relevant legislation relating to derivative regulation) is also closely modelled on the G-20 agreements.
- 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? Or both?
- 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.

State of Play, cont'd.

- 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.

State of Play, cont'd.

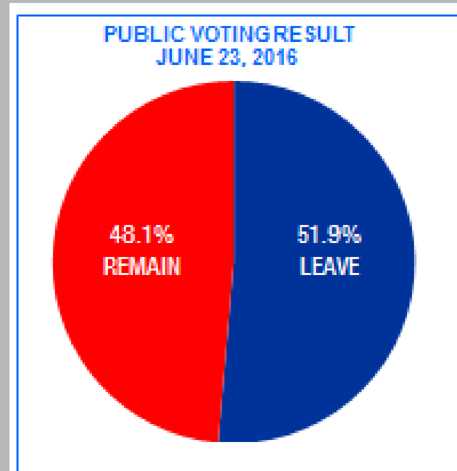
- In relation to certain transactions, the U.S. regulators have staked their claim that the U.S. rules must apply, but non-U.S. regulators are similarly taking the view that their rules must apply:
  - Unless the U.S. and the non-U.S. rules are identical or virtually identical, the applicability of two 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.
- Similarly, the EU Commission has made relatively few equivalence determinations although in relation to clearing requirements, most of the primary non-EU jurisdictions with which EU counterparties trade derivatives are now subject to such 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.

State of Play, cont'd.

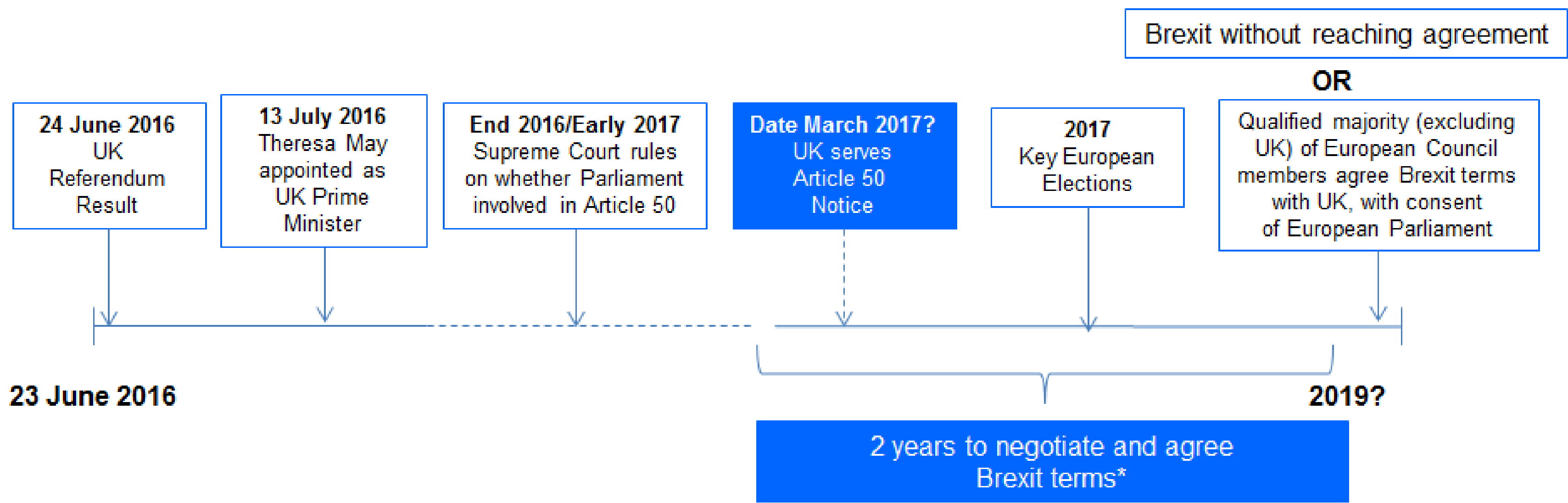
- In thinking about the cross-border regulation of derivatives, one must consider a changed and uncertain political context.
- Difficult to know how the Trump administration will approach these matters, but, based on the Republican proposal to substantially amend Dodd-Frank, it seems a good bet that 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?

