Client Alert

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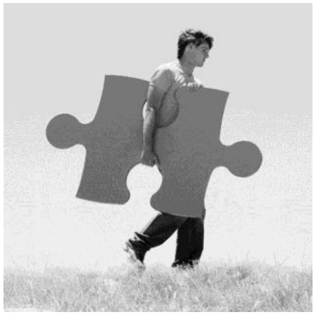

The Treasury Report's Recommendations for Derivatives Regulation

In a previous client alert, available here, we provided an overview of the recent report, the second of four, issued by the U.S. Department of the Treasury ("Treasury") and titled "A Financial System that Creates Economic Opportunities, Capital Markets" (the "Report"). Issued as a response to Presidential Order 13772, "Core Principles for Regulating the United States Financial System," the Report sets out core principles that should, its authors believe, guide the regulation of the U.S. financial system. The Report addressed numerous aspects of the U.S. capital markets, including the equity and debt markets, the Treasury securities market, securitization, financial market utilities, clearinghouses and derivatives.

Of these areas, it may be derivatives that were most deeply affected by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which subjected those instruments, famously lightly regulated before 2010, to comprehensive regulation. Title VII of the Dodd-Frank Act, and the voluminous regulations issued thereunder, represented the pendulum swinging decisively away from light-touch regulation of derivatives and toward heavy-handed oversight, a regulatory regime at once thick with detail, impervious to commercial needs and, to market participants outside the United States, by turns imponderable and alarming.

Now, more than seven years after the passage of the Dodd-Frank Act, the Report appears to represent the pendulum, certainly not retracing its arc, but at least starting to move back generally in the opposite direction. Treasury notes a broad consensus in favor of the central reforms of Title VII of the Dodd-Frank Act. However, the Report notes significant issues and makes substantial recommendations to implement Title VII in a manner less burdensome to market participants and to the U.S. derivatives market as a whole. The Report's recommendations regarding derivatives are accordingly of special interest to market participants.

The derivatives-related issues that the Report identifies relate generally to regulatory harmonization, cross-border matters, capital treatment of derivatives, end-user issues and market infrastructure.

I. Regulatory Coordination and Harmonization

The harmonization of different regulatory regimes has to date proven difficult to accomplish; though based on international agreements, the primary derivatives markets reforms have taken somewhat different shapes in different jurisdictions. In addition, in the United States, the market is regulated by both the Commodity Futures Trading Commission ("CFTC"), responsible to regulate "swaps," and the Securities and Exchange Commission ("SEC"), responsible to regulate "security-based swaps," each as defined in the Dodd-Frank Act.

With respect to the U.S. rules, the Report focuses on the potential for broad harmonization of the CFTC's and SEC's rules and on the CFTC's practices relating to no-action letters.

With respect to international harmonization, the Report focuses on margin rules for uncleared swaps.

A. Harmonization of CFTC and SEC Rules

The Report notes the significant differences between the SEC's rules for security-based swaps and the CFTC's rules for swaps, including, among others, differences in rules relating to trade reporting requirements, trading, clearing, and capital and margin requirements, among others.

Treasury recommends that the CFTC and the SEC give high priority to a joint effort to review their respective rulemakings in each key Title VII reform area, the goal of which should be to harmonize rules to the fullest extent possible. In addition, Treasury states, Congress should consider action to achieve greater harmonization between the CFTC's and SEC's rules.[1]

B. Margin Requirements for Uncleared Swaps

Margin is one of the most important bulwarks against systemic risk in relation to uncleared swaps, but, despite widespread agreement on an international framework, harmonizing the margin rules of different jurisdictions has proven difficult. Treasury notes the view of market participants that the U.S. regulators have taken a more stringent approach than authorities in other jurisdictions to certain aspects of margin requirements for uncleared swaps, placing U.S. firms at a competitive disadvantage.[2] The Report also notes differences in approach among the different U.S. regulatory agencies.

