Derivatives and Cross-Border Issues

June 17, 2015
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Agenda

- Forwards with Embedded Volumetric Optionality
- Proposed Form TO Reporting Relief
- Swap Execution Facilities Update
- Proposed Uncleared Swaps Margin Rules
- Status of cross border harmonization; and
- SEC’s cross border proposal and reporting rules.
Forwards with Embedded Volumetric Optionality

• Broad statutory definition of “swap” goes well beyond “traditional” understanding of swaps (exchanges of series of payments between parties calculated by reference to a notional amount)
• Includes options “of any kind” – whether physically or financially settled
• So…commodity options that call for physical settlement are swaps
• Excludes forward contracts for nonfinancial commodities
• Primary purpose of a forward contract is to transfer ownership of the commodity and not solely its price risk – i.e., commercial merchandizing transactions
• Forwards may contain embedded optionality, including with respect to the amount of commodity to be delivered (i.e., volumetric optionality)
• CFTC has developed a test to determine whether such forwards should be considered excluded forwards or commodity options.
Forwards with Embedded Volumetric Optionality

• 7-Part Test (Original from 2012 Rulemaking). A transaction qualifies as a forward, notwithstanding it contains embedded volumetric optionality when:
  
  (1) The embedded optionality does not undermine overall nature of the agreement as a forward contract;
  
  (2) predominant feature of the agreement is actual delivery;
  
  (3) embedded optionality cannot be severed and marketed separately from the overall agreement;
  
  (4) seller intends to deliver if the option is exercised;
  
  (5) buyer intends to take delivery if the option is exercised;
  
  (6) both parties are commercial parties; and

  (7) the exercise or non-exercise of the embedded option is based primarily on physical factors, or regulatory requirements, that are outside the control of the parties and are influencing demand for, or supply of, the nonfinancial commodity.
Forwards with Embedded Volumetric Optionality

- Note: under the 7-part test, there must be a non-nominal amount of delivery for the contract to qualify as a forward.
- If there is no minimum delivery requirement specified in the contract, then it is a commodity option and not a forward.
- Peaking or swing natural gas supply contracts with no minimum delivery requirement thus are considered commodity options (but likely are trade options).
- Other contracts that have volumetric optionality, the exercise of which is not primarily due to physical factors or regulatory requirements outside the parties’ control, would be commodity options under the original test.
- Physical factors include load growth, weather and certain operational considerations (e.g., available transportation capacity to deliver physical natural gas purchased on the spot market).
Final Interpretation of the 7-Part Test

• The 7-part test – particularly its 7th prong – has been controversial with market participants.

• Issues raised by commenters include:
  • At time of contracting it may not be known if the exercise of optionality is in fact due to physical factors outside of the parties’ control.
  • Counterparties may disagree about the control they have over factors influencing demand for or supply of the nonfinancial commodity.

• CFTC issued proposed interpretation on Nov. 20, 2014 to clarify the 7-part test; after receiving public comment, it issued a final interpretation on May 12, 2015.

• Under the final interpretation, as proposed, the 4th and 5th prongs would be slightly modified to clarify that the test applies to embedded volumetric optionality in the form of both puts and calls.
Final Interpretation of the 7-Part Test

• But, most significantly, the final interpretation, as proposed, would modify the 7th prong as follows:

“The embedded volumetric optionality is primarily intended, at the time that the parties enter into the agreement, contract, or transaction, to address physical factors or regulatory requirements that reasonably influence demand for, or supply of, the nonfinancial commodity.”

• Compare to original 7th prong:

“The exercise or non-exercise of the embedded option is based primarily on physical factors, or regulatory requirements, that are outside the control of the parties and are influencing demand for, or supply of, the nonfinancial commodity.”
Final Interpretation of the 7-Part Test

• Modified 7th prong is meant to reduce uncertainty as to reason for exercise of the option by making inquiry about the intent of the parties at the time of contracting.

• Also recognizes that the parties may have some degree of influence or control over physical or regulatory requirements affecting supply and demand as opposed to their being wholly “outside their control.”

• Indicates that the “physical factors” would be construed broadly to include any fact or circumstance that would reasonably influence the parties’ supply or demand issues.

• Interpretation also expressly states that commercial parties could rely on counterparty representations regarding the intended purpose of the embedded option.

• Final interpretation clarifies that commercial parties are not required to conduct due diligence in order to rely upon such representations.
Interpretation of the 7-Part Test

- Final interpretation also clarifies that commercial parties may choose to either rely upon their good faith characterization of an existing contract (as an excluded forward or exempt trade option) or recharacterize in accordance with the Final Interpretation.
- Important to note that the final interpretation does not change the test’s non-nominal delivery requirement.
- Signals CFTC is likely to take a more relaxed view of the 7-part test.
Trade Options

• Under Dodd-Frank, a commodity option is a swap (whether physically or financially settled).

• Commodity options that qualify for the trade option exemption are subject to reduced Dodd-Frank requirements.

• As applied to non-registrants, these requirements include:
  • Reporting
  • Recordkeeping
  • Anti-fraud and anti-manipulation rules and
  • Position limits (not yet approved and CFTC requested comment on whether position limits should be applied to trade options).
Trade Options

• Under CFTC rules, to qualify for the trade option exemption, a commodity option must involve a nonfinancial commodity (i.e., an exempt or agricultural commodity) and must be:
  • offered by either an “eligible contract participant” as defined in the Commodity Exchange Act (generally, a financially sophisticated entity) or a producer, processor, commercial user of, or merchant handling the underlying physical commodity;
  • offered to a producer, processor, commercial user of, or merchant handling the underlying physical commodity; and
  • intended to be physically settled, so that, if exercised, the option would result in the sale of an exempt or agricultural commodity for immediate or deferred shipment or delivery.
Form TO Reporting

• Under existing CFTC regulations that the CFTC now proposes to modify, trade options that meet these conditions must be reported to a swap data repository in accordance with Part 45 of the CFTC’s regulations, if, during the 12 months prior to the option being entered into, one of the counterparties has been obligated to report a non-trade option swap.

• If neither party has had to report non-trade option swaps under Part 45 during that period, then both counterparties may report their trade options annually on Form TO.