- UK Referendum: Narrow majority voted to leave EU on 23 June 2016.
- Advisory only.
- UK government has indicated intention to give effect to Brexit vote.
- Presently, UK remains an EU member.
- Existing EU-derived laws and regulations continue to apply to UK.
- Uncertainty as to timing and nature of UK's exit and future relationship with the EU has already caused market and currency volatility.



- To commence exit, UK needs to serve notice of its intention to leave EU under Article 50 of the EU Treaty.
- Once Article 50 Notice is served, UK has 2-year period to negotiate and agree Brexit terms.
- Terms need to be approved by a qualified majority of the European Council (excluding UK), and the consent of the European Parliament.
- If no agreement is reached within 2-year period, or any extended period agreed by all members of the European Council, the UK would automatically cease its membership of EU.
- UK Prime Minister, Theresa May, has indicated that the Article 50 Notice will be served by the end of March 2017.
- Following a recent decision of the UK Supreme Court, the Government cannot serve the Article 50 Notice under its royal prerogative and must act under the authority of the UK parliament:
  - Bill to authorize the services of the Article 50 Notice is currently before Parliament but is not expected to delay the Government's timetable.



Brexit – Additional Cross-Border Complexity? cont'd.

- Great Repeal Act (GRA) will:
  - Repeal one law, the European Communities Act 1972.
  - Enshrine thousands more automatically in UK law.
- European Communities Act currently gives direct effect and primacy to EU law.
- GRA will allow UK government to amend or scrap any ex-EU law following Brexit.
- But all ex-EU laws will be preserved and transposed into UK law on Brexit Day.

- Following a speech from Theresa May, the UK Government published a White Paper in February 2017 setting out its plans for leaving the EU.
- White Paper set out 12 Principles to guide the Government in giving effect to Brexit.
- The Principles make it clear that the UK Government will not seek to retain the UK's membership of the European Economic Area ("EEA") and the UK will not continue to be a member of the EU single market:
  - The UK will "take control of its own affairs" and the European Court of Justice will cease to have jurisdiction in the UK;
  - The UK will "design its immigration system to ensure it controls the numbers of people that come to the UK". The EU Free Movement Directive will cease to apply to the UK and the migration of nationals from the EU and elsewhere will be subject to UK laws.

Brexit – Additional Cross-Border Complexity? cont'd.

- The White Paper states that although the UK Government will not seek membership of the EU single market, it will seek access to the single market through a "new, comprehensive, bold and ambitious Free Trade Agreement":
  - New relationships should aim for the freest possible trade in goods and services between the UK and EU;
  - The UK will seek a mutually beneficial new customs agreement with the EU.
- White Paper highlights the importance of financial services to the UK and states the UK will be aiming for the freest possible trade in financial services between the UK and EU:
  - It notes that there are provisions in EU law that allow firms from non-EU countries to provide certain financial services across the EU where the relevant domestic regulations have been deemed equivalent to those of the EU (see further below).
- White Paper states it is in no-one's interests for there to be a "cliff-edge" to business or a threat to stability as the UK leaves the EU – it indicates there will be a phased process of implementation and interim measures will be a matter for regulation.

- Many international banks have branches or subsidiaries in the UK which are used to access the other EU markets.
- Concerns have been raised by such banks and non-EU governments as to the impact of Brexit on such banks and their business.
- There has been much speculation as to whether such banks and their businesses will need to relocate all or part of their businesses:
  - Until it is clearer what relationship will exist between the UK and the EU post Brexit it is difficult for banks to make clear plans;
  - However, banks cannot wait for two years to make post-Brexit plans – many are already making contingency plans.
- One area of considerable concern is whether euro-denominated instruments will be able to continue to be cleared in the UK:
  - In 2015 the European Court of Justice determined that the ECB could not require euro-denominated trades to be cleared in the Eurozone under existing EU law;
  - Once the UK leaves the EU, it would, however, be possible for EU to seek to require such instruments to be cleared in the EU.

