

The SEC's Proposed Cross-Border Swaps Regulations: International Perspectives

Dodd-Frank Insight Webinar Series

July 17, 2013

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Outline

- Overview of SEC Proposed Title VII Cross-border Regulations
- Key Differences with CFTC De Minimis Rules for Non-US Persons
- Substituted Compliance
 - SEC's Approach to Comparability and Challenges Ahead
 - Application to Specific Jurisdictions: Canada and the EU
- CFTC Update: Path Forward, Exemptive Order, Interpretive Guidance

Overview of SEC Proposed Rules

- When must a non-US person register as a security-based swap (“SBS”) dealer?
 - In its SBS de minimis threshold calculations, a non-US person may:
 - Include only transactions with **US persons** or that are “**conducted in the US**”
 - Exclude transactions with non-US branches of US persons
 - Exclude transactions by an SBS dealer affiliate if **operationally independent**
 - If **guaranteed** by a US person, exclude trades with non-US persons (whether or not such trades are guaranteed by US persons)
- **US person** defined territorially
- **Branches** *generally* treated as part of a single legal entity

Overview of SEC Proposed Rules

- What regulatory requirements are applicable to an SBS dealer?
 - Entity-level and transaction-level requirements
 - **Substituted compliance** for all entity-level and some transaction-level requirements
- When must an SBS transaction be reported, disseminated, cleared, or executed on an SEC-registered swap execution facility (SEF)?
- When must SBS market infrastructure entities register with the SEC?
 - Clearing agencies, SEFs, swap data repositories

Key Differences with CFTC – Statutory Underpinning

- Section 722 of Dodd-Frank:

Title VII provisions relating to swaps “shall not apply to activities **outside the United States** unless those activities have a **direct and significant connection** with activities in, or effect on commerce of, the United States,” or contravene CFTC anti-evasion rules

- Section 772 of Dodd-Frank:

“[N]o provision of [Title VII] shall apply to any person insofar as such person transacts a business in security-based swaps **without the jurisdiction** of the United States, unless such person transacts such business in contravention of” SEC anti-evasion rules

“Conducted within the US”

- A security-based swap is conducted within the US if it is:
 - solicited, negotiated, executed, or booked within the US
 - by or on behalf of either counterparty to the transaction
 - regardless of the location, domicile or residence status of either counterparty
- For example, an SBS confirmed by a US securities affiliate is conducted in the US, as is any business conducted by US sales and trading staff
- Proposed rule permits reliance on counterparty’s representation that the SBS is not solicited, negotiated, executed, or booked within the US

“Operationally Independent”

- A non-US person need not count SBS dealing activities of an affiliate that is a registered SBS dealer if the affiliate’s dealing activities are operationally independent
- Two entities’ SBS dealing activities are operationally independent if they maintain separate:
 - sales and trading functions
 - operations including separate back offices
 - risk management
- If any of the above are jointly administered or managed at a central location then a non-US person must include all affiliated SBS dealer dealing activity in its de minimis threshold calculations

Substituted Compliance: The Road Map

- Mary Jo White, Chair of the SEC – May 1, 2012:

“The global nature of this market means that participants may be subject to requirements in multiple countries, and this type of overlapping regulatory oversight could lead to conflicting or costly duplicative regulatory requirements. Market participants need to know which rules to follow, and I believe that this proposal will serve as the road map”

Holistic Approach

- Compliance with the requirements of a comparable non-US regulatory regime would satisfy an SBS dealer's obligations under Dodd-Frank
- SEC will look for similar regulatory outcomes, not identical wording
- Mary Jo White, Chair of the SEC – 1 May 2012:

“This approach would allow the elimination of overlapping regulation when it truly is duplicative, while recognizing that regulatory regimes will necessarily differ in some respects. Crucially and as required, acceptable substituted compliance would advance the important statutory goals of the Dodd-Frank Act, including stability, transparency, and protection against market abuse”