1. Sizing Initial Margin to Actual Risks

The Report notes the view of market participants that the 10-day presumed close-out period that is used to size initial margin requirements is arbitrary and does not reflect likely close-out periods for many transactions. Treasury recommends that the U.S. regulatory agencies work with their international counterparts to amend the uncleared margin framework to tailor it more appropriately to relevant risks.

2. Timing of Margin Transfers

The Report notes that the U.S. rules require parties to transfer margin within one business day, more quickly than is required under the rules of many non-U.S. jurisdictions. This requirement, the Report notes, places a significant burden on certain smaller U.S. market participants and potentially puts U.S. firms at a disadvantage to non-U.S. firms.

The Report recommends that, where warranted, the U.S. regulators should consider amending their rules to permit more "realistic" timing requirements.

3. Scope of End Users Subject to Margin Requirements

The Report notes market participants' view that the scope of the financial end users that are subject to margin requirements is far wider under the U.S. rules than in non-U.S. jurisdictions. Treasury recommends that the CFTC and the prudential banking regulators reconsider treatment of financial end users for purposes of margin and tailor their requirements to focus on the most significant risks.

4. Interaffiliate Transactions

The Report notes the differences between the approach of the CFTC, which, subject to conditions, has exempted interaffiliate transactions from initial margin requirements, and the approach of the prudential banking regulators, which have imposed initial margin requirements on certain interaffiliate transactions. The Report also notes that the prudential banking regulators' margin requirements for interaffiliate transactions differ from the agreed international framework and the rules of the European Union.

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[1] Report at 126-127.
[2] Report at 128.

Treasury recommends that the U.S. prudential banking regulators' consider providing an exemption for interaffiliate transactions similar to the exemptions contained in the CFTC and non-U.S. rules.

5. SEC Margin Rules

Treasury recommends that the SEC, which has not yet finalized its margin rules, should re-propose those rules and finalize them in alignment with the margin rules of the CFTC and the prudential banking regulators.[3]

C. CFTC Use of No-Action Letters

The Report notes the CFTC's frequent use of no-action and interpretive letters during the implementation of Title VII, including 160 staff letters issued in 2014 alone.

The Report recommends that the CFTC move to simplify and formalize all outstanding staff guidance and no-action relief forming part of the Dodd-Frank swaps regulatory framework, including, where necessary and appropriate, amendments to any final rules whose infeasibility have necessitated significant no-action relief.[4]

II. Cross-border Issues

Cross-border issues are, of course, closely related to harmonization issues. The Report discusses in some detail the cross-border issues that face U.S. regulatory agencies and market participants, noting the importance of cooperation with foreign authorities and the goal of promoting a level playing field.

The Report notes that market participants, non-U.S. regulators and others have expressed concerns that the application of U.S. regulations to cross-border activities has led to conflicts and inefficiencies between U.S. and non-U.S. compliance regimes, in turn causing considerably higher operational costs and decreased competitiveness of U.S. entities. Concerns also include the market fragmentation, diminished liquidity and other distortive effects to which the U.S. cross-border rules have contributed.[5]

Broadly, the Report recommends that the U.S. regulatory agencies should reconsider their aggressive approach to regulating transactions involving counterparties located outside of the United States. Specific recommendations include the following.

A. Cross-border Application and Scope

The Report recommends that the CFTC and SEC clarify the cross-border reach of their regulations and harmonize their rules with those of non-U.S. jurisdictions, where possible, to avoid market fragmentation, redundancies, undue complexity and conflicts of law. Specific recommendations include, among others, that the CFTC and SEC consider:

- whether swap counterparties, trading platforms and central counterparties in jurisdictions compliant with international standards should be required to register with the CFTC or the SEC as a result of doing business with a U.S. firm's foreign branch or affiliate;
- whether swap dealer registration should apply to a U.S. firm's non-U.S. affiliate on the basis of trading with non-U.S. counterparties if the U.S. firm's non-U.S. affiliate is effectively regulated as part of an appropriately robust regulatory regime or is otherwise subject to Basel-compliant capital standards; and
- whether U.S. firms' foreign branches and affiliates should be subject to Title VII's mandatory clearing, mandatory trading, margin or reporting rules when they trade with non-U.S. firms in jurisdictions compliant with international standards.

