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Derivatives Update

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Overview

- More than six years after the enactment of Dodd-Frank, there are still regulatory requirements for derivatives that have not fully gone into effect or have not been finalized
- In addition, certain rules may soon be subject to reconsideration
- Today we will discuss some of the areas that remain in play
- Topics will include:
  - Margin developments
  - Cross-border matters and legislative update
  - CFTC update
  - SEC update

Margin Developments

- March 1 was a big day for margin requirements
- That was the stated compliance date, for swaps with many market participants, for variation margin requirements under both the U.S. prudential banking regulators' and the CFTC's rules for margin for uncleared swaps
- Last September 1, variation and initial margin requirements went into effect for transactions among the largest counterparties, dealers with more than $3 trillion in outstanding notional amounts of relevant swaps
- The March 1 compliance date for variation margin involved swaps involving a much larger number of counterparties and, accordingly, a much larger number of agreements to be amended to conform to regulatory margin requirements

- With respect to variation margin, the March 1 date applied to all parties (including financial end users) other than those few major market participants who were required to comply last September
- There was significant concern that market participants would not be able to come into compliance with variation margin requirements in a timely manner
- By their terms, the margin rules required dealers and their financial end user counterparties by March 1 to exchange variation margin on terms that in many cases differ from the parties' current arrangements for the exchange of collateral
  - exchanging of variation margin on a zero-threshold basis
  - capped minimum transfer amount
  - specified types of collateral
  - same-day transfers of collateral

Margin, cont'd.

- As a result, a multitude of agreements needed to be amended
- In early February trade groups, including the International Swaps and Derivatives Association (ISDA), wrote a letter to more than 20 regulatory agencies in the G-20 group of countries requesting a "transitional period" for parties to become compliant
- Concern regarding market disruptions in the absence of such a transitional period
- The trade associations' letter indicated that there was still an overwhelming amount of work to be done before market participants would be in compliance with respect to variation margin

Margin, cont'd.

- The letter stated that, based on data collected from 20 global dealers as of the week-ending January 27th:
  - the average number of CSAs which need to be amended, replaced or executed is 7,972 (for a total of more than 159,000 for the sample 20 firms alone)
  - the average combined total execution rate so far of those active and new CSAs was only 2.11%
  - the average rate of the CSAs which are both executed and ready to trade was only 0.16%
- According to more recent survey numbers from ISDA, 15.31% of active and new CSAs had been executed by February 17

Margin, cont'd.

- A factor complicating compliance efforts is widespread confusion regarding the forms that amendments of existing contractual arrangements should take, with different parties taking different approaches to new ISDA documentation and to their arrangements for legacy transactions predating the effectiveness of the margin rules
- In response to concerns, the U.S. regulators provided relief from the March 1 deadline
- The Federal Reserve and Office of the Comptroller of the Currency (OCC) each gave guidance that applies to the swap dealers subject to their prudential regulation
- In addition, the Commodity Futures Trading Commission (CFTC) provided a no-action letter, which applies to swap dealers not subject to regulation by a prudential regulator

Margin, cont'd.

Margin – CFTC No-Action Letter

- The CFTC's no action letter provides relief until September 1, 2017, stating that the CFTC division providing the letter will not recommend an enforcement action against a dealer for non-compliance with the March 1 variation margin requirements, provided that:
  - The dealer does not comply with respect to a particular counterparty solely because it has not, despite good faith efforts, completed necessary credit support documentation 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 variation margin requirements with such counterparty;
  - the dealer uses its best efforts to continue to implement compliance with the March 1 variation margin requirements with each counterparty;

- To the extent the swap dealer 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 dealer is able to comply with the March 1 variation margin requirements with respect to that counterparty; and
- No later than September 1, 2017, the swap dealer complies with the March 1 variation margin requirements with respect to all swaps to which the those requirements are applicable entered on or after March 1, 2017

Margin – CFTC No-Action Letter, cont'd.

