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Regulatory brief

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Derivatives: Regulatory roulette

Overview

Determining Dodd-Frank conformance obligations is a little like gambling at the roulette table; every spin yields a different result. Releases by the CFTC over the last several months – and days – have left industry participants and platforms alike re-evaluating what they have to comply with and when. Not only has each release introduced its own particular ambiguities regarding the extraterritorial reach of Dodd-Frank, but collectively they have raised a larger question, namely: when will the wheel stop turning?

The CFTC's most recent round of cross-border interpretation has caused confusion and consternation among market participants. For relief, some have started placing their bets on a recently filed lawsuit that seeks to undo much of the CFTC's cross-border regime. Three key regulatory pronouncements at issue are the following:

- In July, the CFTC's Final Cross-border Guidance ("Cross-border Guidance") expanded the interpretation of "US person" to now include counterparties (and as a consequence, transactions) previously thought to be outside CFTC jurisdiction.[1] In a companion order, the CFTC effectively gave non-US dealers and foreign branches of US dealers until December 21st to conform with either CFTC requirements or comparable local law.
- However, on November 14th, a CFTC staff "advisory" stated that registered non-US person swap dealers ("SDs") must comply with "transaction level" requirements (including those related to execution and clearing) when entering into a swap with a non-US person *if the swap is arranged, negotiated, or executed by personnel or agents of the non-US SD located in the US.*[2] A subsequent no-action letter in late November indicated that compliance with this is not required until January 14, 2014.[3]
- Finally, on November 15th, staff guidance stated that non-US multilateral swap trading platforms must register with the CFTC if the platforms allow US persons (or persons located in the US such as personnel and agents of non-US persons) to trade or execute swaps on the platform (either directly or indirectly through an intermediary).[4]

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[1] See "Interpretive Guidance and Policy Statement regarding Compliance with Certain Swap Regulations," 78 Fed. Reg. 45292 (Jul. 26, 2013).

[2] See "Division of Swap Dealer and Intermediary Oversight Advisory: Applicability of Transaction-Level Requirements to Activity in the United States," CFTC Staff Advisory No. 13-69 (Nov. 14, 2013).

[3] See "No-Action Relief: Certain Transaction-Level Requirements for Non-US Swap Dealers," CFTC Letter No. 13-71 (Nov. 26, 2013).

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The flurry of documents was undoubtedly intended to provide the industry with the CFTC's view of the scope of its jurisdiction. The reality, however, is that rather than fostering clarity, each new piece of guidance has raised new issues, making uncertainty and fragmented liquidity the new normal.

These latest releases re-confirm three important lessons that are perhaps fairly obvious by now: First, the CFTC is not afraid to flex its jurisdictional muscle, even if its reach appears too far to some. Second, the fits-and-starts approach to regulatory guidance continues. Third, it is dangerous to bet the bank on the ultimate significance of any of these ever-moving compliance dates.

This **Financial Services Regulatory Brief** analyzes each of the three key CFTC releases since July, and suggests where your chips should be placed with these lessons in mind.

Cross-border guidance and substituted compliance

Where are we?

As detailed in a previous brief,[5] the Cross-border Guidance is a multifaceted document, laying out the CFTC's view on a number of issues, primary among them being the definition of a "US person" and the manner in which the CFTC would roll out and apply its "substituted compliance" regime. The major impact of the latest "US person" definition was to expand the criteria by which one might be considered a "US person" to include off-shore funds that are majority owned by US persons. For non-US SDs, swaps that count toward SD registration thresholds are primarily those with US persons, but with the expanded definition, swaps with more types of counterparties now count toward registration thresholds.

The net effect of these US person changes is that some dealers that had previously not been required to register are now pulled into the registration scheme if their dealing activities with off-shore funds, for example, surpass the SD registration threshold. Over 90 dealers are now registered, which is nearly a 50% increase from the 65 that were registered shortly after last year's December 31st registration deadline.

A secondary consequence of the Cross-border Guidance flows from the CFTC's statement of how, via substituted compliance, foreign SDs or foreign branches of US SDs ("foreign branches") may comply with "comparable" local law in lieu of CFTC regulations. From a high level, the substituted compliance regime is based on the notion that where foreign regulators have some interest in a transaction (due to the location of the parties to the transaction) their rules can serve as a surrogate for CFTC rules, provided the CFTC first determines that the rules of the foreign jurisdiction are comparable to the CFTC's. But in an attempt to account for various trading models, the CFTC created a grid-like matrix of rules which may or may not apply depending on a number of criteria including the location of the parties, their contact to the US through affiliate relationships, and even the type of rule involved.

