Regulatory brief

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Derivatives: Year-ahead US roadmap

It has been three years since the first wave of registrants applied to be swap dealers (SDs) with the Commodity Futures Trading Commission (CFTC). Since then, SDs have focused on modifying their operations and building compliance programs that accommodate the flurry of new rules issued by the agency.[1] Despite these efforts, SDs continue to struggle with a lack of clarity in the rules and with a multitude of no-action letters that delay compliance with certain requirements (e.g., related to reporting and inter-affiliate clearing).

Further complicating matters for SDs, global coordination has been a challenge. Pulling back somewhat from previous efforts to extend its regulatory reach beyond the US, the CFTC has been coordinating with other jurisdictions' regulators toward recognizing each other's rules. This coordination has borne fruit, such as last week's long awaited cross-border clearing framework announced by the CFTC and EU which is set to allow EU dealers to clear through US central clearing parties (and vice versa). However, global alignment remains far off.

Even within the US, compliance complexity will increase if CFTC rules end up out-of-sync with rules that the SEC is poised to issue. Although the CFTC's regulations cover over 90% of the US swaps market, the SEC's oversight of *security-based* swaps means that the SEC's upcoming rulemakings will require recalibrating processes developed to meet the CFTC's approach or even building new ones.[2]

In short, for SDs, it is hardly "mission accomplished." However, given the CFTC's stated commitment to resolving remaining compliance problems as quickly as possible, we expect several outstanding issues to be addressed this year. These developments, combined with those outlined below – especially the upcoming September 1st phase-in of margin requirements for uncleared swaps for the largest SDs[3] – ensure a busy year ahead for the industry.

This **Regulatory brief** provides our view of (a) the key issues that will impact the industry over the next year, and (b) the effect of the SEC's upcoming rulemakings.

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[1] For a listing of many of these requirements, see PwC's *A closer look, Derivatives: Global convergence becomes global confusion* (September 2013).

[2] Very few of these SEC rulemakings have been finalized to date. See PwC's *First take, Ten key points from the SEC's swaps reporting and disclosure rules* (February 2015). Furthermore, no date has been set requiring registration with the SEC, and no compliance dates exist for finalized rules.

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Key issues

1. Trade reporting remains problematic for the industry

Reporting obligations by the CFTC continue to be among the most challenging requirements for SDs to meet, due to persisting uncertainty about what exactly should be reported (e.g., what type of trade confirmation data). Following the release of the initial SD reporting rules in 2012, the CFTC has provided a series of no-action letters delaying certain aspects of reporting such as the identity of counterparties from some jurisdictions. Since then, however, the CFTC has provided little additional guidance other than the recently proposed technical standards for reporting certain swap data elements, which will likely be finalized later this year.

SDs however should not wait for these final standards or for further regulatory guidance. Instead, they should self-identify and fix reporting issues in order to avoid enforcement actions, especially in areas that have been identified as high priority by the CFTC. These areas include quality and accuracy of reported data related to counterparty entity-type, counterparty status as a US or non-US person, and transaction clearing status.

2. Should SDs exempt or clear inter-affiliate swaps?

In 2013, the CFTC provided an exemption from its clearing requirement for swaps between affiliated entities. While simple in concept, SDs expect the exemption to be difficult to employ because they must meet a number of conditions to take advantage of it – for example, clearing outward-facing swaps (i.e., with customers) and maintaining trading documentation between affiliates (i.e., a master agreement).

Until now, a series of CFTC no-action letters have allowed SDs to avoid clearing inter-affiliate trades even if they have not cleared the outward-facing swap.[4] However, the letter that currently provides this relief is due to expire by year-end, at which point an inter-affiliate trade must be cleared if the outward-facing swap is not (assuming no further extension of no-action relief).

As a result, this exempt-or-clear decision will be challenging, especially for SDs with non-US affiliates that lack the technical capability to clear trades on CFTC-approved Designated Clearing Organizations. This decision should be informed by analyzing (a) the clearing requirements in home jurisdictions of each non-US affiliate, (b) the revenue impact of clearing (e.g., revenue loss due to increased clearing cost to clients), and (c) the cost of deploying the infrastructure necessary to exempt inter-affiliate trades.

The exempt-or-clear decision is also likely to be influenced by the impact of the Federal Reserve's upcoming rule proposal to extend limitations on transactions between a bank and its affiliates to include derivatives (i.e., expanding Reg W or Section 23A). Reg W limits a bank's uncleared transactions[5] with its affiliates in excess of certain thresholds.[6] Once this limitation is extended to derivatives transactions, there will be additional incentive for institutions to clear derivatives transactions among their affiliates.