• Eligibility to use Form TO was extended by an April 2013 CFTC no-action letter, under which, if one of the parties is required to report non-trade option swaps under Part 45 during the 12-month period, and that party is a non-SD/MSP, then it may use Form TO, provided that it notifies the CFTC’s Division of Market Oversight by no later than 30 days after entering into trade options having an aggregate notional value in excess of $1 billion during any calendar year.
Proposed Form TO Relief

- On May 7, 2015, the CFTC published in the Federal Register proposed amendments to the trade option exemption (Proposal) that would reduce reporting and recordkeeping requirements for trade option counterparties that are not swap dealers or major swap participants (Non-SD/MSPs).
- The Proposal would eliminate the annual Form TO filing requirement for Non-SD/MSPs in connection with their trade options, while requiring them to notify the CFTC’s Division of Market Oversight by electronic mail if their trade options have, or are expected to have, an aggregate notional value in excess of $1 billion in any calendar year.
- CFTC states that, while there may be surveillance benefits from Form TO data, completing Form TO imposes costs that may be significant for Non-SD/MSPs, particularly small commercial end users.
Proposed Form TO Relief

• Non-SD/MSPs would remain subject to recordkeeping requirements for swaps under Part 45, including obtaining a Legal Entity Identifier, although they would not be required to use unique swap identifiers or unique product identifiers.

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

• The CFTC’s Proposal, if adopted, coupled with the Final Interpretation regarding Forwards with Embedded Volumetric Optionality, will provide welcome relief for many Non-SD/MSP commercial end users with respect to their physically settled trade options.

• Comment period has been extended until June 22, 2015.
Swap Execution Facilities Update

• Background
• To promote pre-trade price transparency, Dodd-Frank mandates that swaps that the CFTC has determined are required to be cleared must be traded on a swap execution facility (SEF) or designated contract market (DCM), unless the swap is not “made available to trade” on any DCM/SEF or another clearing exception applies.
• CFTC’s “Made Available to Trade” (“MAT”) rule provides that a swap that is subject to mandatory clearing must be executed on a SEF or DCM only if a SEF or DCM has made the swap “available to trade” After listing, a SEF or DCM may make a MAT determination for a group, category, type or class of swap. A MAT determination is then provided to the CFTC.
• The trading mandate for interest rate swaps and credit default swaps that the CFTC has determined are required to be cleared took effect in February 2014.
SEF Update

• Currently, there are almost two dozen provisionally registered SEFs.
• The CFTC, in its release of its core principles and other requirements for SEFs, surprised the market by stating, in a footnote, that if a facility operates in a manner that meets the SEF definition, it is required to register as a SEF, even if it facilitates the execution of only “Permitted Transactions” that are not subject to the trade execution mandate.
• In a subsequent advisory, CFTC staff stated that a multilateral swaps trading platform located outside the U.S. that provides U.S. persons or persons located in the U.S. (including personnel and agents of non-U.S. persons located in the U.S.) with the ability to trade or execute swaps on the platform will register with the CFTC as a SEF.
• As will be explained later, this has led to market fragmentation, as non-U.S. trading platforms have shunned U.S. participants in order to avoid SEF registration.
SEF Update

• Commissioner Giancarlo’s White Paper
  Commissioner Giancarlo in late January 2015 released a “White Paper,” in which he argued for a fundamental reconsideration of the CFTC’s SEF rules.

• In general, the White Paper argues that the rules are having the effects of:
  • driving global market participants away from transacting with entities subject to CFTC swaps regulation,
  • fragmenting swaps trading into numerous artificial market segments,
  • making it highly expensive and burdensome to operate SEFs
SEF Update

- Specific criticisms made by the White Paper include, among others, that:
  - CFTC rules mandating methods of trade execution on SEFs, such as central limit order books and request for quote systems, are not required by the statute, which permits SEFs to offer swaps trading through “any means of interstate commerce.”
  - Impartial access does not mean that SEFs have to provide “open access” – requiring SEFs to serve every type of market participant or operate all-to-all marketplaces is not supported by law.
  - CFTC staff’s void ab initio policy creates a competitive disadvantage for U.S. swaps market relative to futures (where resolution of error/out trades permitted).
SEF Update

- The CFTC has taken a number of steps in an attempt to improve SEF trading (some of which pre-date, and others in response to, Commissioner Giancarlo’s paper).
- These steps do not represent a fundamental re-thinking of the CFTC’s SEF rules as called for by Commissioner Giancarlo, but make more modest adjustments.
- They include the following:
  - Phased-in compliance for package transactions
  - Certain relief for block trades
  - Relief for error trades
  - Relief regarding SEF confirmations
  - Guidance regarding SEF financial resources
  - Certain flexibility regarding execution methods
- CFTC also currently is working on some additional SEF issues.
SEF Update

- Phased-in Compliance for Package Transactions (NAL 14-137)
- CFTC staff has phased in the compliance with MAT determinations for package transactions through a series of no-action letters, the most recent, NAL 14-137, issued on November 10, 2014.
- A “package transaction” is defined as:
  - A transaction involving two or more instruments that is executed between two or more counterparties;
  - That is priced or quoted as one economic transaction with simultaneous or near simultaneous execution of all components;
  - That has at least one component that is a swap that is made available to trade and therefore is subject to the trade execution requirement; and
  - Where the execution of each component is contingent upon the execution of all other components.
### SEF Package Transactions Compliance Dates