Brexit – Additional Cross-Border Complexity? cont'd.

- “Passporting” refers to the process whereby a firm authorized in one member state can provide authorized activities or services in other EU member states without the need for separate authorization.
- Passporting must be considered on a case by case basis in relation to each relevant piece of EU financial regulation.
- Following Brexit, the UK will not be an EU member state so firms will not be able to obtain passporting rights though an authorization from a UK regulatory authority.
- UK will become a “third country” upon leaving the EU and EEA.
- Loss of passporting rights is potentially severe for UK-based banks and financial institutions who could lose the ability to sell products and services directly to customers in EU member states.
- In the context of derivatives regulation, EMIR has equivalence provisions, notably in the context of mandatory clearing – derivatives subject to mandatory clearing must be cleared either by a CCP established in the EU or a third country where the legal, supervisory and enforcement arrangements are equivalent to those in EMIR.

Brexit – Additional Cross-Border Complexity? cont’d.

- Even if the relevant EU passports will not be available to UK authorized firms following Brexit, it may still be possible for firms to access the single market through other means:
  - Specific arrangements negotiated between the UK and the EU, including pursuant to the Brexit negotiations;
  - Reliance on ‘equivalence’ provisions in certain EU legislation;
  - Firms establishing branches or subsidiaries in EU jurisdictions;
- It is likely that firms will rely upon a mix of all of the above following Brexit.

- In relation to "equivalence", certain EU legislation relating to banks and financial services enables firms located outside the EU to obtain the benefit of all or part of the relevant legislation if the law/regulation in the non-EU jurisdiction is regarded as "equivalent" to the relevant EU legislation:
  - Equivalence is dealt with on a case by case basis in respect of each piece of relevant EU legislation;
  - The EU Commission is required to determine the legislation/regulation of the non-EU jurisdiction to be equivalent to relevant EU legislation;
  - The EU and the non-EU jurisdiction will also generally be required to have cooperation arrangements in place, e.g. in relation to information sharing;
  - Will usually require reciprocity from non-EU jurisdiction;
  - Equivalence is granted in respect of a jurisdiction, not to individual firms or entities.

Brexit – Additional Cross-Border Complexity? cont'd.

- Equivalence determinations generally take considerable time:
  - Equivalence is not automatic – it is discretionary and must be requested.
- UK will, however, be in a unique position as of "Brexit Day". All existing EU laws will form part of EU law under the GRA.
- EU may be concerned about future amendments to UK law – however this is also an issue for any non-EU jurisdiction which is the subject of an equivalence determination:
  - Equivalence determinations can always be withdrawn at EU's discretion.
- Equivalence in relation to relevant legislation is likely to form part of the Brexit negotiations.
- Concern has already been raised in some EU jurisdictions about the possible general reliance of the UK on equivalence determinations.

- In a recent speech in London, then CFTC Chairman Massad highlighted additional complications that could arise from Brexit notwithstanding the UK Government's intention to seek to retain existing EU financial regulation under the GRA and to seek to rely on equivalence provisions.
- Complexities highlighted by Chairman Massad include:
  - In relation to clearinghouse recognition, unless a specific agreement can be reached as part of the Brexit negotiations, the process for deciding whether the EU will grant equivalence will not start until the UK leaves the EU;
  - Negotiators will need to determine whether they can agree to a process or relationship for the post-Brexit world during Brexit - many in the EU including EU trade commissioner Cecilia Malmström have noted that the two year period is intended to negotiate the terms of "divorce" – not new trade agreements;
  - If the EU determines to move the clearing of euro-denominated products from London to the EU post Brexit, that 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.

CHOICE Act, cont'd.

- 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, which passed the House on January 12, 2017, largely along party lines (only 7 Democrats voted in favor of the measure): 239-182.
- H.R. 238, among other things, also provides for CFTC re-authorization.

CHOICE Act, cont'd.

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.
- CFTC has granted time-limited no-action relief that provides a grace period from variation margin requirements.
- Unclear whether other regulators will follow suit.