[3] Report at 128-30.
[4] Report at 130-32.
[5] Report at 134.

B. Substituted Compliance

The Report states Treasury's recommendation that effective cross-border cooperation should include meaningful substituted compliance, a doctrine under which a U.S. regulator may permit a market participant to comply with non-U.S. rules in lieu of complying with applicable U.S. rules. While the CFTC and SEC's rules and proposed rules have for years contemplated substituted compliance determinations, there have been few such determinations, and the CFTC's method for making comparability determinations has been somewhat controversial. The Report's recommendations include, among others, the following:

- the CFTC and SEC should be judicious when applying their swaps rules to activities outside the United States and should permit entities, to the maximum extent practicable, to comply with comparable non-U.S. derivatives regulations, in lieu of complying with U.S. regulations; and
- the CFTC and the SEC should adopt substituted compliance regimes that consider the rules of other jurisdictions, in an outcomes-based approach, in their entirety, rather than relying on rule-by-rule analysis, while also working toward achieving timely recognition of U.S. regulations by foreign regulatory authorities.

C. ANE Transactions

With respect to so-called "ANE" transactions, trades between non-U.S. entities but "arranged, negotiated or executed" by personnel located in the United States, Treasury recommends that the CFTC and SEC reconsider any U.S. personnel test as a basis to apply transaction-based requirements and, in particular:

- the CFTC should provide certainty to market participants regarding its guidance (which has been subject to ongoing no-action relief) stating that transaction-level requirements apply to ANE transactions, either by retracting that guidance or moving forward with a rulemaking; and
- the CFTC and the SEC should reconsider the implications of applying their Title VII rules to transactions between non-U.S. firms or between a non-U.S. firm and a foreign branch or affiliate of a U.S. firm merely on the basis that U.S.-located personnel arrange, negotiate or execute the swap, especially for entities in comparably regulated jurisdictions.[6]

III. Capital Treatment in Support of Central Clearing

The Report notes several issues relating to capital treatment and central clearing. These include the imposition of significant capital requirements on initial margin for centrally cleared derivatives by means of the supplementary leverage ratio ("SLR") and the resulting higher capital charges incurred by futures commission merchants ("FCMs"), which discourage FCMs from clearing derivatives transactions for clients.

Further, the Report states, the SLR, because it employs the current exposure method ("CEM") to measure derivatives exposures, does not correctly gauge risks and results in higher leverage ratio capital requirements for certain derivatives products, relative to other measures. Overall, the Report states, the CEM requires FCMs and other clearing members to maintain significantly more capital than is required by the actual risks arising from their customers' derivatives activities.

Treasury's recommendations include the following:

- regulators should balance the post-crisis goal of moving more derivatives into central clearing with appropriately tailored and targeted capital requirements;
- regulators should adopt the recommendation contained in Treasury's previous banking report, which would soften the application of the SLR to centrally cleared derivatives by deducting initial margin for such derivatives from the leverage ratio denominator;

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[6] Report at 134-136

- regulators should adopt a risk-adjusted approach for valuing option transactions to better reflect actual exposures; and
- over the longer term, regulatory capital requirements should transition from using the CEM to using calculations based on the Standardized Approach for Counterparty Credit Risk developed by the Basel Committee on Banking Supervision, which provides an offset for initial margin and recognition of appropriate netting sets and hedged positions.[7]

IV. End User Issues

The issues that the Report identifies in relation to end-users include the swap dealer *de minimis* threshold, the amount of relevant dealing activity in which a party may engage without being required to register as a swap dealer; the definition of "financial entity," which determines which entities may be eligible for the end-user exception to mandatory clearing; and position limits, which, when finalized, could limit the ability of end-users to engage in transactions relating to certain commodities.