<table>
<thead>
<tr>
<th>Category</th>
<th>Relief Expiration</th>
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<tbody>
<tr>
<td><strong>MAT/MAT</strong></td>
<td>Relief expired May 15, 2014 pursuant to CFTC NAL 14-12.</td>
</tr>
<tr>
<td><strong>MAT/Non-MAT (Cleared)</strong></td>
<td>Relief expired June 1, 2014 pursuant to Package Transaction NAL 14-62.</td>
</tr>
<tr>
<td><strong>MAT/Agency MBS</strong></td>
<td>Relief expired May 15, 2015 pursuant to NAL 14-137</td>
</tr>
<tr>
<td><strong>MAT/New Issuance Bond</strong></td>
<td>Relief from CEA section 2(h)(8) until February 12, 2016. Under this relief, the swap components subject to the trade execution requirement are not required to be executed on a SEF or DCM. Relief from Commission Regulation § 37.9 and CEA section 5(d)(9) until February 12, 2016, which permits a SEF or DCM to offer any method of execution for the swap components. Relief from Commission Regulation § 37.3(a)(2) until February 12, 2016, which permits SEFs to not offer an Order Book as a minimum trading functionality for the swap components.</td>
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<td><strong>MAT/Futures</strong>: At least one individual swap component is subject to the trade execution requirement and all other components are contracts for the purchase or sale of a commodity for future delivery, i.e., futures contracts. This category may include:</td>
<td>Relief from CEA section 2(h)(8) until <strong>November 14, 2015</strong>. Under this relief, the swap components subject to the trade execution requirement are not required to be executed on a SEF or DCM. Relief from Commission Regulation § 37.9 and CEA section 5(d)(9) until <strong>November 14, 2015</strong>, which permits a SEF or DCM to offer any method of execution for the swap components. Relief from Commission Regulation § 37.3(a)(2) until <strong>November 14, 2015</strong>, which permits SEFs to not offer an Order Book as a minimum trading functionality for the swap components.</td>
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<td>• MAT swap v. Eurodollar futures</td>
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<td><strong>MAT/Non-MAT (Uncleared)</strong>: At least one of the swap components is subject to the trade execution requirement and at least one of the components is a CFTC swap that is not subject to the clearing requirement. This category may include:</td>
<td>Relief from CEA section 2(h)(8) (i.e. requirement that swap component subject to MAT must be executed on SEF or DCM) <strong>expired</strong> on February 15, 2015 under NAL 14-137. Relief from Commission Regulation § 37.9 and CEA section 5(d)(9) until <strong>February 12, 2016</strong>, which permits a SEF or DCM to offer any method of execution for the swap components. Relief from Commission Regulation § 37.3(a)(2) until <strong>February 12, 2016</strong>, which permits SEFs to not offer an Order Book as a minimum trading functionality for the swap components.</td>
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| **MAT/Non-Swap Instruments**: At least one of the swap components is subject to the trade execution requirement and at least one of the components is not a swap. This category excludes U.S. Dollar Swap Spreads, MAT/Futures, MAT/Agency MBS, and MAT/New Issuance Bond. This category may include:  
  - MAT swap v. single-name credit default swap  
  - MAT swap v. bond (secondary market transaction) | Relief from CEA section 2(h)(8) (i.e. requirement that swap component subject to MAT must be executed on SEF or DCM) expired on February 15, 2015 under NAL 14-137.  
  Relief from Commission Regulation § 37.9 and CEA section 5(d)(9) until **February 12, 2016**, which permits a SEF or DCM to offer any method of execution for the swap components.  
  Relief from Commission Regulation § 37.3(a)(2) until **February 12, 2016**, which permits SEFs to not offer an Order Book as a minimum trading functionality for the swap components. |
| **MAT/Non-CFTC Swap**: At least one of the swap components is subject to the trade execution requirement and at least one of the components is a swap over which the CFTC does not have exclusive jurisdiction (e.g., a mixed swap) | Relief from CEA section 2(h)(8) (i.e. requirement that swap component subject to MAT must be executed on SEF or DCM) expired on February 15, 2015 under NAL 14-137.  
  Relief from Commission Regulation § 37.9 and CEA section 5(d)(9) until **February 12, 2016**, which permits a SEF or DCM to offer any method of execution for the swap components.  
  Relief from Commission Regulation § 37.3(a)(2) until **February 12, 2016**, which permits SEFs to not offer an Order Book as a minimum trading functionality for the swap components. |
SEF Update

• Block Trades (NAL 14-118)
  • In a no-action letter issued on Sept. 19, 2014, CFTC staff addressed the issue of pre-trade credit checks for block trades and provided relief from the so-called “occurs away” requirement in CFTC Reg. 43.2 (defining block trades for purposes of real-time reporting).
  • As a result, SEFs are allowed to facilitate the execution of block trades on their non-Order Book trading systems or platforms while they evaluate and address the technology and other pre-execution credit check issues associated with block trading that occurs “away from” the SEFs’ trading system or platform.
  • The relief expires December 15, 2015.
SEF Update

• Error Trades (NAL 15-24)
  • CFTC staff issued no-action relief on April 22, 2015 that provides relief to SEFs and DCMs from certain trade execution requirements similar to that granted in prior no-action letters to address clerical or operational errors that cause a swap to be rejected from clearing (which would be void ab initio), as well as such errors discovered after a swap has been cleared.
  • The relief expires on June 15, 2016.

• SEF Confirmations (NAL 15-25)
  • CFTC staff has issued no-action relief on April 22, 2015 extending previously granted relief that would permit the SEF legal confirmation to incorporate the ISDA Master Agreement by reference.
  • This relief also clarified and reduced the SEF reporting responsibility regarding uncleared swaps – SEFs need only report “Primary Economic Terms” – as well as any Confirmation Data they do in fact have.
  • Relief expires March 31, 2016.
SEF Update

• **SEF Financial Resources** (NAL 15-26)
  - CFTC staff has issued guidance that clarifies the calculation of projected operating expenses for the purpose of determining the financial resources that the law requires SEFs to hold.
  - Specifically, the guidance clarifies that variable commissions that SEFs pay do not have to be included in a SEF’s calculation of projected operating costs.

• **Flexibility Regarding Methods of Execution**
  - Chairman Massad has stated that CFTC staff has been working with SEFs to make it clear that its rules permit flexibility in methods of execution as long as the regulatory standards and goals are met.
  - CFTC staff has confirmed that an auction match trading protocol is acceptable as long as SEFs provide adequate transparency regarding the process for setting the offer price.
SEF Update

• Other Issues CFTC Staff Currently Working On:
• **Cleared Swap Reporting** - Chairman Massad has stated that the CFTC intends to issue a proposal to revise its rules on the reporting of cleared swaps, which will help improve trading by simplifying reporting obligations.
• **Additional Issues** - CFTC Chairman Massad has stated that the CFTC is looking at a number of additional issues concerning SEFs.
  • He has announced that a staff roundtable is planned later this year on the made available to trade determination process, where market participants have suggested that the CFTC play a greater role in determining which products should be mandated for trading and when than under current rules.
  • He also has stated that the CFTC is looking at concerns about the lack of post-trade anonymity for certain types of trades.
• **Harmonization** - In addition, as other jurisdictions develop their rules on trading, Chairman Massad has said that the CFTC will look to try to harmonize the rules as much as possible so as to minimize the risk of market fragmentation.
Proposed Uncleared Swaps Margin Rules
Overview

• Line between cleared and uncleared swaps
• Historical model for margin for uncleared swaps
• Proposed uncleared swaps margin rules
  • Overview
  • Initial Margin
    • Definitions of “Financial End User” and “Material Swaps Exposure”
    • Treatment of FX Swaps and FX Forwards
    • Threshold Amount and Eligible Collateral
    • Calculation – Model vs. Table-Based Method
• Variation Margin
• Phase-in Schedule
• Eligible Master Netting Agreements
• Cross Border Application
Cleared and Uncleared Swaps

- Rationale for pushing swaps toward a cleared environment by means of the Dodd-Frank Act:
  - Many swaps were not collateralized prior to Dodd-Frank.
  - To the extent they were, valuations and exchanges of collateral might not occur on a daily basis.
- Central goal of Dodd-Frank was to subject most swaps to central clearing to mitigate systemic risk.
Cleared and uncleared Swaps

• Clearing mitigates systemic risk through:
  • Credit risk reduction: requiring initial and variation margin and guarantee of performance by clearinghouse in case of default
    • When swaps are cleared, there is a central counterparty and the swap is subject to the margin requirements of the relevant derivatives clearing organization.
  • Operational Discipline: Daily mark-to-market margin transfer
  • Risk mutualization and multilateral netting
• Critics contend that mandatory clearing concentrates risk at clearinghouses, the failure of which would have catastrophic results
Cleared and Uncleared Swaps

• Bank regulators’ supplemental leverage ratio may make cleared swaps more expensive by treating margin (even though legally segregated) as a bank asset that cannot be counted against the derivative exposure.

