FS Regulatory Brief

Derivatives: Cross-border at the cross roads

June 2013

Overview

With less than one month to go before expiration of the Commodity Futures Trading Commission's (CFTC) cross-border relief (Exemptive Order), anxiety is growing among global derivatives market participants. While there are plenty of views regarding how best to regulate cross-border transactions, consensus has not emerged among international regulators, although some progress has been reported.

Market participants, therefore, face several uncertainties over the next few weeks: what sets of rules will apply to their cross-border swap transactions; whether compliance with home country rules will suffice for foreign based dealers; and whether the status quo under the Exemptive Order will continue pending further negotiations among international regulators. If the Exemptive Order expires without additional relief from the CFTC, swaps market participants will be left without a compass to navigate the regulatory landscape.

What's at stake for all international regulators is striking the right balance between discouraging regulatory arbitrage and protecting the global competitiveness of their domestic markets, while remaining true to the G20's post-financial crisis goals of mitigating systemic risk, protecting against market abuse and enhancing transparency of derivatives transactions worldwide. The obstacles to reaching consensus stem from differences in approach among regulators – both in the US and abroad – and from uncoordinated implementation timetables for derivatives regulations.

This **Financial Services Regulatory Brief** describes the state of play and provides our view of various possible regulatory outcomes over the next few weeks. To be sure, the path to compliance is not well marked.

Where do we stand?

Status of CFTC approach

As of today, foreign based entities and foreign branches of US Swap Dealers (SDs) are conducting their swaps related activities under the CFTC Exemptive Order issued in December 2012 that will expire July 12, 2013.[1] Essentially, the Exemptive Order temporarily: 1) relieves certain foreign firms from having to register with the CFTC as an SD or a Major Swap Participant (MSP) by modifying the aggregation requirements related to their subsidiaries' swaps activity;[2] 2) relieves foreign branches of US SDs and MSPs from having to comply with transaction level requirements for their swaps with non-US persons; and 3) relieves foreign based SDs and MSPs from having to comply with entity

[1] See PwC *Financial Services Regulatory Brief: Cross-Border Clarity: CFTC provides guidance and additional time for industry to address cross-border swaps* (December 2012).

[2] See PwC *Financial Services Regulatory Brief: Certain foreign-owned US banks may avoid registration under swap dealer aggregation rule* (December 2012).

pwc

level requirements.[3] However, all SDs and MSPs, including foreign based SDs and foreign branches of US based SDs, must currently comply with transaction level requirements for their swaps with US persons. The Exemptive Order has a US person definition and aggregation instructions that determine which swaps must be counted toward the *de minimis* $8 billion threshold for SD registration, as well as which counterparties and transactions trigger compliance with transaction level requirements.

The Exemptive Order was welcome relief following the highly controversial proposed cross-border guidance (Proposed Guidance) issued by the CFTC in July 2012. The Proposed Guidance was viewed by many market participants, foreign regulators and some US legislators as an unwarranted extension of CFTC jurisdiction to foreign based firms and transactions. The principal objections to the Proposed Guidance focus on: the broad and complicated US person definition; the application of CFTC registration requirements and other rules as a result of US person guarantees of foreign affiliates and transactions; and the limited ability of foreign based SDs to rely on their home country rules as substituted compliance for CFTC requirements.

The CFTC has not finalized its cross-border guidance. Based on statements by the CFTC Chairman and several commissioners, it does not seem likely that they will reach a broad consensus any time soon. Three commissioners appear to favor extending the Exemptive Order through the end of 2013 (to provide more time for discussion among global regulators), while the Chairman and another commissioner want to finalize the guidance now.

