

Derivatives Alert

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Four Times Square
New York, NY 10036
212.735.3000

1440 New York Ave., N.W.
Washington, D.C. 20005
202.371.7000

CFTC and European Commission Make Progress on Cross-Border Agreements

On October 13, 2017, the Commodity Futures Trading Commission (CFTC) announced two cross-border developments with the European Commission (EC) that take significant steps toward reconciling regulation of cross-border derivatives and cross-border entities generally. First, the CFTC approved a determination finding the CFTC and European Union (EU) margin requirements for uncleared swaps to be comparable.¹ The EC also adopted an equivalence decision regarding the CFTC margin requirements.² Second, CFTC Chairman J. Christopher Giancarlo and Valdis Dombrovskis, the EC's Vice President for Financial Stability, Financial Services and Capital Markets Union, announced "A Common Approach on Certain Derivatives Trading Venues"³ (the Giancarlo-Dombrovskis Common Approach).³

Chairman Giancarlo stated, "Today marks a significant milestone in cross-border harmonization between the EC and the CFTC. These cross-border measures will provide certainty to market participants and also ensure that our global markets are not stifled by fragmentation, inefficiencies, and higher costs. Indeed, these measures are critical to maintaining the integrity of our swaps markets."⁴ Vice President Dombrovskis echoed that sentiment stating, "[F]inancial markets are truly global. Working together is the best way to ensure their stability and resilience while avoiding market fragmentation and overregulation. ... Together, these two measures will provide certainty to markets, minimise regulatory arbitrage, and encourage competition on a level playing field."⁵ While the equivalence determinations regarding the EU uncleared margin requirements under the European Market Infrastructure Regulation (EMIR)⁶ and CFTC uncleared margin requirements are effective immediately,⁷ implementation of the Giancarlo-Dombrovskis Common Approach is expected to take more time.

¹ See Press Release (PR 7629-17), CFTC, "CFTC Comparability Determination on EU Margin Requirements and a Common Approach on Trading Venues" (Oct. 13, 2017) (hereafter "CFTC Press Release").

² See Press Release, European Commission, "Vice-President Valdis Dombrovskis' Press Statement With the US Commodity Futures Trading Commission (CFTC)" (Oct. 13, 2017) (hereafter "EC Press Release").

³ Supplemental Document (PR 7629-17), CFTC, "A Common Approach on Certain Derivatives Trading Venues" (Oct. 13, 2017).

⁴ See CFTC Press Release, *supra* note 1.

⁵ See EC Press Release, *supra* note 2.

⁶ Council Regulation 648/2012, 2012 O.J. (L 201) 1 (EU) (hereafter "EMIR"); Commission Delegated Regulation 2016/2251, 2016 O.J. (L 340) 9 (EU) (hereafter "EU Del. Reg.").

⁷ See CFTC Notice, Comparability Determination for the European Union: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, (Oct. 13, 2017) (hereafter "CFTC Comparability Determination"). The comparability determination is specific to registered swap dealers that are subject to the CFTC's margin requirements and not the Prudential Regulators margin requirements, as the Prudential Regulators have not yet issued a comparability determination for the European margin requirements. See *id.* at 14-15.

Margin Requirements for Uncleared Swaps

In January 2016, the CFTC finalized its uncleared margin rule, which requires certain registered swap dealers⁸ to post and collect initial and daily variation margin for over-the-counter, uncleared swaps entered into with other swap dealers and “financial end users” (e.g., private funds, securitization vehicles, pension plans, insurance companies, registered investment companies and business development companies).⁹ (The U.S. banking regulators (Prudential Regulators) also adopted largely parallel rules for those registered swap dealers they regulate.)¹⁰ The CFTC’s requirements became effective for variation margin during this past year, causing adjustments to current margining practices.¹¹ Ensuring compliance has required most swap dealers to amend their current documentation with other market participants for uncleared swaps.¹² The CFTC requirements concerning initial margin also are requiring adjustments, albeit subject to a phased-in compliance schedule, with compliance dates extending to 2020.¹³

The CFTC subsequently published a final rule specifying how its margin requirements would apply to cross-border transactions.¹⁴ This rule confirmed that substituted compliance would be available for certain foreign entities that were swap dealers subject to both CFTC and foreign requirements,¹⁵ but not until the CFTC

issued a comparability determination for the applicable foreign jurisdiction.¹⁶

The absence of a CFTC comparability determination meant that swap dealers subject to multiple regulators were expected to comply with both sets of rules once they became effective.¹⁷ This caused increasing concerns as variation margin requirements became effective¹⁸ due to the differences in the regulatory approaches to margin taken by the CFTC and EC (such as the kinds of transactions¹⁹ and counterparties subject to margin,²⁰ which types of eligible collateral can be posted,²¹ collateral

¹⁶ See 17 C.F.R. § 23.160(b)-(c).

¹⁷ See CFTC Cross-Border Rule, *supra* note 14 at 34,821.