• CFTC Chairman Tim Massad states that the treatment of margin in supplemental leverage ratio will have a “significant negative effect on clearing.”

• Basel Committee on Banking Supervision’s leverage ratio working group reportedly is working on a new FAQ document to address the ratio’s treatment of margin.

• CME reportedly considering a rule change in consultation with the CFTC that would allow customers to have accounts directly at the clearinghouse (so they would not count toward a bank intermediary’s leverage ratio).
Swaps Subject to Mandatory Clearing

• Dodd-Frank Act amended the Commodity Exchange Act to require designated categories of swaps to be cleared.

• CFTC required to conduct ongoing review whether category of swaps should be cleared and review can be triggered by CFTC or a derivatives clearing organization.

• To date, covers most interest rate swaps and some credit default swaps.
Swaps Subject to Mandatory Clearing

- Swaps subject to mandatory clearing (to date):
  - 4 types of interest rate swaps (fixed-for-floating swaps, basis swaps, forward rate agreements and overnight index swaps)
  - 2 types of index credit default swaps (North American untranche CDS indices and European untranche CDS indices)
- There have been no new mandatory clearing determinations since the initial set, which were made in December 2012.
- According to ISDA estimates, approximately 16% of outstanding swaps, measured by notional value, were cleared by U.S. CCPs at the end of 2007.
- By 2014, 74% were cleared based on CFTC data.
Swaps Subject to Mandatory Clearing

• Next mandatory clearing determination: Non-Deliverable Forwards in Foreign Exchange (NDFs)?
  • Considered at CFTC’s Global Markets Advisory Committee (GMAC) meeting last October
  • GMAC subcommittee made recommendation that NDF clearing be coordinated with EU regulators with a clear timeline for implementation
  • In February 2015, EU deferred action on requiring NDF clearing for now in order to consider comments raised during the consultation process
  • Unclear whether CFTC will follow GMAC subcommittee recommendation
• Broader debate: extent to which relatively illiquid products such as some NDFs should be subject to mandatory clearing
Historical Model – Uncleared Swaps

• Uncleared swaps have long been transacted subject to ISDA Master Agreements, which provide for common legal terms for multiple transactions and close-out netting upon a default
• In the early days of the ISDA Master Agreement, parties would draft their own security agreements
  • Wide variety, little standardization
• Then, in 1994, ISDA published the ISDA Credit Support Annex, which still functions as a standard document in the marketplace
• The ISDA Credit Support Annex forms part of the ISDA Master Agreement itself (technically part of the Schedule to the Agreement)
• It is a privately negotiated document
• Historically, very few if any regulatory requirements
• New form of CSA – 2013 Standard Credit Support Annex – has not gotten traction in the market
Historical Model – Uncleared Swaps

• Prior to the financial crisis, it was typical for creditworthy parties to an ISDA Master Agreement to accept a certain amount of uncollateralized exposure to each other in the form of a “Threshold”
  • The Threshold in many cases would vary according to the parties’ credit ratings
  • Typically, the higher the credit rating, the higher the Threshold of uncollateralized exposure
A large majority of ISDA Credit Support Annexes provided for collateral (in many cases subject to a Threshold) only for mark-to-market exposure – no collateral in addition to that.

When collateral in addition to that required to account for mark-to-market exposure was required, it was typically expressed as an “Independent Amount”.

“Independent Amounts” equate roughly to “Initial Margin” in the proposed rules.

However, under the ISDA CSA there is (unless otherwise agreed) only one calculation of the amount of collateral that is required.

• The Independent Amount is part of this calculation.
• ISDA did provide standard language to eliminate offsets of Independent Amounts, but this has been less often used in practice.
Historical Model – Uncleared Swaps

• The default rule under the ISDA CSA is that the secured party has the right to rehypothecate or otherwise use collateral posted to it
• This is a significant economic benefit for dealers, who can use collateral posted to them to cover their obligations to post collateral under related hedges
• Lack of the rehypothecation right would affect dealers’ pricing
• Worth noting, however, that in the context of ISDA CSA, discussion over rehypothecation has generally centered on collateral representing mark-to-market value
  • A stronger argument exists that rehypothecation should be disallowed for Independent Amounts (initial margin)
• Parties requiring dealers not to rehypothecate collateral typically require the use of a custodian, which mitigates dealer credit risk but also adds an extra (if minor) cost
Post-Crisis Changes

- Ever greater use of collateral to correspond to mark-to-market values (Thresholds of zero)
- More negotiation over rehypothecation right
- When regulators’ proposed margin rules become final, existing documentation will likely need to be amended to reflect regulatory requirements
Proposed Margin Rules for Uncleared Swaps

- The Prudential Regulators (Federal Reserve Board, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Farm Credit Administration and Federal Housing Finance Agency) and CFTC re-proposed margin rules for uncleared swaps last Fall (originally proposed in 2011) in order to take into account the framework published by the Basel Committee on Banking Supervision and IOSCO on September 2013.
- Proposals divide swap market participants into 4 categories:
  - Swap entities (e.g., swap dealers and major swap participants)
  - “Financial end-users” with “material swaps exposure”
  - Financial end-users without material swaps exposure
  - Other counterparties (e.g., commercial end users)
- Margin requirements vary depending on status.
Proposed Margin Rules – Overview

• If implemented in their proposed form, the margin rules would
  • require swap entities to bilaterally exchange initial margin with other swap entities and with a broad range of financial end users whose use of swaps met a notional amount-based threshold (“material swaps exposure”), all such initial margin to be segregated and not subject to rehypothecation or other use;
  • require swap entities to exchange variation margin with swap entities and with a broad array of financial end users (without regard to the existence of material swaps exposure) without any threshold; and
  • permit the calculation of initial margin by means of either a model-based method or a table-based method.
Proposed Margin Rules – Overview

• The proposed margin rules would also
  • permit offsets in relation to calculations of either initial margin or variation when (among other things) such offsets relate to swaps that were subject to the same “eligible master netting agreement”;  
  • require the use of cash as variation margin; and  
  • provide for staggered compliance dates ending in 2019 for initial margin, and apply to swaps transacted prior to a relevant compliance date if such swaps were subject to the same eligible master netting agreement as swaps transacted after such compliance date.
Proposed Rules – Initial Margin