- 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.
- The definitions of FX forwards, FX swaps and cross-currency swaps differ in certain ways, and in the case of currency swaps in material respects.
- The holding of initial margin is subject to stricter segregation requirements under EU margin rules, compared to U.S. rules.

- Under EU rules, collateral that is eligible for initial margin is eligible also for variation margin and vice-versa.
- EU rules state that margin must be "provided" of the same business day on which the margin calculation is made. Due to a change in the terminology used during the process of finalizing the draft margin rules from "collect" to "provide", the market generally assumes that the provisions of the EU rules are met if all irrevocable payment/transfer instructions are given on the day of calculation; even if the collateral is not confirmed received until the following business day.
- This interpretation has not yet been confirmed by ESMA.
- In addition, the EU rules do not specify any time of day/relevant time zone to be used in determining the latest time by which margin can be "provided" in compliance with U.S. rules. Particularly in cross-border deals, this is leading some counterparties to specify in their credit support documents a time of day in a time zone that is most beneficial in aiding compliance with the EU rules.

Margin – Cross Border Issues, cont'd.

- U.S. rules permit collateral that is eligible to be used for IM for VM only in the case of financial end users.
- U.S. rules require that VM for swaps between dealers be in cash only (U.S. dollars, major currencies as defined in the rules or the swap settlement currency).
- U.S. rules require exchange of IM (where required) and VM on or before the next business day after the "day of execution." (i.e., T+1)
- Day of execution accommodates scenarios where counterparties are in different time zones.
- However, concerns have been raised that timeframes for calculating an exchanging margin may not be realistic.

Margin – Cross Border Issues, cont'd.

- 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.
- Acting Chairman Christopher Giancarlo stated in a speech in January that he is aware that market participants face hard challenges in meeting the March 1 VM compliance deadline, and in particular is concerned about smaller firms, including American pension and retirement funds, that may not be able to get their documentation done in time, causing market disruption.
- He stated that he intends "to look at solutions to ease the March 1st transition in a responsible manner," noting that Singapore, Hong Kong and Australia announced last month that their new VM rules would be subject to a six-month transition period.

- On February 7, 2017, ISDA sent a "VM Big Bang" letter to the regulators of most of the G-20 nations, stating that its surveys indicated that, as of January 27, 2017, the average combined total execution rate of active CSA requiring amendment and new CSAs was only 2.11% (less than 5 weeks before the March 1 deadline). It therefore requested regulatory forebearance in the form of a transitional period between March 1, 2017 and September 1, 2017 during which participants would actively attempt to finalize the necessary documentation for VM rules compliance, but would not be subject to sanction for non-compliance.

CFTC Staff No-Action Letter

- On February 13, 2017, CFTC staff issued time limited no-action relief granting a grace period for swap dealers (SDs) to come into compliance with the VM rules from March 1 to Sept. 1, 2017 (subject to conditions). (CFTC Staff Letter No. 17-11)
- Relief does not extend the March 1 date; rather it provides a grace period during which time SDs may come into compliance with the uncleared swaps margin rules.
- Without a proper transition, CFTC staff believes there could be a significant impact on the ability to hedge positions for pension funds, asset managers, and insurance companies that manage Americans' retirement savings and financial security.
- Acting Chairman Giancarlo noted in a statement accompanying the letter that while the CFTC remains committed to the March 1 date, "the facts on the ground cannot be ignored that as much as ninety percent of [financial end-users] are not ready to meet the new [margin] requirements despite their best efforts to do so."

- Giancarlo also noted that “[g]lobal systemic risk is not reduced by the abrupt cessation of risk hedging activity by American life insurance companies and retirement funds at a time of enormous changes in financial rates and global asset values.”
- That said, Giancarlo added that “this action by the CFTC does not change the scheduled time of arrival for the agreed margin implementation. It just foams the runway to ensure a safe landing.”