Perhaps in recognition of the fact that most non-US jurisdictions are lagging far behind in issuing final rules that could be evaluated for comparability, the CFTC permitted non-US dealers and foreign branches to comply with local law rather than CFTC rules (in some cases) until December 21st. In order for local law to apply beyond that date, the CFTC would have to act. CFTC Chairman Gary Gensler has indicated that by December 21st, the CFTC will have made substituted compliance determinations for "entity level" rules (such as capital and risk management regulations) but he was less certain with respect to transaction level rules (including clearing and execution).

What happens on December 21st?

As the clock ticks down to December 21st, the CFTC hasn't yet made any comparability determinations. While this has caused understandable anxiety throughout the industry, the reality is that the December 21st date may be less important than initially meets the eye. Although we would expect the CFTC to make some favorable comparability determinations by that date, and probably provide relief in other respects where comparability is not found (or a decision is not made), the broader question is whether such a determination will in fact be "favorable" to non-US market participants outside the US. At the end of the day the notion of "comparability" suggests that local law will have to be very similar to CFTC requirements in order to receive this favorable determination, so regardless, something similar to Dodd-Frank is likely to ultimately govern.

Therefore, those foreign dealers, prospective foreign dealers, and foreign branches that have been debating between two options – either building toward the CFTC's regulatory requirements or hoping that compliance with local law will be deemed sufficient when the CFTC ultimately makes its comparability determinations – are better advised to build toward CFTC conformance. At this point, it should be abundantly clear that the CFTC is willing to see rules go into effect despite industry resistance.

[4] See "Division of Market Oversight Guidance on Application of Certain Commission Regulations to Swap Execution Facilities" (Nov. 15, 2013).

[5] See PwC's *A Closer Look, Derivatives: Global convergence becomes global confusion* (Sept. 2013).

Furthermore, to the extent that the substituted compliance determinations create some substantive distinctions from the CFTC's regime, it would not be surprising if the guidance around the determinations creates more complexity than clarity. The case in point is the CFTC's July no-action letter concerning the intersection between the CFTC's risk mitigation requirements and the European Market Infrastructure Regulation ("EMIR"). In the letter, the CFTC staff found that EMIR provisions regarding portfolio compression, portfolio reconciliation, and confirmations were "essentially identical" to CFTC requirements, thus enabling entities in EMIR jurisdictions to comply with local law on these points.[6]

However, with regard to swap documentation rules, the CFTC made fairly granular determinations, finding that some provisions within EMIR's documentation rules were essentially identical to CFTC requirements while others were not. The result is a checkered application of local and CFTC requirements.[7] While not technically a "substituted compliance" determination, the approach taken in the no-action letter suggests the CFTC may take a similarly granular view with its substituted compliance determinations, thus giving industry participants yet another layer of requirements with mixed applications.

What to do now?

Ultimately, market participants need to take a hard look at what substituted compliance may mean and the extent to which even a "favorable" determination will provide relief from CFTC requirements as a practical matter. Moreover, if the CFTC's comparability determinations are less than comprehensive – and there is plenty of evidence to suggest they will be – the prudent course is to build toward compliance with CFTC requirements.

Finally, dealers will have to take into account the preferences of their counterparty clients. We have observed that at least some globally active buy-side participants have decided to cut the Gordian knot by requesting that all transactions with dealers be Dodd-Frank compliant.

[6] It is possible that the CFTC found these to be "essentially identical" because the standards are already largely market practice.

[7] See "No-Action Relief for Registered Swap Dealers and Major Swap Participants from Certain Requirements under Subpart I of Part 23 of Commission Regulations in Connection with Uncleared Swaps Subject to Risk Mitigation Techniques under EMIR," CFTC Letter No. 13-45 (Jul. 11, 2013).

Advisory on non-US SD compliance with transaction level requirements

Where are we?

On November 14th, the CFTC staff issued an "advisory" that sought to clarify another point regarding CFTC jurisdiction, raised in footnote 513 of the Cross-border Guidance.[8] Staff advised that registered non-US person SDs must comply with transaction level requirements when entering into a swap with a non-US person *if the swap is arranged, negotiated, or executed by personal or agents of the non-US SD located in the US*. As framed by the CFTC chairman, the advisory is intended to address regulatory arbitrage: in the Chairman's view, a US SD on the 32nd floor of a building in New York should be on equal footing with a non-US dealer with personnel on the 31st floor performing core functions (e.g., arranging, facilitating, or executing swaps).