- Initial margin is intended to secure potential future exposure, that is, adverse changes in value that may arise during the period of time when a swap or group of swaps is being closed out.
- Initial margin is in addition to the variation margin that corresponds to changes in mark-to-market value.
- Under the proposed rules, where initial margin is required, it would be provided by each party to the other party:
  - No netting
  - Computed separately from variation margin
- Figures to increase costs significantly and thus to change materially the economics of the swap market.
- Initial margin must:
  - be segregated,
  - held at an agreed upon third party custodian not affiliated with the swap entity or counterparty, and
  - not be re-hypothecated or re-pledged.
Proposed Rules – Initial Margin

• Initial Margin required for trades between swap entities and either:
  • other swap entities, or
  • financial end users with material swaps exposure.
• No specific requirement for trades with “other counterparties,” but Prudential Regulators would require swap entities to collect margin from any counterparties at such times and amounts (if any) that appropriately address credit risk.
• CFTC’s proposal does not contain this requirement, but does require swap entities to calculate daily hypothetical margin requirements for non-financial end users with material swaps exposure to the swap entity and compare that amount to the amount of margin actually collected (if any).
• The basic structuring of collateral posting for commercial end users essentially has been preserved.
Definition of “Financial End User”

• Definition of “financial end user” based on an list of enumerated financial market status types under various U.S. statutes and regulations
• Examples:
  • banks
  • broker-dealers
  • investment companies
  • insurance companies
  • commodity pools
  • ERISA plans
• Expressly excluded:
  • sovereign entities (central governments or an agency or department thereof); and
  • multilateral development banks
Definition of “Financial End User”

• Note that a “Financial End User” for purposes of the margin proposals is not the same as a “Financial Entity” for purposes of the end-user exemption from mandatory clearing.

• Was controversy as to whether margin was required of parties otherwise eligible for clearing exemption.

• This January, in the Business Risk Mitigation and Price Stabilization Act of 2015, Congress clarified this by statute for some entities otherwise exempt from clearing.
Margin and Exemptions from Mandatory Clearing

- The Business Risk Mitigation and Price Stabilization Act of 2015, in attempting to clarify the circumstances in which commercial end users may have no margin obligations, appears to blur the two definitions of “Financial End User” and “Financial Entity”
- That Act, which has been signed into law, states that margin requirements “shall not apply to a swap in which a counterparty qualifies for an exception under section 2(h)(7)(A)” of the Commodity Exchange Act
- Section 2(h)(7)(A) of the CEA is the exception to mandatory clearing for end users
  - In order to make use of this exception, an entity must not be a “Financial Entity”
- There are seven exemptions from mandatory clearing, three statutory, three via the CFTC’s exemptive authority, and one via CFTC staff no-action relief.
Legislation Regarding Margin

• The table on the following page shows the clearing exemptions, the margin exemptions proposed by CFTC and the prudential regulators, and the relief provided by the Business Risk Mitigation and Price Stabilization Act of 2015.
# Margin Under Business Risk Mitigation and Price Stabilization Act

## Summary of Clearing and Margin Exemptions

<table>
<thead>
<tr>
<th>Clearing Exemption</th>
<th>Statutory and Regulatory Basis for Clearing Exemption</th>
<th>Exemption from Margin Requirements Proposed by CFTC and Prudential Regulators?</th>
<th>Exemption from Margin Requirements Provided by the Business Risk Mitigation and Price Stabilization Act?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial End-User</td>
<td>Commodity Exchange Act § 2(h)(7)(A) &amp; 17 C.F.R. § 50.50</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Commercial End-User Affiliate</td>
<td>Commodity Exchange Act § 2(h)(7)(D)</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Captive Finance Company</td>
<td>Commodity Exchange Act § 2(h)(7)(C)(iii)</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Cooperative</td>
<td>Commodity Exchange Act § 3(c) &amp; 17 C.F.R. § 50.51</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Inter-affiliate</td>
<td>Commodity Exchange Act § 3(c) &amp; 17 C.F.R. § 50.52</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Small Bank</td>
<td>Commodity Exchange Act § 2(h)(7)(C)(ii) &amp; 17 C.F.R. § 50.50(d)</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Treasury Affiliate</td>
<td>CFTC No-Action Letter 14-144</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>
Margin – More Congressional Relief?

- The CFTC’s reauthorization has lapsed for years.

- An act to reauthorize the CFTC recently passed the House and includes provisions exempting treasury units of end-users (so-called “treasury affiliates”) from clearing and re-defining the term “financial entity” to exclude captive finance companies.

- This would ensure that every entity currently eligible for an exemption from clearing is also statutorily exempt from margin requirements save for with respect to uncleared inter-affiliate trades.
Definition of “Material Swaps Exposure”

- “Material swaps exposure” defined as $3 billion average daily aggregate notional amount of uncleared swaps, security-based swaps, FX swaps, and FX forwards, with all counterparties for June, July, and August of the previous calendar year for financial end users.

- Calculation is made on a consolidated basis and includes:
  - Swaps between a financial end user and its affiliates; and
  - Swaps between these affiliates and third parties.
Definition of “Material Swaps Exposure”

- Not easy to aggregate exposures across all affiliates
- Could be especially difficult because of the low level of “control” that the proposed rules would require for an affiliation to exist.
- The “control” necessary for a company to be an “affiliate” of another company is defined as
  - only 25 percent (not 50 percent or more) of the ownership or control, directly or indirectly, of (i) a class of voting securities or (ii) the total equity, directly or indirectly, or
  - control in any manner of the election of a majority of the directors or trustees of the company.
- This definition of “control” means that entities with relatively low levels of affiliation would, under the Proposals, be required to work together to determine the notional amounts of their swaps.
Definition of “Material Swaps Exposure”

• The fact that the “material swaps exposure” definition is based on $3 billion in aggregate notional amount puts it at odds with the BCBS/IOSCO Framework.
• BCBS/IOSCO Framework provides for the posting of initial margin based on a far higher aggregate notional amount of €8 billion (approx. $9 billion).
• If the U.S. regulators were to adopt a different standard for “material swaps exposure” than is adopted in other countries, U.S. companies and their affiliates could be hamstrung in comparison with companies with no ties to the U.S.
• If applicable to non-U.S. market participants, the lower U.S. number could cause such participants to shun the U.S. market and deepen the existing market fragmentation.
• CFTC Chairman Massad has stated that the U.S. $3 billion threshold should be harmonized even if it means increasing the U.S. definition of material swaps exposure.
Treatment of FX Swaps and Forwards

• “Foreign exchange forward” is defined as a transaction that solely involves the exchange of two different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange.