- **Applicability of Relief:**
  - Relief applies only to SDs subject to the CFTC's uncleared swaps margin rules, i.e., SDs that are not banks;
  - Prudential Regulators rules apply to SDs that are banks;
  - Unclear whether the Prudential Regulators will provide relief, or regulators internationally;
  - The EU Commission has confirmed that it will not extend the March 1 date – this confirmation was given on January 31, 2017, prior to the ISDA letter;
  - Given that the largest swap dealers are subject to the Prudential Regulators' rules and many non-U.S. swap dealers that are subject to the CFTC will also have to comply with EMIR, the impact of the CFTC's relief likely will be limited if the prudential regulators and the EU Commission do not follow suit.

- **Conditions for Relief:**
  - The SD does not comply with the March 1 VM Requirements with respect to a particular counterparty solely because it has not completed necessary credit support documentation (including custodial segregation documentation, if any) with such counterparty or, acting in good faith, requires additional time to implement operational processes to settle variation margin in accordance with the March 1 VM Requirements with such counterparty;
  - The SD uses its best efforts to comply with the March 1 VM Requirements with each counterparty as soon as possible following March 1, 2017;

- **Conditions for relief (cont'd):**
  - To the extent the SD has existing variation margin arrangements with a counterparty, it must continue to post and collect variation margin with such counterparty in accordance with such arrangements until such time as the SD is able to comply with the March 1 VM Requirements with respect to that counterparty; and
  - No later than September 1, 2017, the SD complies with the March 1 VM Requirements with respect to all swaps to which the March 1 VM Requirements are applicable (entered on or after March 1, 2017) (i.e., back-loading is required).

- **CFTC Monitoring of Progress by SDs:**
  - CFTC staff notes that it intends to monitor the progress of SDs who rely on the relief;
  - According to the letter, such SDs are expected to make "continual, consistent, and quantifiable progress" towards compliance with the March 1 VM requirements with all covered counterparties on a rolling basis during the grace period, and that all SDs should be in compliance with the March 1 VM Requirements with all covered counterparties by September 1, 2017.

CFTC Staff No-Action Letter, cont'd.

- CFTC staff are also providing no-action relief with regard to the minimum transfer amount (MTA): (CFTC Letter No. 17-12)
  - The uncleared swaps margin rules permit a swap dealer to have a minimum transfer amount of $500,000 (per counterparty) in order to avoid administrative costs of small margin transfers less than that amount;
  - The relief would permit an SD that enters into swaps with separately managed accounts (SMAs) to treat each account as a separate counterparty, subject to certain conditions, for purposes of applying the MTA, despite the fact that such accounts are owned by the same legal entity;
  - The MTA could be no greater than $50,000 for each SMA, the swaps of such SMA are subject to a master netting agreement that does not permit netting across SMAs and swaps must be entered into by an asset manager on behalf of an SMA owned by the legal entity granted under authority in an investment management agreement.

Prudential 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.

Prudential Regs - Cross-Border Margin, cont'd.

- 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.

Prudential Regs - Cross-Border Margin, cont'd.

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 not 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.

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.

EU Basis for Extraterritoriality

- Certain provisions of EMIR will apply to extraterritorial derivatives activities, where certain circumstances exist.
- A contract for a class of derivatives that has been declared to be subject to the clearing obligation will be compulsorily clearable where it is entered into between two entities established outside the EU, where:
  - Those entities would be subject to the clearing obligation if they were established in the EU: and
  - The contract has a "direct, substantial and foreseeable effect within the EU"; or
  - The imposition of compulsory clearing is necessary or appropriate to prevent the evasion of any provisions of EMIR.

- “would be subject to the clearing obligation if they were established in the EU” means that a party would be categorized as a “financial counterparty”, or a “non-financial counterparty” with aggregate OTC derivatives positions above the clearing threshold (an “NFC+”), if it were established in the EU (a non-financial counterparty below the threshold is referred to as an “NFC-”)
- “direct, substantial and foreseeable effect” is limited to circumstances where either:
  - one of the parties benefits from a guarantee from a financial counterparty in the EU, if the guarantee:
    - covers all or part of the liability under the relevant OTC contract; and
    - covers liabilities of at least EUR8 billion; and
    - is at least equal to 5% of the aggregate current exposures in OTC contracts of the relevant financial counterparty, or
  - both parties would qualify as financial counterparties if they were established in the EU and enter into the contract through one of their EU branches

EU Basis for Extraterritoriality, cont’d.