The advisory has provoked consternation among non-US dealers who (taking comfort in footnote 513) had assumed that as long as a swap was executed between themselves and non-US counterparties (i.e., foreign-to-foreign), the transaction was outside the reach of CFTC regulation even if negotiated or executed on a trading desk sitting in the US. The advisory has called into question a number of possible booking models in addition to creating confusion as to what level of activity from personnel outside of the front office would be considered "arranging, facilitating, [or] executing swaps." In addition to pulling these foreign-to-foreign swaps into scope, the advisory also seems to pull in swaps between foreign entities intermediated by a US-based introducing broker.

What happens on January 14th?

Given the ambiguity of footnote 513, and the late-breaking November 14th advisory, many non-US swap dealers were caught off-guard by the application of transaction level rules to trades between non-US counterparties that were negotiated or executed through a US desk. To accommodate this, the CFTC provided a grace period until January 14, 2014 for compliance to begin.

[8] Footnote 513 states that "the Commission takes the view that a US branch of a non- US swap dealer ... would be subject to Transaction-Level requirements, without substituted compliance available" because a branch "does not have a separate legal identity apart from its principal entity." What it does not say is that even limited activity by a branch – negotiating or executing a trade between the non-US principal and a non-US counterparty – would result in application of transaction level requirements. See Cross-border Guidance at 45350 n. 513.

From our view of the market, the significance of the January 14th date among actors is split. For some, the advisory confirmed what they expected as a result of the footnote – that the CFTC will take an interest in transactions that touch the US in any significant way. Those who operationalized with this in mind are ready. For others who took a more hopeful view, the advisory has created some undesirable options: either adjust client service models to avoid contact with the US or adapt quickly to run such trades through transaction level requirements.

What to do now?

At the end of the day, the practical reality is probably close to the situation regarding the December 21st substituted compliance deadline – namely, it is wiser to work toward conforming with transaction level requirements than to wait with fingers crossed. Some actors hold out hope that the lawsuit questioning the validity of the CFTC's Cross-border Guidance will provide relief in time, but the likelihood of receiving short term relief through litigation seems slim. Others seem to hope that a new CFTC Chairman (who will replace Chairman Gensler when his term expires at the end of this year) will reverse course, but Congress is unlikely to confirm a new Chairman in time to provide relief (assuming the new Chairman would be motivated to do so).

Finally, an important point with respect to our analysis of the December 21st date similarly applies here. Global buy-side firms are beginning to look for consistent processes regardless of the US person status of their counterparty.

Non-US swap trading platform guidance

On November 15th, the CFTC released more jurisdictional guidance, this time with regard to registration requirements for execution platforms as swap execution facilities ("SEFs") or designated contract markets ("DCMs").[9] The CFTC release states that multilateral swaps trading platforms located outside the US which provide US persons or persons located in the US (including personnel and agents of non-US persons) with the ability to trade or execute swaps on the platform ("either directly or indirectly through an intermediary") must register as a SEF or DCM.

While the entities primarily affected by this guidance are the SEFs themselves, users of the platforms did not escape unscathed. Uncertainty over the scope of CFTC regulation has already caused some important market consequences, with foreign execution platforms denying US persons access in order to avoid tripping over possible SEF registration requirements.

The advisory confirmed what these platforms already feared: that participation by US persons would require registration. The guidance went a step further, however, by indicating that participation by US persons, "either directly or indirectly through an intermediary," would require registration.

Given what appears to be the consensus among non-US platforms – that it's easier to exclude participants who are (or even may be) US persons than it is to register – the overriding effect of the guidance seems to fall upon participants who may see liquidity pools shrink with restricted participation.

Conclusion

The CFTC has had a delicate balance to maintain with each extraterritorial pronouncement, which helps explain the incremental approach it has taken. On one hand, Dodd-Frank gives the CFTC authority to regulate transactions that have a direct and significant impact in the US, and the CFTC has assertively applied its regulations to transactions involving US persons wherever they occur. Moreover, the CFTC is clearly concerned about fairness where US SDs compete with non-US SDs for business transacted in the US.

On the other hand, the CFTC's jurisdictional line is difficult to draw when the interests of other national regulators with equal jurisdictional claims are involved. The reality of the global market – with entities with complex global booking models – further compounds the problem, although the level of market dissatisfaction over the CFTC's efforts depends on whose ox is being gored: US dealers likely view much of the guidance as a means to ensure parity between themselves and non-US SDs with a US presence.

Regardless of this attempt at balance, the result is a roulette wheel of uncertainty regarding the CFTC's jurisdictional reach and application of its rules. For global entities scrambling to comply with these latest pieces of guidance, certainty, above all, is the wished-for outcome. In the meantime, reality suggests that the best course of action is prudent decision making – and hedging your bets with respect to a pending lawsuit.

[9] See "Division of Market oversight Guidance on Application of Certain Commission Regulations to Swap Execution Facilities" (Nov. 15, 2013).

Additional information

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