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U.S. SWAP REGULATION: CROSS-BORDER DEBATE AMONG ISSUES TO WATCH

MARK D. YOUNG, MAUREEN A. DONLEY, RACHEL KAPLAN REICHER, AND
ELIZABETH A. DOYLE

The U.S. Commodity Futures Trading Commission's final guidance on the cross-border application of certain of its swap regulations may have been one of the commission's most significant regulatory efforts in 2013.

Since the enactment of Dodd-Frank in 2010, the CFTC and the SEC have proceeded at different speeds to address previously unregulated markets for swaps and security-based swaps, respectively. The CFTC moved quickly to develop and adopt a panoply of swap rules. The SEC proceeded more cautiously and, to date, has adopted a fraction of the regulations for security-based swaps that Dodd-Frank contemplates.

As the CFTC's first swap rules took effect in 2013, market participants dedicated considerable resources to comply with a host of new regulations, primarily rules that require every swap to be reported to a swap data repository and many interest rate and credit derivative swaps to be cleared by a de-

Mark D. Young, a partner of Skadden, Arps, Slate, Meagher & Flom LLP, is co-head of the firm's Derivatives Group. Maureen A. Donley, of counsel at the firm, focuses on derivatives and regulatory counseling. Rachel Kaplan Reicher, a counsel at the firm, focuses on derivatives regulation, legislative advocacy, and business and transactional counseling. Elizabeth A. Doyle is an associate at the firm. The authors can be reached at mark.d.young@skadden.com, maureen.donley@skadden.com, rachel.reicher@skadden.com, and elizabeth.doyle@skadden.com, respectively.

rivatives clearing organization. Swap dealer registration also became a reality in 2013, with at least 90 swap dealers (“SDs”) registering with and now regulated by the CFTC. Finally, CFTC rules took effect in October 2013 requiring those operating “many-to-many” electronic and voice-trading platforms to register as swap execution facilities (“SEFs”).¹ In 2014, some swaps offered on these platforms could become subject to a CFTC mandate that trading of those swaps must occur on a registered SEF or a traditional futures exchange (otherwise known as a designated contract market).

The path to compliance with these and other CFTC rules has been rather bumpy because of operational hurdles and confusion in the industry regarding the new regulations. The uncertainty also was exacerbated by the CFTC’s limited resources and, on the eve of launching SEFs, the federal government shutdown. CFTC staff issued more than five dozen no-action letters and other forms of guidance last year, many of which were published on the eve of compliance dates and aimed at providing interim relief until market participants could implement changes needed to comply with new regulations. However, it was the CFTC’s final guidance on the cross-border application of certain of its swap regulations that may have been one of the commission’s most significant regulatory efforts in 2013.

THE CROSS-BORDER DEBATE

In July 2013 on the eve of the expiration date of CFTC temporary guidance in this area, then CFTC Chairman Gary Gensler and European Commissioner Michel Barnier announced a “path-forward” agreement regarding their joint understandings of cross-border derivatives regulation.

Recognizing the international nature of the derivatives market, the path forward stated that the U.S. and EU agreed that jurisdictions and their regulators should be able to defer to each other when justified by the quality of their respective regulation and enforcement regimes rather than risk conflicts of law, inconsistencies and legal uncertainty by applying U.S. and EU law simultaneously. The agreement paved the way for substituted compliance determinations in the U.S. and equivalence determinations in the EU. These determinations would enable a market participant to comply with the regulatory requirements of one jurisdiction rather than both jurisdictions.

The CFTC's resulting final guidance issued soon after the path forward agreement provided a definition of a "U.S. person" and adopted exclusions of certain non-U.S. transactions from the SD and major swap participant registration threshold calculations. The CFTC guidance also sets forth a framework under which the commission could entertain "substituted compliance" applications, which would allow a non-U.S. entity to comply with the laws of its home jurisdiction instead of the relevant CFTC "entity-level" and "transaction-level" requirements when the requirements in the entity's home jurisdiction are comparable.

However, a November 2013 CFTC advisory limited the availability of substituted compliance and took a more territorial approach to regulating swap dealing activity that occurs within the United States. According to the advisory, a non-U.S. SD regularly using personnel or agents located in the U.S. to arrange, negotiate or execute a swap with a non-U.S. person cannot avail itself of substituted compliance, even if the transaction is booked in a non-U.S. branch of the non-U.S. swap dealer. Instead, such a transaction is, or soon will be, subject to the CFTC's transaction-level requirements, which include the clearing requirement, the trade execution mandate and real-time public reporting obligations.

Echoing the reaction of much of the international swap community, a spokesman for European Commissioner Barnier was "surprised" by the CFTC advisory, which "seem[s] to us to go against both the letter and spirit of the path forward agreement.... [The advisory is] another step away from the kind of inter-operable global system that we want to build."

At the end of 2013, the CFTC issued the first comparability determinations — for Australia, Canada, the EU, Hong Kong, Japan and Switzerland. These comparability determinations permit substituted compliance with non-US requirements in lieu of some but not all CFTC regulations. In an apparent effort to deflect criticism regarding its approach to cross-border issues — and in the wake of a lawsuit challenging its Cross-Border guidance — the CFTC began 2014 by taking the unusual step of requesting public comments on all aspects of its November 2013 advisory.

The practical implementation of this substituted compliance framework may prove to be one of the CFTC's more challenging issues in 2014. Although it is too early to tell whether U.S. or EU regulations will be less

onerous for market participants, the CFTC's early substituted compliance determinations indicate that substituted compliance and equivalence determinations may not fully eliminate duplicative regulatory compliance. Some market commentators worry that the November 2013 advisory invites retaliation by the European Commission, which is considering whether CFTC regulations are comparable to Europe's regulatory framework. The ability of the CFTC to successfully engage foreign governments on international derivatives concerns will be critical to the success of its cross-border regulatory approach.

ADDITIONAL ISSUES TO WATCH

SEC Developments

The SEC proposed its own rules and interpretive guidance in 2013 to address the cross-border application of security-based swap rules, which differ from the CFTC's final guidance in some respects. During the coming year, it will be important to monitor whether disparities develop between the two U.S. regulatory agencies.

Additionally, the SEC has yet to adopt the critical mass of regulations needed to launch the Dodd-Frank framework for SEC-regulated security-based swaps. Accordingly, we can expect more activity from the SEC in establishing trade execution and clearing mandates, recordkeeping and reporting requirements, business conduct standards and rules to govern security-based swap data repositories and security-based swap execution facilities.

Changes in Leadership

CFTC Chairman Gensler ended his tenure on January 3, 2014, along with other commissioner departures. President Obama has nominated as the new chairman Timothy Massad, the Treasury Department official who oversaw the Troubled Asset Relief Program following the 2008 financial crisis, and brokerage firm executive Christopher Giancarlo and securities lawyer Sharon Bowen as new commissioners. It is unclear when the Senate will act on these nominations.

It remains to be seen how new leadership will impact the CFTC agenda. The CFTC still has significant proposed rules to address in 2014, including outstanding proposals for conflicts of interest for registered entities and a recent re-proposal of position limits for exempt and agricultural futures, options and economically equivalent swaps. Although for the past several years the CFTC has worked with the SEC, Federal Reserve, FDIC and other regulators, the finalization and implementation of uncleared margin rules has yet to occur.

It is possible that the CFTC may operate with just two existing commissioners — one Republican and one Democrat — for the foreseeable future. It will be interesting to see how the agency functions in this structure, which inevitably will require consensus and cooperation.

NOTE

¹ A many-to-many trading platform is a trading platform on which more than one person has the ability to execute or trade swaps with more than one other person.