Categories of Substituted Compliance

- SEC would evaluate comparability in each of the four categories:
 - Requirements applicable to a registered non-US SBS dealer
 - Regulatory reporting and public dissemination of data
 - Mandatory clearing for security-based swaps
 - Mandatory trade execution for security-based swaps

Comparability: Considerations

- In making a substituted compliance determination with respect to a foreign jurisdiction, the SEC will consider:
 - Scope and objectives of the jurisdiction’s regulatory requirements
 - Effectiveness of its supervisory compliance program
 - Practices of its enforcement authority

Application for Substituted Compliance

- Applications for substituted compliance determinations to be submitted by one or more market participants, not foreign regulators
- Other market participants may rely on substituted compliance determinations, once made
- The SEC will not consider hypothetical or anonymous requests, though will honor request for confidentiality

Uncertainties

- SEC expects substituted compliance determinations for approximately 30 jurisdictions, most of which have not finalized their own SBS rules
- Until these determinations are made:
 - Market uncertainty will be costly for SBS dealers and may fragment liquidity and increase risk
 - Will market participants be forced to comply with US rules until substituted compliance is possible?

Administrative Challenges

- Substantial burden on SEC to respond to requests for substituted compliance determinations
- No overarching regulatory body to resolve disputes between jurisdictions
- SEC may periodically review substituted compliance within a jurisdiction to determine whether the laws/regulations in that jurisdiction continue to achieve suitable regulatory goals

Political Challenges

- Coordination between SEC and CFTC on cross-border rules
- Risk of creating an uneven playing field for the global swaps market: International transactions structured to omit any US component?
- Trade negotiation-style “reciprocity” element to substituted compliance determinations and ultimate global coordination?

Derivatives Regulatory Landscape: Canada

- Security-based swaps in Canada are predominantly in banks. But:
- Under Canada Constitution, banks are regulated only federally:
 - Federal regulator: Office of the Superintendent of Financial Institutions (OSFI)
 - OSFI Derivatives Best Practices Guidelines:
 - Implement G20 commitments for OTC Derivatives
 - Under review in light of international harmonization
- Securities are regulated at provincial level:
 - Provincial regulators coordinate through Canadian Sec. Administrators (CSA)
 - Under Canada Constitution, provincial regulators may not regulate banks but are following SEC's lead and shifting into swaps regulation
 - Three provincial regulators have proposed rules governing security-based swaps. Others are expected to follow based on CSA model rules
- Regulation of futures and options is also provincial and fragmented