Margin – Fed/OCC Guidance

- Separately, the Fed/OCC guidance states the regulatory agencies' expectation that swap dealers subject to prudential regulation by the Fed or OCC will prioritize their compliance efforts, achieving full compliance by March 1 in relation to those counterparties whose transactions pose "significant" credit or market risks
- For other counterparties, swap dealers must make good faith efforts to comply with variation margin requirements in a timely manner, and in no case later than September 1, 2017

- In initial examinations with respect to variation margin, with respect to counterparties not posing significant credit or market risks, examiners will focus on management systems, compliance programs, actions taken to update documentation, policies, procedures, and processes, as well as training of appropriate staff
- Question: what does “substantial exposure” mean, for purposes of the Fed/OCC guidance?
- Given this uncertainty, not yet entirely clear what approach banks are taking

Margin – Fed/OCC Guidance, cont’d.

Margin – EU Relief

- Somewhat similar relief applies in the EU
- The March 1 deadline under the EU margin rules was not pushed back
- However, late last month the European Supervisory authorities stated their expectation that EU competent authorities would generally apply a risk-based approach in their day-to-day enforcement of variation margin requirements after March 1
- Competent authorities will require European dealers to take into account counterparty exposures and risk of default, document their steps taken toward full compliance and put in place alternative arrangements to contain risk, such as using existing Credit Support Annexes to exchange variation margin
- No general forbearance, but assessments of dealers' compliance will be made on a case by case basis

Margin – Cross Border

- In addition, the rules of other certain jurisdictions also provide for a "transitional period" through August 31, 2017
- However, although somewhat alleviated by the relief provided, there remain real questions as to how the margin rules of different jurisdictions will apply to cross-border transactions
  - Differing rules
  - Confusion over how to apply differing rules
  - Confusion over how to amend contractual arrangements in order to comply with differing rules

- To take one example: 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

Margin – Cross Border, cont'd.

- Once a market participant manages to document its new arrangement for the exchange of collateral, it must determine which 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
- Is any approach viable other than “greater of” or restricted trading?
- So far, our advice has generally been a “greater of” approach entailing compliance to the greatest degree required by any applicable set of rules

Margin – Cross Border, cont’d.

Title VII Status

- Margin is one of the last of the Title VII rules for swaps to be implemented
- A large majority of the CFTC requirements for swaps have gone into effect fully
- This differs significantly from the status of the SEC's rules for security-based swaps, very few of which are now in effect and require compliance

- Certain CFTC rules will likely be revisited in the coming years
- However, from a legislative perspective, it appears that there will be no fundamental rethinking of Title VII
- It appears that legislation will focus in significant part on cross-border matters, that is, how U.S. rules and non-U.S. rules apply to cross-border transactions

Title VII Status, cont'd.

Title VII – Cross Border

- 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
- 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
- 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?

- The U.S. regulatory scheme – both of the CFTC and of the SEC – 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

Title VII – Cross Border, cont'd.

- 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

Title VII – Cross Border, cont'd.

Legislative Initiatives

- The Financial CHOICE Act of 2016 is the Republican bill intended to substantially revise Dodd-Frank, which passed the House of Representatives Financial Services Committee during the last Congress
- Current status is unclear; House Financial Services Committee is not providing any update on next steps
- If enacted, would institute major changes to Dodd-Frank
- Interestingly though, with respect to derivatives regulation, the Act's most significant provision concerns cross-border matters, not the substance of the Dodd-Frank Title VII reforms

- Very similar cross-border provisions are also contained in H.R. 238, the Commodity End-User Relief Act, which passed the House on January 12, 2017 and next goes to the Senate for consideration
- H.R. 238, among other things, also provides for CFTC re-authorization
- Bottom line: despite Trump administration's statements that it will roll back Dodd-Frank, it appears that Title VII is here to stay
  - Constituency for repealing Title VII, given all the work that the market has done to comply?
  - Basis in international agreements

Legislative Initiatives, cont'd.

- Section 468 of the CHOICE Act, and Section 312 of the Commodity End-User Relief 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

- Those provisions 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.

Legislative Initiatives, cont'd.

- 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

Legislative Initiatives, cont'd.

- H.R. 238 also contains provisions relating to
  - protections of futures customers;
  - reforms of the CFTC itself; and
  - targeted relief for end-users such as certain utilities and commercial market participants

Legislative Initiatives, cont'd.