3. The largest SDs have only a few months to prepare for the phase-in of margin for uncleared swaps

The recently finalized margin rules for uncleared swaps[7] will have a considerable impact on market participants' technology infrastructures and business models. Technologically, SDs are preparing for a significant increase in the volume of exchanged initial margin when the requirements begin to phase-in later this year, and should assess whether collateral management systems are capable of handling the volume.

Additionally, the final rules will make derivatives more expensive and lead to higher funding and liquidity needs to support the increased collateralization. Therefore, SDs should assess the business impact of the rules and consider options other than uncleared swaps (e.g., cleared swaps, alternative products, or new trading strategies).

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[3] The CFTC's margin requirements for uncleared swaps were finalized shortly after banking regulators finalized their own substantially similar requirements. See PwC's *Regulatory brief, Derivatives: Clear road ahead for uncleared margin* (November 2015). Many other jurisdictions around the world have similar requirements which will also go into effect on September 1st.

[4] No Action Letter 15-63 provides relief from the requirement to clear an affiliate's outward-facing swaps in order to benefit from the inter-affiliate exemption for clearing. As an aside, this letter has been consistently accompanied by the contents of No Action Letter 15-62 which provides relief from mandatory execution requirements between affiliates. We believe 15-62 is likely to become permanent because back-to-back transactions general do not contribute to price discovery (unlike transactions that are outward-facing).

[5] These limitations on banks' transactions traditionally include extension of credit to an affiliate, investment in the securities of an affiliate, or purchasing assets from an affiliate. The Dodd-Frank Act added derivatives to this list of limitations, which the Federal Reserve's upcoming Reg W proposal will implement.

[6] These thresholds prohibit a bank from transacting with an affiliate if the transaction would cause the aggregate amount of the bank's limited transactions to (a) with the particular affiliate, exceed 10% of the bank's capital or (b) with *all* affiliates, exceed 20% of the bank's capital.

[7] See note 3.

Finally, SDs should review their credit agreements with counterparties and third-party service providers such as custody banks. Many SDs are recognizing that existing credit agreements lack provisions for the exchange of margin or third-party handling of collateral, so agreements must be amended according to the final rules' requirements.

4. The first wave of business continuity and disaster recovery audit reports are nearly due

The CFTC requires that SDs audit their business continuity and disaster recovery plans every three years using a qualified third-party service (with the first audit performed three years after an SD's registration with the CFTC). However, the agency has yet to specify whether this must be done as an assessment or an attestation. The timing of the report is also unclear (i.e., whether it must be completed prior to or after the end of the three-year period).

The first SDs to apply for registration[8] are currently in the process of finishing their reports without having settled on a common industry approach to these uncertainties. Therefore, we expect to see fairly wide variation in the form and timing of the first-wave reports. The CFTC will likely leverage these reports as a learning exercise to identify what works best for the industry and the agency, and to provide additional guidance to SDs that need to meet the obligations in the future.

5. Scrutiny of compliance policies and controls continues

The CFTC specifically requires an SD's Chief Compliance Officer to assess the effectiveness of its compliance program's policies and procedures and to remediate any deficiencies. Since last year, domestic SDs' adherence with this requirement has been tested through targeted examinations by the National Futures Association. These examinations will continue this year and will expand in scope to also include non-US SDs. To prepare, SDs should have well-documented policies, a comprehensive inventory of controls, a clear policy for control design, and consistent guidelines for identification and escalation of problems.

6. SD registration de minimis threshold remains unchanged, for now

Last November, the CFTC issued a report on the *de minimis* swap dealing threshold that, once triggered, would require a dealing entity to register with the agency as an SD. The threshold currently stands at $8 billion in gross notional swap dealing annually, but is set to fall to $3 billion in December 2017 unless the CFTC modifies it by July 2017.

The report is the agency's first step in considering its options regarding the threshold, and mentions a number of alternatives such as replacing it with new thresholds specific to each asset class, or excluding transactions made on a swap execution facility from threshold calculations. Notably, the report includes a discussion of limitations faced by the CFTC in measuring swap dealing activity, citing data quality issues. Therefore, while the CFTC is unlikely to act on the threshold itself until next year, we expect greater regulatory focus on the accuracy of reported data and/or new data requirements.

7. A common US-EU approach to cross-border clearing is on the horizon, but details are missing

The CFTC and EU regulators announced a high level agreement on common requirements for central clearing parties (CCPs) on February 10th. The agreement paves the way for US CCPs to gain recognition by EU regulators, thus avoiding higher costs of clearing for their EU clients that would otherwise discourage these clients from clearing in the US. Implementing the agreement will be essential before clearing becomes mandatory in the EU this summer.

To gain this recognition, US CCPs will need to meet certain requirements, including changing their initial margin models and collecting initial margin based on a two-day liquidation period (rather than the current one-day US industry standard). Although details are yet to be made public, we expect generally higher margin requirements for US CCP member firms. Therefore, these firms should be ready to deploy additional funding and liquidity if needed.