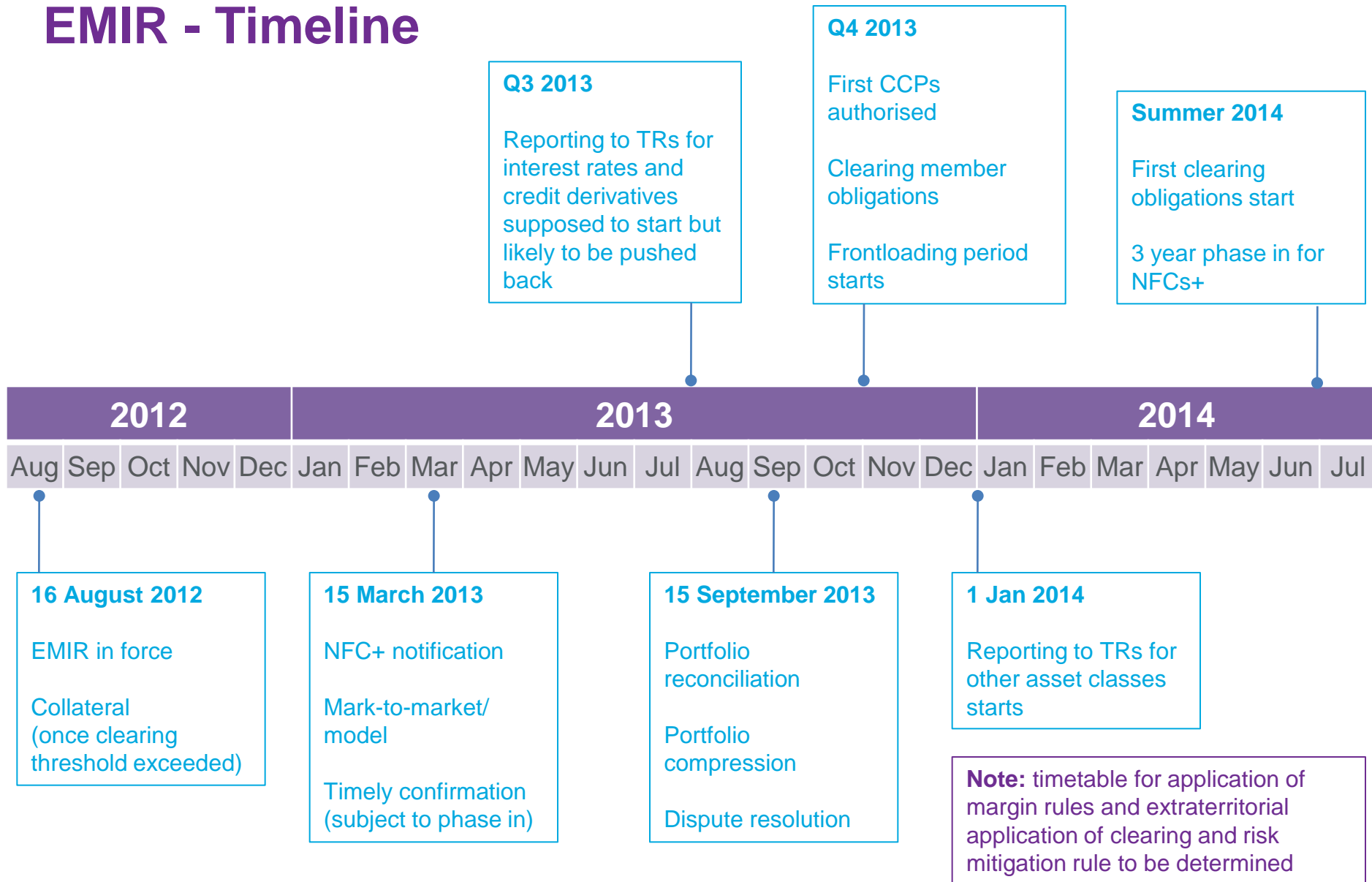
Comparability Challenges: Canada

- SEC must determine substituted compliance in the context of a fundamentally different regulatory framework:
 - No regulatory body equivalent to the CFTC
 - No national regulator equivalent to the SEC
 - Banks regulated federally by OSFI implementing G20 commitments but Dodd-Frank Act goes beyond G20 commitments
- Canadian bank challenge: Significant overlapping regulation from various regulators

Comparability Challenges: EU

- Main law implementing derivatives market reform is European Markets Infrastructure Regulation (EMIR) - applies directly in 28 member states
- Several mismatches read against Dodd Frank:
 - Scope
 - CCP authorization (including segregation and porting)
 - Transaction-level rules: clearing, reporting, risk mitigation
 - No entity-level authorization rules or trading obligation: MiFID I & MiFID II
 - EMIR covers also non-authorized persons (NFC+)
 - Timetable

EMIR - Timeline



EMIR Approach to “Third Country Entities”

- Clearing may apply
 - EU - third country
 - Third country - third country provided "contract has a direct, substantial and foreseeable effect in the Union or where such an obligation is necessary or appropriate to prevent the evasion of EMIR"
 - ESMA draft RTS expected July 2013
- Risk mitigation rules (timely confirmation, portfolio reconciliation and compression, dispute resolution processes, mark to market and exchange of collateral) may apply
 - EU - third country
 - Third country - third country provided ...
- But not trade reporting or record keeping

MiFID II & MiFIR

2013

European Parliament and Council of the EU to negotiate MiFID II and MiFIR proposals to replace MiFID

8 October 2013

European Parliament to consider MiFID II legislative proposals in plenary session

Q4 2015 - mid 2016

Earliest anticipated implementation date of MiFID II Directive and MiFIR.