¹⁸ The CFTC has only published one other comparability determination for the margin requirements finalized by the Japanese regulator, see Comparability Determination for Japan: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 63,376 (Sept. 15, 2016).

¹⁹ The CFTC requirements apply to uncleared swaps executed by registered swap dealers and covered counterparties, thereby excluding transactions such as foreign exchange (FX) spot transactions, which are not subject to CFTC jurisdiction, and FX forward transactions and FX swaps, which are excluded from the “swap” definition pursuant to the Department of Treasury’s 2012 determination. 17 C.F.R. §§ 23.150 (scope), 23.151 (definitions). In contrast, the EU margin requirements apply to all “OTC Derivatives,” as that term is defined in Annex I to Directive 2004/39/EC and as it is implemented by Articles 38 and 39 of Regulation (EC) No 1287/2006, which provides no similar carve-out. See EMIR Art. 2(7). The EU rules provide a temporary exception from the EU margin requirements for FX forwards. See EU Del. Reg. Art. 37(2).

²⁰ The CFTC variation requirements apply to registered swap dealers with respect to uncleared swaps with other swap dealers as well as “financial end users.” 17 C.F.R. § 23.153. The definition of financial end user specifically includes a wide range of financial entities such as banks, credit institutions, money services businesses, entities regulated by the Federal Housing Finance Agency, entities regulated by the Farm Credit Administration, certain entities regulated by the U.S. Securities and Exchange Commission, insurance companies, pension plans, commodity pools and investment companies. It broadly includes any entity “that is, or holds itself out as being, an entity, person, or arrangement that raises money from investors, accepts money from clients, or uses its own money primarily for investing or trading or facilitating the investing or trading in loans, securities, swaps, funds, or other assets.” 17 C.F.R. § 23.151. The CFTC initial margin requirements apply to transactions between swap dealers and a smaller subset of “covered counterparties,” which are defined by the CFTC Final Margin Rule as “financial end users with material swaps exposure” (defined by the margin requirements to mean an entity that, together with its affiliates, has an average daily aggregate notional amount of certain transactions for June, July and August of the preceding calendar year that exceeds \$8 billion) or other swap dealers. 17 C.F.R. §§ 23.151 (definitions); 23.152 (initial margin requirements).

The analogous definition in EU requirements, “financial counterparty,” is more limited, including investment firms, credit institutions, insurance companies, UCITS, pension plans and alternative investment funds that are authorized or registered in accordance with various EU directives. See EMIR Art. 2(8). All other entities that are also not clearing entities are “non-financial counterparties” and only subject to the margin requirements if their trading volume exceeds the clearing threshold. See EMIR Art. 2(9) (NFC definition), Art. 10(1) (NFC+ definition).

²¹ The EU margin requirements include certain types of collateral such as cash in the form of a claim for the repayment of money (e.g., money market deposits), corporate bonds, the most senior tranche of a securitization, and convertible bonds that can be converted only into equities listed on specific indexes whereas none of these collateral types are permitted under the CFTC margin requirements. Compare EU Del. Reg. Art. 4(1) and 17 C.F.R. § 23.156(a)(1), (b)(1).

⁸ The CFTC rules apply only to swap dealers that are not subject to regulation by the Prudential Regulators. See Commodity Exchange Act (hereafter “CEA”) Section 4s(e)(2)(B).

⁹ See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 636 (Jan. 6, 2016) (codified at 17 C.F.R. pt. 23) (hereafter “CFTC Final Margin Rule”).

¹⁰ See Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74,840 (Nov. 30, 2015) (codified at 12 C.F.R. pts. 45, 237, 349, 624, 1221); see also Margin and Capital Requirements for Covered Swap Entities, 81 Fed. Reg. 50,605 (Aug. 2, 2016) (codified at 12 C.F.R. pts. 45, 237, 349, 624, 1221). For more information about the Prudential Regulators’ requirements, see “Prudential Regulators Finalize Margin Requirements for Non-Cleared Swaps,” Skadden client alert, Nov. 2, 2015, and “Prudential Regulators Extend Swaps Clearing Exemptions and Exceptions to Non-Cleared Swap Margin Requirements,” Skadden client alert, Aug. 9, 2016.

¹¹ The variation margin requirements became effective for all uncleared swaps with swap dealer counterparties on March 1, 2017, although the U.S. regulators — in conjunction with most foreign regulators — provided some flexibility in response to widespread concerns that many swap dealers were unable to achieve full compliance by that date. See “Regulators Provide Some Flexibility on the Swaps Variation Margin Compliance Deadline,” Skadden client alert, Feb. 24, 2017.

¹² See “Non-Cleared Swap Variation Margin Requirements to Spark Credit Support Annex Amendments for Financial End Users,” Skadden client alert, Dec. 2, 2016.

¹³ See 17 C.F.R. § 23.161.