EU Basis for Extraterritoriality, cont'd.

- In respect of uncleared OTC derivative contracts, non-EU entities will be subject to those of EMIR's risk mitigation obligations, including the obligation to post margin, to which they would be subject if they were established in the EU, where either of the following conditions is met:
  - Those contracts have a direct, substantial and foreseeable effect in the EU; or
  - The relevant risk mitigation obligation is necessary or appropriate to prevent the evasion of any part of EMIR
- Therefore, subject to satisfaction of one of the above conditions, non-EU entities equivalent to financial counterparties would be subject to obligations in respect of exchange of margin, holding appropriate amounts of capital, timely confirmation of trades, portfolio reconciliation and dispute resolution procedures.

- Non-EU entities equivalent to NFC+s will (subject to satisfaction of one of the above conditions) be subject to the same risk mitigation obligations as financial counterparties, except as to the holding of capital, whereas those non-EU entities equivalent to NFC-s would be subject only to obligations as regards timely confirmation of trades, portfolio reconciliation and dispute resolution procedures.

EU Basis for Extraterritoriality, 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;

- 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.

- 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 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.

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.

CFTC No-Action Relief for EU

- On February 1, 2017, the CFTC's Division of Swap Dealer and Intermediary Oversight issued a no-action letter stating that from February 4, 2017 to May 8, 2017, it would not recommend enforcement action against a swap dealer that is subject to and in compliance with the uncleared swaps margin rules of the EU for failure to comply with the CFTC's rules.
- February 4, 2017 was the date when many swap dealers must begin complying with EU's uncleared swaps margin rules.
- The letter states that the CFTC is working on the comparability determination for the EU and the EU is also working on an equivalence determination with respect to the CFTC's rules.
- Relief is necessary because without the a comparability determination, many swap dealers operating in the EU would be required to comply with both CFTC and EU rules.

“Equivalence” in EMIR

- Compared to the CFTC comparability determinations, the EMIR equivalence framework is almost entirely opaque.
- In the EU, Article 13 of EMIR permits the EU Commission to adopt implementing acts, declaring the equivalence of the legal, supervisory and enforcement arrangements of a non-EU country, in respect of the clearing, reporting or risk mitigation provisions of EMIR.
- If an implementing act is adopted in respect of a non-EU country, this implies that counterparties to a transaction subject to EMIR shall be deemed to have fulfilled their clearing, reporting and risk mitigation provisions where at least one of the counterparties is established in that non-EU country.
- Such an implementing act can be withdrawn if the EU Commission, in cooperation with ESMA, concludes that there has been an insufficient or inconsistent application of the equivalent requirements by that non-EU country’s authorities.

EU-U.S. "Common Approach" to CCPs

- With respect to cleared swaps, there has been significant progress with respect to international harmonization.
- On February 10 2016, then EU Commissioner for Financial Stability, Financial Services and Capital Markets Union, Jonathan Hill, and then CFTC Chairman Timothy Massad announced a "Common Approach" regarding requirements for central clearing counterparties (CCPs).
- The common approach to CCPs is aimed at helping the cleared swaps market to remain unfragmented.
- The EU Commission had previously made positive "equivalence" decisions for the regulatory regimes of CCPs in Australia, Hong Kong, Japan and Singapore, Mexico, Canada, South Africa, Switzerland and the Republic of Korea.
- In December 2016 the EU made further equivalence determinations for CCPs in various non-EU jurisdictions including India, Brazil, UAE and the Dubai International Financial Centre.

EU Commission Equivalence Decision re the U.S.