The CFTC agenda is within the control of the CFTC Chairman. If an agreement cannot be forged among a majority of the Commissioners to adopt final guidance, there are, at least, two alternative paths that he could take: 1) get a majority of Commissioners to extend the Exemptive Order (as is, or with conditions); or 2) do nothing and leave it up to market participants to determine the reach of the Dodd-Frank Act with the Proposed Guidance as the backdrop. The relevant Dodd-Frank extraterritoriality provision permits CFTC jurisdiction over cross-border swap activities that have a "direct and significant connection with activities in, or effect on, commerce of the United States." Needless to say, without final CFTC guidance, market participants face substantial operational and legal risk in interpreting this provision on their own.

Sources of conflict

The current conflict among CFTC commissioners is being fuelled by a number of sources. International derivatives regulators, including the CFTC and the Securities and Exchange Commission (SEC), are scheduled to meet in Montreal on June 20th to continue their dialogue on the regulation of cross-border derivatives transactions. The group has been urged by the G20 finance ministers to report by July specific and practical recommendations for the resolution of the remaining cross-border conflicts, gaps and duplicative requirements (with a goal of reaching resolution by September 2013). The G20's July timeframe coincides with the expiration date of the CFTC's Exemptive Order, adding pressure on all sides to try to find common ground for compromise.

Complicating the upcoming international discussions for the CFTC Chairman are the SEC's recently proposed cross-border rules and guidance. As discussed in our May 2013 *Financial Services Regulatory Brief, SEC's*

[3] Transaction level requirements relate to clearing and swap processing, margining (and segregation) for uncleared swaps, trade execution, swap trading relationship documentation, portfolio reconciliation and compression, real-time public reporting, trade confirmation, daily trading records, and external business conduct standards. Entity level requirements relate to capital adequacy, chief compliance officer related rules, risk management, swap data recordkeeping, swap data reporting, and large trader reporting for physical commodity swaps.

Take on Cross-Border Derivatives Rules – Catalyst for global moderation or unwelcome complication?, the SEC's approach is viewed by many as a more palatable alternative to the CFTC's Proposed Guidance. The SEC offers a less expansive US person definition, allows substituted compliance for both entity level and transaction level requirements and addresses US guarantees in ways that wouldn't require SD registration of foreign affiliates. Based on public statements, the SEC approach does not appear to have influenced the CFTC Chairman; rather it seems to have driven a deeper wedge between the CFTC and SEC which may embolden foreign regulators in the ongoing negotiations.

Congress is also taking sides in the debate. A bill (HR 1256) that recently passed the House with bipartisan support generally supports the SEC's approach (although the bill is unlikely to pass the Senate and is opposed by the White House). The bill calls for joint rulemaking by the CFTC and SEC and would exempt from Dodd-Frank derivatives regulation non-US persons that are in compliance with the requirements of one of the nine largest foreign swap market jurisdictions. This exemption would apply unless the CFTC and SEC determine that a foreign jurisdiction's requirements are not "broadly equivalent" to US requirements. The bill perhaps increases the pressure on the CFTC to extend the Exemptive Order pending negotiations among global regulators.

Meanwhile in the EU, the deadline for the European Securities and Markets Authority (ESMA) to deliver its advice to the European Commission (EC) as to whether the US derivatives regulatory regime is sufficiently equivalent to the EU's has recently been delayed from June until September 1st; the letter extending the deadline cites ongoing cross-border developments as the basis. The ESMA equivalence assessments under the European Markets and Infrastructure Regulation (EMIR) relate to clearing, reporting and risk mitigation techniques for uncleared derivatives. An equivalence determination is one of the preconditions before US central counterparties and trade repositories can apply for EU recognition. Until the delay, it was rumored that ESMA would find at least some US requirements *not equivalent* (although the EC is not obligated to accept this advice for legal implementation). The delay in the ESMA equivalence determination will allow international comparability and substituted compliance discussions to proceed without this added complication.