A. Swap Dealer de Minimis Threshold

The Report notes market participants' view that the *de minimis* threshold for swap dealer registration is appropriately set at $8 billion and should not be lowered, and that uncertainty about what future action, if any, the CFTC may take regarding the *de minimis* level has caused many market participants to limit their U.S. trading activity.

Treasury recommends that the CFTC maintain the swap dealer *de minimis* registration threshold at $8 billion and make clear that any future changes to the threshold will be subject to a formal rulemaking, including public comment.[8]

B. Definition of Financial Entity

The Report notes that there have been numerous proposals to amend the definition of "financial entity," which determines which entities may be eligible for the exception to mandatory clearing for non-financial entities that use swaps to hedge or mitigate commercial risk.

Treasury states that it would support a legislative amendment to the Commodity Exchange Act to give the CFTC rulemaking authority to modify and clarify the scope of the "financial entity" definition.[9]

C. Position Limits

The Report states Treasury's favorable view of position limits, which, it states, if appropriately tailored, can protect market participants from threats of manipulation or cornering while not disrupting legitimate speculation. The Report recommends that the CFTC complete its position limit rules as contemplated by its statutory mandate, with a focus on detecting and deterring market manipulation and other fraudulent behavior, while:

- ensuring the appropriate availability of bona fide hedging exemptions for end users and exploring whether to provide a risk management exemption;
- considering calibrating limits based on the risk of manipulation, for example, by imposing limits only for spot months of physical delivery contracts where the risk of potential market manipulation is greatest; and
- considering the deliverable supply holistically when setting the limits (that is, considering the global physical market of the relevant commodity and not only U.S. futures).[10]

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[7] Report at 136-38.
[8] Report at 139.
[9] Report at 142.
[10] Report at 142-43.

V. Market Infrastructure

A. SEF Execution Methods and MAT Process

The Report also contains recommendations regarding the trade execution requirement, which requires many swaps to be executed on a swap execution facility ("SEF") or designated contract market by means of an "order book" method or a "request for quote" method in which requests for quotes must be transmitted to at least three market participants in the SEF. Market participants, the Report states, have expressed concern that limiting trading to the order book and request for quote methods is overly restrictive, undermines Congressional intent, discourages trading swaps on SEFs and harms pre-trade price transparency.

Treasury also notes concerns that the SEF-driven process by which swaps are determined to be made available to trade ("MAT") may not require sufficient liquidity before a swap must be executed on a SEF or designated contract market. Further, the Report notes concerns over the requirement that multiple-to-multiple trading platforms, if they facilitate trades for U.S. market participants, must register as SEFs even if they offer only transactions that are not subject to the trading mandate, as this requirement has led many non-U.S. trading platforms to exclude U.S. parties.

Treasury recommends that the CFTC:

- consider rule changes to permit SEFs additional methods to execute swaps subject to the trade execution requirement, rather than restricting execution to the order book and request for quote methods, to the extent consistent with statutory provisions and goals;
- reevaluate the MAT determination process to ensure sufficient liquidity for swaps to support a mandatory trading requirement; and
- consider clarifying or eliminating the requirement that trading platforms facilitating transactions for U.S. market participants register as SEFs even if they offer only transactions that are not subject to the trade execution requirement.[11]

B. Swap Data Reporting

The Report states Treasury's view that swaps market transparency has been impeded by the technical complexity of the CFTC's rules, which imposes unnecessary burdens on market participants, and by the failure of the CFTC to standardize reporting fields and harmonize reporting requirements with other regulators. The Report further notes that the data available to regulators is often of questionable quality.

Treasury states its support of the CFTC's "Roadmap to Achieve High Quality Swaps Data," announced in July 2017, to standardize reporting fields, harmonize data elements and technical specifications with other regulators and to improve validation and quality control processes.[12]

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[11] Report at 143-45.
[12] Report at 146-47.

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