CFTC Update

- Large majority of CFTC Title VII rules are in effect
- New CFTC Acting (for now) Chairman J. Christopher Giancarlo describes himself as in favor of the Dodd-Frank reforms
- However, he has noted what he has described as flaws in the CFTC's implementation of swaps trading rules, missteps in its cross-border harmonization, and its inattentiveness to the deterioration in trading liquidity and increased market fragmentation
- His past statements (including in the recent past) make it appear that he will wish to revisit certain rules, including, among others, the CFTC's SEF (swap execution facility) rules, its cross-border rules and its swap data reporting rules

CFTC Update – SEF Rules

- In 2015, Acting Chairman Giancarlo published a “white paper” on the CFTC’s swap execution rules
- In it, he argued that the CFTC’s execution rules for swaps were highly over-engineered, disproportionately modeled on the U.S. futures market, biased against human discretion and contrary to the letter and spirit of Title VII
- Acting Chairman Giancarlo argued that the CFTC’s rules for swap execution, which require many swaps to be executed in an order book or a request for quote system where the quote is sent to three participants, was not warranted by Dodd-Frank, contrary to market practices in other countries, and a cause of market fragmentation, with non-U.S. parties seeking to avoid the requirement
- He reaffirmed these views in a recent speech

CFTC Update – Cross-Border

- Acting Chairman Giancarlo has criticized certain of the CFTC's cross-border rules
- Currently, under the CFTC's cross-border rules for margin, to request a comparability determination, a dealer or foreign regulatory authority must provide the CFTC with detailed information regarding numerous elements of the relevant non-U.S. rules
- It is highly possible that the result in any case may be that the CFTC may arrive at only partial substituted compliance, a finding that certain non-U.S. rules are comparable to U.S. rules, but also a finding that certain non-U.S. rules are <u>not</u> comparable to U.S. rules and, accordingly, the U.S. rules must apply
- Commissioner Giancarlo was roundly critical of this approach

- In his dissent from the CFTC's cross-border margin rules, Acting Chairman 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"
- More recently he stated: "I generally believe the best route to regulating the trading of swaps in global markets is thoughtful deference to fellow G-20 regulators"
- He stated that "making swaps market reform work for America… means no longer asking U.S. market participants to go it alone and take it on the chin in implementing global regulatory reform as too often has been done"

CFTC Update – Cross-Border, cont'd.

CFTC Update – Swap Reporting

- With respect to swap data reporting, Acting Chairman Giancarlo has also been critical, stating that the failure of current reporting requirements to provide transparency into the swap counterparty exposures of major financial institutions was disappointing
- He noted that market participants vary significantly in how they report the same data field to swap data repositories (SDRs), and SDRs vary in how they report the data to the CFTC
- He stated:
  - "What is needed is a concerted and cooperative effort by regulators, market participants, commercial technology vendors and academia that draws on the emerging fields of big data analysis, network science and financial cartography. It is long past time to broaden this important implementation. Making market reform work for American means bringing all parties together and finally making swaps data reporting a reality."

SEC Update

- SEC's position with respect to its Title VII rules for security-based swaps (SBS) differs from the CFTC's position with respect to its rules for swaps
- The SEC has finalized many of its rules, but they do not yet require compliance
- SEC has appeared to be planning a "big bang" approach in which many of its rules would become effective when registration of security-based swap dealers (SBSDs) is required

- Former SEC Chair Mary Jo White last July stated that the SEC's rules for SBS was a "key priority for all of the Commissioners and staff" and that the SEC's goal was to complete the remaining rules for the registration of security-based swap dealers by the end of 2016
- Then came the presidential election and, shortly thereafter, Republican admonitions about midnight rulemakings
- SEC Acting Chairman Michael Piwowar has stated that he does not intend to 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

SEC Update, cont'd.

- Significant outstanding rulemakings include:
  - rules establishing capital, margin and segregation requirements for SBSDs;
  - rules establishing recordkeeping and reporting requirements for SBSDs;
  - rules establishing a process for a registered SBSD to make an application to the SEC to allow an associated person who is subject to a statutory disqualification to effect or be involved in effecting security-based swaps on the SBSD's behalf
- These have all been proposed but not issued in final form
- Under the SEC's rules for SBSD registration, these are all prerequisites for registration to be required

SEC Update, cont'd.

- 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 Update, cont'd.

Questions?

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