Further complicating efforts to harmonize CFTC and EU regulations is the fact that implementation of EMIR is significantly behind CFTC rules. For example, there are reports that there will be delays in implementing the EMIR reporting requirements until 2014. There will also be a gap with respect to mandatory trade execution. These requirements will be introduced as part of the Markets in Financial Instruments Directive (MiFID), which is unlikely to come into force before 2016, much later than the CFTC's recently adopted swap execution facility related rules.[4] By contrast, most CFTC rules have been finalized, while certain requirements will be phased in through the end of the year.

Adding to the uncertainty are reports that the White House is about to nominate a candidate to replace the CFTC Chairman. The current Chairman's term expired over a year ago and, by law, he cannot remain in office beyond the current session of Congress (i.e., the end of 2013) without re-confirmation. As is typical, the nomination of the new Democratic Chairman is likely to be paired with the nomination of the new Republican commissioner to replace a Republican commissioner who has announced her intended resignation. While it is unlikely that these nominations, confirmations and installations of a new Chairman and Commissioner could be accomplished before July 12th, the noise associated with the

[4] See *PwC Financial Services Regulatory Brief, Derivatives: SEFs – Opening bell sounds* (June 2013).

process could be a distraction for the relevant players. It is unclear, however, if or how the process might influence the current Chairman – whether it would make him more or less receptive to compromise and delay, given his stated views as to the policies and risks at issue.

What is likely to happen?

With the short timeframe until July 12th, it seems unlikely that any comprehensive, final agreements related to cross-border regulation will be reached by the deadline – whether among international regulators; between the CFTC and SEC; among CFTC Commissioners; or between the White House and Congress. So, all eyes remain on the CFTC Chairman. If a majority of CFTC Commissioners is unwilling to approve final cross-border guidance, will he be willing to compromise on an extension of the Exemptive Order (with or without modifications) or will he do nothing? While the CFTC Chairman is known to drive a hard bargain up until the last moment, he has demonstrated repeatedly that he is willing to compromise in the end to take account of concerns of market participants.

Our view, therefore, is that the CFTC will likely extend the Exemptive Order sometime prior to July 12th to avoid the uncertainty that would come from doing nothing. The timeframe and conditions of such relief are harder to predict, however. In other circumstances, the CFTC has allowed very limited extensions of time, and has coupled such extensions with complicated conditions. One example of a precedent that might be relevant here is the CFTC's temporary relief related to the inter-affiliate clearing exemption issued in April 2013.[5] As a condition on the exemption from clearing of inter-affiliate swaps, the CFTC required that affiliates clear their outward facing swaps, either under US rules or in compliance with comparable foreign requirements. The CFTC recognized that foreign requirements had not yet been implemented in some places and had not even been enacted in others. As a result, the CFTC provided temporary relief from the clearing requirement for outward facing swaps, but the relief was more generous for jurisdictions that had enacted mandatory clearing (EU, Japan and Singapore at the time) than those that had not yet adopted such requirements. Given this precedent, it is possible that an extension of the Exemptive Order could include a variety of conditions designed to keep the pressure on foreign jurisdictions to pursue implementation of the G20 initiatives and derivatives reform.

While global firms will need to remain vigilant over the next few weeks, it is unlikely that any significant changes to the status quo will be immediate. It is more likely that extended exemptive relief will allow the cross-border situation to evolve over the next few months as some of the key players change and foreign regulatory schemes continue to come on line.

---

[5] See *PwC Financial Services Regulatory Brief, Inter-Affiliate Swaps Clearing Exemption – A trade worth making?* (April 2013).

Additional information

For additional information about PwC's Financial Services Regulatory Practice and how we can help you, please contact:

Dan Ryan
Financial Services Regulatory Practice Chairman
646 471 8488
daniel.ryan@us.pwc.com

Alison Gilmore
646 471 0588
alison.gilmore@us.pwc.com

Contributors: Phyllis Cela and William Penner.

www.pwcregulatory.com

To learn more about financial services regulation from your iPad or iPhone, click here to download PwC's new Regulatory Navigator App from the Apple App Store.

Follow us on Twitter @PwC_US_FinSrvcs