[8] These institutions applied to become registered SDs with the CFTC in late 2012 and early 2013.

8. Non-US dealers again face a deadline this year for CFTC rules to apply to them

The CFTC's controversial advisory from 2013 will again become an issue for non-US dealers, as it is set to take effect on September 30th of this year. The advisory requires transactions between a non-US dealer and a non-US counterparty to be subject to various CFTC requirements if the transactions have a "US nexus."[9] Given that the deadline for meeting this advisory has been pushed off by the CFTC several times, and that cooperation between the CFTC and other regulators has increased over the past year, we believe the CFTC will ultimately scale back this advisory.[10] For their part, SDs have been largely holding off on implementing the advisory, although they have been analyzing the advisory's potential impact.

Relatedly, the industry is still waiting to see if the CFTC makes further substituted compliance determinations to supplement those made in December 2013.[11] Ultimately, however, these determinations may be less important than initially meets the eye, because gaining a favorable substituted compliance determination from the CFTC will likely mean that the foreign requirements are similar to the CFTC's anyway. Recognizing this reality, several large buy-side actors have already demanded of SDs that transactions be CFTC-compliant.

The SEC effect

The SEC has also been developing a new regulatory regime for the portion of swaps market that it regulates, i.e., security-based swaps (SBS). However, the SEC has taken a much slower pace in issuing its SBS rules than the CFTC. The SEC has so far completed much of its cross-border approach[12] and registration framework but has yet to finalize most other rulemakings, including those related to reporting, recordkeeping, business conduct, capital, margin, segregation, and statutory disqualification waivers.[13]

The industry is hopeful that the SEC will tightly align its rulemakings with the CFTC, as differences between their approaches increase operational and compliance risk. Many market participants have common systems and processes to manage both CFTC- and SEC-regulated swaps, so divergences will create challenges. The SEC has indicated that it is considering this operational complexity as part of its rulemakings, but it has also stated that justifiable reasons exist for some discrepancies due to differences between the products that the two agencies regulate.

Ultimately, however, we expect swaps requirements issued by the SEC to be generally consistent with the CFTC's. Therefore, SBS dealers should be preparing for compliance in light of similar CFTC rules that have already been finalized, with a focus on identifying technology changes which take the most time. Some SDs also have begun assessing whether or not they would be required to register with the SEC as SBS dealers by identifying which transactions would count toward the registration threshold (which is based on dealing activity) and by ensuring that their infrastructure can capture the data needed to make the assessment.

Dealers that expect to have to register with the SEC should catalogue their affiliates that may require separate registration and analyze the extent to which their transactions with these affiliates might be impacted by the upcoming rules. Finally, institutions should verify their ability to capture and report data accurately to the SEC, as the agency is likely to focus on data quality much like the CFTC has done.

Looking more globally

Beyond the issues highlighted above, SDs operating globally have the not-inconsequential task of continuing to adapt their follow-the-sun trading models to meet the broad reforms of other G20 nations. SDs should monitor regulatory changes, identify compliance dates, and develop trade logic to tag trades that implicate more than one regulatory regime. We expect to continue to see considerably more work on the global front and a sharper focus on the availability of cross-border relief.

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[9] Transactions with a US nexus are "arranged, negotiated, or executed" by personnel or agents located in the US. See PwC's *Regulatory brief, Derivatives: Regulatory roulette* (December 2013).

[10] Furthermore, the SEC last week finalized a rule (substantially as proposed) defining such transactions with a US nexus, which was more restrained than the CFTC's approach by limiting the types of non-US dealer activities that would be subject to it and by curtailing the requirements. See PwC's *First take, Key points from the SEC's swaps proposal for non-US dealers* (May 2015).

[11] The CFTC has so far made only limited substituted compliance determinations based on its July 2013 cross-border guidance. See PwC's *Regulatory brief, Derivatives: A first take on cross-border comparability* (December 2013) and *A closer look* cited in note 1. Furthermore, the SEC has so far side-stepped the issue by not laying out a substituted compliance approach as part of its final cross-border rule issued in 2014, thus heightening the focus on the CFTC's approach. See PwC's *First take, Ten key points from the SEC's final cross-border rule* (June 2014).

[12] See *First takes* cited in notes 10 and 11.

[13] The SEC rule cited in note 10 addresses which transactions count toward requiring registration as a non-US SBS dealer, which built on the registration framework that was finalized last year. See PwC's *First take, Ten key points from the SEC's swap dealer registration and waiver rulemakings* (August 2015). The SEC has also partially completed its reporting framework. See *First take* cited in note 2.

Additional information

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