2013

2014

2015

2016

Q1

Q2

Q3

Q4

Q1

Q2

Q3

Q4

Q1

Q2

Q3

Q4

Q1

Q2

Q3

Q4

21 June 2013

Council adopted its general approach to the MiFID II legislative proposals

CFTC Substituted Compliance Regime

- Non-US SDs may comply with home country regulations instead of CEA
- Home country regulations must be “comprehensive” and “comparable”
- CFTC comparability determined on a requirement category basis (13 categories in all) and not based on foreign regime as a whole
- Entity level requirements (except for Large Trader Reporting) for non-US SDs are in scope for substituted compliance
- Some Transaction level requirements for non-US SD trades with non-US persons guaranteed by US persons and trades with non-US branches of US SDs are in scope for substituted compliance
- Non-US branch of US SD may use substituted compliance for trades with non-US persons (whether or not guaranteed by a US person or a conduit affiliate) or another non-US branch of a US SD

CFTC Substituted Compliance Regime

- External Business Conduct standards don't apply where non-US SDs or non-US branches of US SDs face non-US persons or a non-US branch
- Factors to consider in determining comparability:
 - Scope and objectives and comprehensiveness of foreign requirement
 - Comprehensiveness of foreign regulator's supervisory compliance program
 - Foreign regulator's authority to support and enforce oversight of non-US SD
- Process: at a minimum, non-US SD must state the factual basis, with specificity, for requesting a CFTC recognition of comparability
- Application may be submitted upon CFTC swap dealer registration
- CFTC recognizes that some EU rules are essentially identical in July 11th CFTC No-Action letter re: portfolio reconciliation and swap confirmations

CFTC-EU Common Path Forward

- Published July 11, 2013
- Non-US funds to be included in definition of US person if majority US-owned or principal place of business (i.e., manager) in the US
- Exemption from mandatory clearing: ‘stricter-rule-applies’
- Risk mitigation: compliance with EMIR rules will suffice for CFTC
- EU initial clearing mandate will cover IRS and index CDS
- Trade Execution: Transitional relief for certain EU-regulated MTFs
- Substituted compliance

CFTC Exemptive Order

- January Order expired July 12; Exemptive Order effective July 13, 2013
- Exemptive Order generally extends January Order from July 13, 2013 until September 29, 2013:
 - Definition of US person
 - SD de minimis threshold calculations for non-US persons (i.e., may exclude trades with non-US persons and non-US branches of registered US SD)
 - Aggregation of US and non-US affiliate dealing activity
- Transitional relief for non-US SDs established in Australia, Canada, EU, Hong Kong, Japan, or Switzerland
 - Where substituted compliance “is possible”, SDs may defer entity-level and certain transaction-level requirements until earlier of December 21, 2013 or 30 days following issuance of an applicable substituted compliance determination
- Other transitional relief

CFTC Interpretive Guidance and Policy Statement

- Published in Federal Register July 16, 2013, effective immediately
- Broadens definition of US person to include:
 - Legal entity formed in the US or with its principal place of business in the US (includes funds)
 - Non-US fund if majority US-owned, except if offered only to non-US persons
 - Non-US entity if majority-US owned and a US owner bears unlimited responsibility for obligations of the entity
 - Foreign branch of a US person
- Swap Dealer De Minimis Calculations
 - Exclude swaps with foreign branch or US-guaranteed affiliate
 - Exclude swaps executed anonymously on a SEF, DCM or FBOT
 - Aggregation limited to dealing activity of non-SD affiliates

CFTC Interpretive Guidance and Policy Statement

- Foreign branch – when are swaps viewed as traded with foreign branch
- Entity-level and transaction-level requirements
 - Description of the requirements
 - Application to various market participants
- Substituted Compliance

Next Steps

- The SEC is accepting comments on the proposed regulations until August 21, 2013

Thank you!

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