• “Foreign exchange swap” is defined as a transaction that solely involves an exchange of two different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange and a reverse exchange of those two currencies at a later date and at a fixed rate that is agreed upon on the inception of the contract covering the exchange.
Treatment of FX Swaps and Forwards

- Foreign Exchange Swaps and Forwards not subject to margin requirements because they were exempted by the Treasury Secretary (with a few exceptions not including margin) from the CEA.
- However, Swap Entities regulated by a Prudential Regulator may be required to pay and collect variation margin for these instruments under Prudential Regulator Supervisory Guidance
  - Footnote 27 in Prudential Regulators’ proposed margin rules
Treatment of FX Swaps and Forwards

- FX Swaps and Forwards are included in the material swaps exposure calculation.
- Requiring foreign exchange forwards and foreign exchange swaps to be aggregated for purposes of determining the existence of material swaps exposure could unduly increase costs for counterparties who use such products heavily, but use other derivatives only sparingly.
- Not clear why such products, which are often short-dated, and which do not themselves require any initial margin, should be aggregated for purposes of determining whether material swaps exposure exists.
Initial Margin Threshold Amount

- There is an “initial margin threshold amount” of $65 million, below which initial margin need not be collected
  - Applies on a consolidated entity level, across each party and its affiliates in respect of all uncleared swaps and security-based swaps
    - like the definition of “material swaps exposure” would require aggregation across “affiliates”
  - Initial margin threshold amount reduces any initial margin that is required to be posted by a party
  - If the initial margin requirement is less than the initial margin threshold amount, then there is no requirement to post initial margin
Initial Margin Threshold Amount

- Initial margin threshold amount has been justified, in part, by concerns over liquidity in instruments constituting permitted initial margin
- Concerns over the enormous amount of collateral that would otherwise be used in swaps market (and segregated there)
- In addition, there is a $650,000 minimum transfer amount across initial and variation margin
Eligible Collateral for Initial Margin

- Eligible Collateral: Initial margin may be the following (with schedule of applicable haircuts for non-cash collateral)--
  - Cash;
  - U.S. government securities; Government Sponsored Enterprise securities; securities issued by BIS, ECB, IMF and MDBs; and certain liquid/low-risk foreign government securities;
  - Publicly-traded debt (other than asset-backed securities);
  - Publicly traded equities listed in certain major indices; and
  - Gold:
    - but not: securities issued by (i) the pledgor or an affiliate of the pledgor; or (ii) banks, savings and loans and similar entities
Calculation of Initial Margin

• The required amount of initial margin is to be calculated daily, on the basis of either a risk-based model or a table-based method.

• Both the risk-based model and the table-based method permit offsetting exposures to be reflected only for swaps that are subject to the same “eligible master netting agreement”:
  • Defined as a written, legally enforceable agreement, that, among other things, has been subject to sufficient legal review by the swap entity that the swap entity may conclude with a well-founded basis that the agreement, in the event of a legal challenge, including an insolvency-related proceeding, would be ruled to be legal, valid, binding, and enforceable under the law of the relevant jurisdictions.
  • Not clear if “sufficient legal review” may require an opinion of counsel.
  • Not necessarily clear in each case which jurisdictions are “relevant” for purposes of such legal review.
Initial Margin – Risk-based Models

- Risk-based model would be subject to stringent regulatory requirements:
  - written approval of the relevant regulator for use of a risk-based model
  - Demonstration on an ongoing basis that the model satisfies all of the regulators’ requirements
  - Prior notice to regulators before making changes to model or its assumptions
Initial Margin – Risk-based Models

- Risk-based model would be required to calculate initial margin based on an assumed close-out period of 10 business days
- The assumed length of the close-out period is of critical importance to the calculation of initial margin, because the longer the assumed close-out period, the greater the initial margin amount
- Proposed ten-business-day liquidation horizon is expressly intended to disfavor uncleared swaps relative to cleared swaps
  - According to the CFTC Proposal, by requiring “ten day initial margins for uncleared swaps and only five day margin for cleared swaps,” the Proposals “make cleared swaps relatively more attractive”
- The assumed close-out period is the period for which the initial margin required by the proposals would be intended to mitigate risk, which should correspond to the period when a swap or set of swaps is in the process of being closed out
- A ten-business-day close-out period is materially longer than the usual close-out period for most uncleared swaps
Initial Margin – Risk-based Models

• A risk-based model would be permitted to recognize an offsetting exposure for a swap only in relation to another swap that falls within the same category, and not in relation to another swap that falls within another category
• Categories of swaps include agriculture, credit, energy, equity, foreign exchange/interest rate, metals, and other
• Overall initial margin amount would be based on the sum of the initial margin amounts for each such category
• However, swap entities could not offset interest rate exposures across categories
  • For example: no right to offset exposure arising from interest rate swaps against interest rate exposures arising either from the financing legs of equity swaps or the fixed rate side of credit default swaps
Initial Margin – Table-based Method

• The table-based method to calculate initial margin would provide for initial margin requirements ranging from 1 percent to 15 percent of notional amount, depending on the type of swap

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

- Variation margin required for trades between Swap Entities and:
  - Other Swap Entities and
  - All financial end users.
- Must be paid and collected daily.
- May be less disruptive to market than initial margin because already in widespread use.
- A swap entity may calculate variation margin on an aggregate, net basis under an eligible master netting agreement as discussed above under initial margin.
Variation Margin Requirements

- Differences with initial margin:
  - No threshold for variation margin—variation margin must always be paid/collected.
  - Segregation is not required for variation margin and re-hypothecation of variation margin is permitted.
  - Eligible collateral: **cash only**, as opposed to initial margin for which a broader list of collateral types permitted.
  - Cash must be US dollars (not major currencies as permitted for initial margin) or currency in which payment obligations are required to be settled.
Variation Margin Requirements

- U.S. regulators’ approach differs from BCBS/IOSCO Policy Framework, which does not distinguish between eligible collateral for initial and variation margin.
- More restrictive U.S. requirement may push market liquidity away from the U.S. and into other markets, as market participants likely would be required to liquidate assets (and incur transaction costs) to generate cash to meet the requirement.
- In the case of investment managers whose returns are based on staying fully invested in securities, the need to liquidate securities may cause tracking errors, and in certain cases, could introduce currency basis risk.
Proposed Phase-in Schedule

- Prudential Regulators and CFTC proposals last Fall proposed:
  - Compliance deadline of December 1, 2015 for variation margin.
  - A phased compliance schedule for initial margin, extending from December 1, 2015 to December 1, 2019, depending upon the uncleared swaps exposure (includes FX swaps and forwards) of both the swap entity combined with its affiliates and the counterparty combined with its affiliates over the measuring period of June through August of the current year.

- On March 18, 2015, BCBS/IOSCO announced a delay in the implementation of initial margin and variation margin requirements by nine months starting September 1, 2016.

- Delayed-implementation schedule with regard to variation margin for swap entities belonging to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives is less that €3 trillion, until March 1, 2017.
Eligible Master Netting Agreements

• Margin requirements would not apply to transactions entered into before the rules’ effective date, except that transactions subject to an eligible master netting agreement applicable to pre-effective date transactions would be subject to margin requirements for all swaps under the eligible master netting agreement.