- On 16 March 2016, the EU Commission adopted an equivalence decision relating to the U.S. which mirrors the stipulations in the Common Approach.
- The decision declares that the legal and supervisory arrangements of the CFTC for derivative clearing organizations (DCOs) that have been declared as systemically important by the FSOC (or DCOs that have opted into similar standards) are equivalent to the EU requirements under EMIR provided that the DCO's internal rules and procedures meet certain requirements including:
  - For contracts executed on regulated markets, a minimum liquidation period of two days for initial margin is applied to clearing members' proprietary positions;
  - For all derivatives contracts, measures are in place to limit procyclicality equivalent to provisions in EMIR;
  - The DCO has sufficient pre-funded available resources to withstand the default of at least two clearing members to which it has the largest exposure under extreme conditions.

- The conditions do not apply to U.S. agricultural commodity derivatives traded and cleared domestically in the U.S. (recognizing the nexus of these contracts with the U.S. economy, their importance to U.S. farmers and the low degree of systemic interconnectedness of these markets with the rest of the financial system).
- U.S. CCPs need to apply to the European Securities and Markets Authority (ESMA) for recognition and will need to demonstrate compliance with the conditions above.
- Once recognized by ESMA, U.S. CCPs can continue to provide services in the EU, while complying with CFTC requirements.

EU Commission Equivalence Decision re the U.S., cont'd.

ESMA Amendments

- In April 2016, ESMA proposed amending relevant technical standards to enable EU CCPs to apply an alternative standard for client margining – this would allow EU CCPs to margin on a one day margin period of risk basis, consistent with the approach in the U.S.
- Amendments proposed by ESMA were subsequently adopted by the EU Commission.
- This change reduces the possibility for regulatory arbitrage across jurisdictions.

Equivalence of US Trading Rules

- The EU Commission has not yet proposed the adoption of an equivalence decision under EMIR to determine that U.S. trading venues are equivalent to regulated markets in the EU.
- Since compulsory on-exchange trading of derivatives will not be introduced in the EU until MiFID II takes effect, this determination will have more relevance to the determination of which trades are "OTC" for the purpose of determining whether a non-financial counterparty is above or below the clearing threshold.
- Such a determination will be particularly important in the context of the MiFID II rules relating to exchange trading of derivatives.
- MiFID II does not come into force until 3 January 2018 but, at such time, trading of derivatives that are subject to the trading requirement can only be traded on non-EU trading venues in respect of which the EU Commission has adopted an equivalence determination.

CFTC Expands Mandatory Clearing

- On September 28, 2016, the CFTC expanded the existing clearing requirement for interest rate swaps to include fixed-to-floating interest rate swaps, basis swaps, forward rate agreements, and overnight index swaps denominated in currencies that were not covered by the CFTC's first clearing requirement determination (these were U.S. dollars, Euros, Japanese Yen, and Pounds Sterling).
- Specifically, the expanded interest rate swaps required to be cleared include:
  - Fixed-to-floating interest rate swaps denominated in Australian dollar (AUD), Canadian dollar (CAD), Hong Kong dollar (HKD), Mexican peso (MXN), Norwegian krone (NOK), Polish zloty (PLN), Singapore dollar (SGD), Swedish krona (SEK), and Swiss franc (CHF);
  - Basis swaps denominated in AUD;
  - Forward rate agreements (FRAs) denominated in NOK, PLN, and SEK; and
  - Overnight index swaps (OIS) denominated in AUD and CAD, as well as U.S. dollar-, euro-, and sterling-denominated OIS with termination dates up to three years.

- The end-user exception may be elected with respect to the expanded set of swaps subject to mandatory clearing, just as with the initial set.
- Also as under the first mandatory clearing determination, market participants will not be required to clear swaps subject to the determination entered into before the applicable compliance date.
- The compliance schedule differs from that for the first clearing determination, which was phased in based on the type of market participant.
- Instead, the phased-in compliance schedule is based on when analogous clearing requirements have taken, or will take, effect in non-U.S. jurisdictions for each type of swap subject to the determination.
- There is a two-year time limit after the determination is published in the Federal Register.