• Swap entities would need to enter into a new eligible master netting agreement in order to exclude pre-compliance date swaps from the margin rules.

• Creating an incentive for parties to divide their swap portfolios may increase systemic risk by reducing netting sets.
Cross Border Application

• Prudential Regulator proposal excludes non-cleared transactions of foreign covered swap entities that would otherwise be covered by their rules if neither the counterparty to the foreign covered swap entity nor any guarantor of either counterparty’s obligations is:
  • Organized in the U.S.;
  • A branch or office of entities organized in the U.S.; or
  • A covered swap entity controlled by a U.S.-organized entity.
• CFTC proposal include an Advance Notice of Proposed Rulemaking that offers three alternative approaches for the cross-border application of its margin requirements:
  • A Transaction-Level approach that is based on its current Cross-Border Guidance;
  • The Prudential Regulator approach; and
  • An Entity-Level approach (based on whether the swap entity is a U.S. person).
Margin – Cross-Border Disparity

• There are differences between European Union and the United States in the entities exempt from clearing and margining.

• Under the EMIR regime margining requirements for uncleared swaps is contemplated where one of the parties is a financial entity and the other is an “NFC+” entity. The United States equivalent of an NFC+ entity would not have margin requirements.

• These differences are despite the origin of margin requirements in a G-20 commitment.
Status of Cross Border Harmonization and SEC’s Cross Border Proposal and Reporting Rules
Status of CFTC Cross-Border Guidance

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

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

• SEC final rules do not address which substantive requirements will apply to which transactions and to which market participants.
• SEC has also finalized its Regulation SBSR, regarding reporting of security-based swaps and rules regarding security-based swap data repository registration.
• The SEC has also published for public comment proposed amendments to its cross border rules that would address how the SBSD definition would apply to transactions between non-U.S. persons where dealing activity occurs in the U.S.
Statutory Basis for Extraterritoriality

- Dodd-Frank’s provisions for extraterritorial jurisdiction differ somewhat with respect to the CFTC and the SEC:
  - **CFTC**: Under Title VII section 722(d), activities outside the U.S. may be regulated if:
    - they have a direct and significant connection with activities in, or effect on, commerce of the U.S.; or
    - they contravene such rules or regulations as may be prescribed under the Act, necessary or appropriate to prevent the evasion of the relevant provisions of the Act;
  - **SEC**: Under Title VII section 772(c), a person transacting a business in security-based swaps outside the U.S. may be regulated if:
    - such person transacts such business in contravention of such rules and regulations as the SEC may prescribe as necessary or appropriate to prevent the evasion of the relevant provisions of the Act.
Current Status of Cross-Border Harmonization

• Path forward:
  ➢ acknowledged simultaneous application of EMIR/Title VII could lead to conflicts of law, inconsistencies and uncertainty;
  ➢ sets out high level agreement between EU Commission and CFTC as to how to resolve certain issues.

• Since then there has been little visibility into discussions among regulators.
• Scattered statements that progress has been made, but difficult to verify or specify.
Current Status of Cross-Border Harmonization (cont’d)

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

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

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

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

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

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

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

• In the European Commission press release announcing the recognition of CCPs in Australia, Hong Kong, Japan and Singapore, Michel Barnier, then European Commissioner for Internal Markets and Services, was quoted as saying:

  ➢ “Today’s decisions show that the EU is willing to defer to the regulatory frameworks of third countries, if they meet the same objectives as EU rules. We have been working in parallel on assessing twelve additional jurisdictions and finalising those assessments is a top priority. This includes the United States: we are in close and continued dialogue with our colleagues at both the SEC and CFTC as we develop our assessments of their respective regimes and discuss their approaches to deference.”

• The press release continued:

  ➢ Equivalence assessments are undertaken using an outcome based approach. This requires that the relevant rules operating in the third country satisfy the same objectives as in the EU, i.e. a robust CCP framework promoting financial stability through a reduction in systemic risk. It does not mean that identical rules are required to be in place...
EU CCP Recognition (cont’d)

• CFTC Chairman Massad in a speech last week:
  • “The fact is I believe we are making good progress. I expect that we will get there. [European Commissioner for Financial Stability, Financial Service and Capital Markets Union] Lord Jonathan Hill and I had a very good discussion last month… We have resolved some issues, in particular the terms of substituted compliance in the application of U.S. law to European clearinghouses that must register with us. Our law does not require registration in all cases; it is only if a clearinghouse clears futures listed in the U.S. or clears swaps for U.S. customers. And I believe we have agreed on a good substituted compliance framework assuming we can resolve the other issues… I also believe we are both committed to resolving this without creating any disruption to the market, as evidenced by the European Commission’s further postponement of the imposition of capital charges.”
U.S. Relief for EU MTFs

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

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

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

- In part because of the requirement that many swaps with U.S. market participants be traded on SEFs, liquidity has fragmented between the U.S. and other jurisdictions.
- Fragmentation results from the decision of the CFTC to finalize its regulations to implement mandatory clearing and mandatory trading platform execution of swaps prior to regulators in other jurisdictions, while at the same time, with its cross-border rules, placing significant regulatory burdens on market participants in other jurisdictions transacting or facilitating transactions with U.S. parties.
- Disincentives to transact with U.S. parties.
Swap Market Fragmentation (cont’d)

  
  "Since the start of the CFTC’s SEF regime in October 2013, and accelerating with mandatory SEF trading in February 2014, swaps markets have divided into separate trading and liquidity pools between those in which US persons are able to participate and those in which US persons are shunned… Non-US person market participants are curtailing transactions with US counterparties to avoid getting caught up in the CFTC’s peculiar US swaps trading rules."
  
  "[I]t’s as if the US Center for Disease Control, in order to protect the US population from an offshore outbreak of a deadly virus, dictated that EU doctors could give vaccines to American patients only in accordance with US protocols for syringe sterilization and disposal. How would such a requirement prevent a contagion from spilling onto US shores? It’s difficult to make the connection. Similarly, it’s difficult to make the connection between the application of US trade execution rules to offshore trades and risk to the US economy. The prescription is unrelated to prevention of the disease."
Swap Market Fragmentation (cont’d)

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

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

• Under the cross-border guidance, many of the CFTC’s substantive rules, including for mandatory clearing and trade (SEF) execution, will apply to any swap involving a U.S. Person (as defined):

  ➢ however, in a transaction between, for example, New York head office of a U.S. swap dealer and the German head office of a German swap dealer, the EU’s rules should presumably govern the transaction to the same extent the U.S. rules do;
  ➢ if the EU were to take a position parallel to that of the CFTC and require the application of the EU’s rules to a transaction involving an EU swap dealer, the transaction would be governed by both U.S. and EU rules;
  ➢ any material differences between these two sets of rules could be a significant issue for the parties to such a transaction and, by extension, for the swaps market as a whole.
Harmonization and the CFTC’s Guidance (cont’d)

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

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

- Basic idea of substituted compliance is that a market participant may substitute compliance with a local non-U.S. rule for compliance with a U.S. rule.
- To make a substituted compliance determination, the CFTC must determine that the foreign jurisdiction’s requirements “are comparable with and as comprehensive as the corollary area(s) of regulatory obligations encompassed by” the CFTC’s own rules.
- The language of substituted compliance informs much of the discussion around harmonization.
- Tension between a requirement-by-requirement approach and a “holistic” or “outcome based approach”.
- The SEC has indicated that it, like the CFTC, will adopt a substituted compliance regime.
Substituted Compliance (cont’d)

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

• Taking the CFTC’s view of its authority one step further, the CFTC in November 2013 issued a “Staff Advisory” regarding swaps “arranged, negotiated or executed, or executed by personnel or agents of the non-US SD located in the United States”.

• In the advisory, the CFTC took the position that, because of its supervisory interest in swap dealing activities within the United States, even where a swap is between a non-U.S. branch of a non-U.S. swap dealer and another non-U.S. Person, the CFTC’s Transaction-Level Requirements will apply to the swap if it is “arranged, negotiated, or executed by personnel or agents of the non-U.S. swap dealer located in the United States.”

• It appeared that the CFTC would require counterparties to a swap to comply with certain transaction level requirements even if both were foreign and entered into a swap through non-U.S. offices, if one entity employed U.S.-based front office personnel or agents in relation to the swap.
Harmonization and CFTC Advisory 13-69 (cont’d)

• However, a series of no-action letters have granted relief, currently extended until September 30, 2015 (or any prior date of CFTC action), to non-U.S. swap dealers failing to comply with the Transaction-Level Requirements in relation to swaps with many non-U.S. person.

• In addition, the CFTC has issued a request for comment on “whether the Commission should adopt” the advisory “as Commission policy, in whole or in part”.

• Similarly, the SEC, in its release of its final cross-border rules, stated that it anticipated soliciting additional public comment regarding approaches by which the cross-border application of the “security-based swap dealer” definition could reflect activity between two non-U.S. persons where one or both are conducting dealing activity within the United States.
CFTC Advisory 13-69 – Comparison with SEC

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

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

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

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

• However, the SEC specifically requested comment on whether it is “appropriate not to apply the clearing and trade execution requirements to transactions that a non-U.S. person, in connection with its dealing activity, arranges, negotiates, or executes using personnel located in a U.S. branch or office.”
“Arranged, negotiated, or executed” is not defined in the proposed rules; instead, guidance is provided in the Proposal’s preamble.

Under the guidance, “arranged, negotiated, or executed” in the U.S. encompasses “market-facing activity” — i.e., the activity of sales and trading personnel, including communications with potential counterparties or their agents — that is conducted through a branch or office in the territorial United States by personnel of the non-U.S. person or by an (affiliated or unaffiliated) agent of such person.

The non-U.S. person would not be required to consider the location of its counterparty’s operations or personnel (or that of the counterparty’s agent) in determining whether the transaction should be considered in its own de minimis calculation, which it might have been required to do under the SEC’s original May 2013 proposal.

This clarification is intended to avoid unnecessary costs and complexity that may make compliance difficult for market participants.
Market-Facing Activity

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

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

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

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

- “Personnel” in this context is to be interpreted in a manner consistent with the definition of the term “associated person of a security-based swap dealer” in the Securities Exchange Act of 1934, regardless of whether the non-U.S. person or its agent is itself an SBSD.
- The SEC states its expectation that it will examine whether a particular entity is able to control or supervise the actions of an individual in determining whether such individual is considered “personnel” of a U.S. branch, office, or agent of the SBSD.
Non-Market Facing Activities

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

• Involvement of U.S.-based attorneys in the negotiation of the terms for a transaction also would not, by itself, bring a transaction within market-facing activity.
External Business Conduct Standards

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

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

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

• “Foreign business” would be any business that is not “U.S. business.”
Security-Based Swap Reporting

- SEC adopting release for Reg. SBSR delays establishing a final compliance schedule for security-based swap (SBS) reporting.
- Compliance schedule for SBS reporting is subject to a separate proposal.
- Reg. SBSR (when compliance is required):
  - Provides for an "interim reporting phase" generally requiring all SBS to be reported within 24 hours of execution; no delay is provided for public dissemination of block trades;
  - Leaves many details of SBS reporting to registered security-based swap data repositories ("SBSDRs");
  - Establishes a reporting hierarchy similar to the CFTC’s; and
  - Requires reporting of historical SBS and inter-affiliate transactions.
- SBSDR registration compliance date 365 days after FR publication.
Security-Based Swap Reporting

• The data required to be reported under Reg. SBSR does not appear to align with the information required to be reported under the CFTC’s regulations regarding swap data reporting.

• Concern about lack of harmonization of required reporting not only with CFTC but internationally as well.

• Last week numerous industry groups endorsed in a letter a set of data reporting principles that ISDA proposed in February of this year.

• Among the principles:
  • Regulatory reporting requirements for derivatives transactions should be harmonized within and across borders.
  • Policy-makers should embrace and adopt the use of standards – such as LEIs, UTIs, and UPIs – to drive improved quality and consistency in meeting reporting requirements.
  • Where global standards do not yet exist, market participants and regulators can collaborate and secure agreement on common solutions to improve consistency and cross-border harmonization.
  • Laws or regulations that prevent policy-makers from appropriately accessing and sharing data across borders must be amended or repealed.
The scope of the SBS trade reporting and public dissemination requirements under the recently adopted Reg. SBSR also would be amended under the Proposal by:

- requiring that all transactions that are “arranged, negotiated or executed” in the U.S. (including such transactions by de minimis SBSDs) are both reported and publicly disseminated;
- changing the reporting hierarchy so that when a non-U.S. de minimis dealer faces a U.S. person, the parties may choose who reports (rather than putting the burden on the U.S. person); and
- requiring reporting when two non-U.S. persons trade through a U.S. platform or broker-dealer, including a security-based swap execution facility.
U.S. Person Definition

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

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

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

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

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

- SEC also expressly excludes certain entities from the U.S. person definition, which were not excluded by the CFTC.
- The excluded entities are the International Monetary Fund, the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the United Nations, and their agencies and pension plans, and any other similar international organizations, their agencies and pension plans.
- The CFTC took a different approach to these entities, not excluding them from the U.S. person definition, but instead exempting them from substantive rulemakings, including from swap dealer and major swap participant registration.
Questions?

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