Clearing Requirement – EU

- As from 21 June 2016, four classes of interest rate swaps started to become subject to the clearing obligation on a phased basis:
    - Basis (float-to-float) swaps denominated in EUR, GBP, JPY and USD;
    - Plain vanilla (fixed-to-float) swaps denominated in EUR, GBP, JPY and USD;
    - Forward rate agreements denominated in EUR, GBP and USD;
    - Overnight index swaps denominated in EUR, GBP and USD;
- On 9 February 2017, mandatory clearing started to be phased in for fixed to floating rate interest rate swaps and forward rate agreements denominated in Norwegian Krone, Swedish Krona and Polish Zloty.
- On 9 February 2017, mandatory clearing started to be phased in for untranched CDS transactions referencing the iTraxx Europe Main and iTraxx Europe Crossover indices.
- ESMA is consulting whether the phase in period for all the above transactions should be extended for smaller counterparties.
- ESMA decided not to subject FX non-deliverable forwards to mandatory clearing at the moment, but did not rule out a change to this position in the future, based on future market developments.
- It has also not ruled out subjecting other FX derivatives to mandatory clearing in the future.

Clearing Requirements – End Users

- Parties required to clear:
  - CFTC has provided an end-user exemption for market participants that are not "financial entities," meet certain reporting obligations and use the relevant swap or swaps to hedge or mitigate commercial risk;
  - EU has no direct equivalent to the CFTC's end-user exception. The closest equivalent is the categorization of the NFC-;
  - An NFC- is, broadly, a person or entity established in the EU, that is not a financial counterparty and that does not have OTC derivatives contracts with an aggregate gross notional value exceeding the relevant clearing threshold;
  - There are different clearing thresholds for different asset types – EUR 1 billion for each of credit and equity derivatives, and EUR 3 billion for each of interest rate, FX and commodity and other derivatives. The non-financial counterparty must aggregate all of its OTC contracts, and those of all other non-financial counterparties within its group but may exclude contracts that are "objectively measurable as reducing risks directly relating to the commercial or treasury financing activity of the non-financial counterparty or of that group";
  - Once a non-financial counterparty exceeds any one of the thresholds, based on the rolling average position over 30 working days, they are considered an NFC+ for all purposes of EMIR, until their rolling average position over a 30 working day period does not exceed any of the thresholds.

Exchange Trading Requirement – EU

- Compulsory exchange trading is mandated by the Markets in Financial Instruments Regulation for centrally cleared derivatives contracts that are considered by ESMA to be sufficiently liquid to be traded only on:
  - Regulated markets;
  - Multilateral trading facilities;
  - Organized trading facilities; and
  - Non-EU trading venues in respect of which the EU Commission has adopted an equivalence decision for the relevant country (so far no such decisions have been adopted),

  and at least one class of which is actually traded on one of these venues.
- ESMA has finalized its regulatory technical standards specifying which derivative contracts are considered to be sufficiently liquid for this purpose.
- However, the implementation date for MiFIR and the MiFID II Directive does not come into effect until January 2018.
- This leaves the EU lagging a long way behind the U.S. in this respect.

EU equivalent of U.S. Cross-Border Rules

- There is no EU equivalent of the U.S. Cross-Border Rules.
- However, subject to "equivalence" determinations:
  - EU financial counterparties and NFC+s will always be subject to the obligation to clear a clearable OTC derivative through an EU CCP authorized under EMIR or a non-EU CCP recognized under EMIR, except when facing an NFC- or their non-EU equivalents;
  - All EU counterparties to derivative contracts have an obligation to report their trades to an EU trade repository authorized under EMIR or to a non-EU trade repository recognized under EMIR, irrespective of whom they are facing;
  - Certain risk mitigation provisions (confirming trades, portfolio reconciliation) will apply to all EU parties to OTC derivatives, irrespective of whom they are facing, and all of the risk mitigation provisions will apply to EU financial counterparties, whomever they are facing;
  - For EU counterparties, the question of which branch they are acting through is irrelevant to all EMIR obligations.

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.

- 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.

- 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 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 Acting Chairman Michael Piwowar has stated that during his tenure as Acting Chairman, 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 Cross-Border Rules, cont'd.

- 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 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.

- 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 U.S. 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.

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

- 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).

- 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’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.

- 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.

Questions?

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