¹⁴ See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants — Cross-Border Application of the Margin Requirements, 81 Fed. Reg. 34,818 (May 31, 2016) (codified at 17 C.F.R. pt. 23) (hereafter “CFTC Cross-Border Rule”). For more information about the final cross-border rule, see “CFTC Finalizes Cross-Border Margin Rules for Uncleared Swaps,” Skadden client alert, June 3, 2016.

¹⁵ See 17 C.F.R. § 23.160(b).

valuation methods²² and margin transfer timing²³). In order to ameliorate the obstacles that would have been created if swap dealers were required to maintain dual compliance systems, the CFTC's Division of Swap Dealer and Intermediary Oversight provided temporary relief from compliance with the CFTC margin requirements to registered swap dealers that complied with the EU margin requirements.²⁴ The CFTC's new equivalence determination will take the place of the temporary relief and provide much-needed certainty surrounding how the CFTC will perceive a swap dealer's compliance with the EU margin requirements.

As a result of its comparability determination, the CFTC noted:²⁵

a [swap dealer] that is subject to the both the [CFTC] Final Margin Rule and EU's margin rules with respect to an uncleared swap that is also a non-centrally cleared OTC derivative may rely on substituted compliance for all aspects of the [CFTC] Final Margin Rule and the [CFTC] Cross-Border Margin Rule. Any such [swap dealer] that, in accordance with this comparability determination, complies with the EU margin rules, would be deemed to be in compliance with the [CFTC] Final Margin Rule but would remain subject to the Commission's examination and enforcement authority.²⁶

In acknowledging the differences in approaches by the two regulators, the CFTC noted that, in determining equivalence, "[i]nstead of demanding strict uniformity with the Commission's margin requirements, the Commission evaluates the objectives and outcomes of the foreign margin requirements in light of foreign regulator(s)' supervisory and enforcement authority."²⁷ Nevertheless, under the CFTC's equivalence determination, a swap dealer cannot voluntarily comply with the EU margin requirements; thus, substituted compliance only is available in

scenarios where both the entity and the transaction are otherwise subject to both the CFTC and EU margin regimes.²⁸

Giancarlo-Dombrovskis Common Approach on Certain Derivatives Trading Venues

In 2009, global leaders agreed that all standardized over-the-counter derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate.²⁹ The rate at which this reform has been implemented has varied across jurisdictions. The United States implemented the swaps trading mandate in 2014. The EU is expected to implement its trading mandate on January 3, 2018.

The Commodity Exchange Act (CEA) requires counterparties to execute certain swap transactions on a designated contract market (DCM), a registered swap execution facility (SEF) or a SEF that is exempt from registration.³⁰ The CFTC may exempt, conditionally or unconditionally, a SEF from registration if the CFTC finds that the facility is "subject to comparable, comprehensive supervision and regulation on a consolidated basis by ... the appropriate governmental authorities in the home country of the facility."³¹ Anyone subject to the EU's corresponding trade execution mandate must execute certain swap transactions on regulated markets, multilateral trading facilities, organized trading facilities or certain third-country trading venues.³² Qualifying third-country trading venues are subject to an equivalence regime. To meet the EU requirements, the EC must determine that the legal and supervisory framework of that third country ensures that a trading venue authorized in that country complies with legally binding requirements that are equivalent to the requirements for regulated markets, multilateral trading facilities and organized trading facilities resulting from the Markets in Financial Instruments Regulation, the Markets in Financial Instruments Directive and the Market Abuse Regulation.³³ Third-country trading venues must also be subject to effective supervision and enforcement in that third country, and the third

²² Although many of the types of collateral permitted by the CFTC requirements are also permitted under the EU requirements, the EU requires the valuation percentage of certain types of collateral to be lower based on the credit rating of the issuing entity. See EU Del. Reg. Art. 6-7; Annex II.

²³ In the initial margin context, the CFTC requirements set initial margin requirements based on the swap dealers' daily recalculations of initial margin. 17 C.F.R. § 23.152(a)-(b). The EU margin requirements only require initial margin to be calculated after certain events during the lifetime of the transaction. EU Del. Reg. Art. 9(2)-(3); Art. 13(2). In the variation margin context, the CFTC requirements impose a same-day margin transfer obligation on registered swap dealers. 17 C.F.R. § 23.153(a)-(b). Although the EU requirements also impose shortened timing requirements, they permit variation margin to be transferred within two business days of the calculation date, where certain conditions are met. See EU Del. Reg. Art. 9(1); Art. 12.

²⁴ See "Time Limited No-Action Position for Swap Dealers Complying With European Union Uncleared Swap Margin Requirements," CFTC Staff Letter No. 17-05, Feb. 1, 2017; see also "Extension of Time Limited No-Action Position for Swap Dealers Complying With European Union Uncleared Swap Margin Requirements," CFTC Staff Letter No. 17-22, Apr. 18, 2017.

²⁵ See CFTC Comparability Determination, *supra* note 7 at 80.

²⁶ See 17 C.F.R. § 23.160(c)(4).

²⁷ See CFTC Comparability Determination, *supra* note 7 at 7.

²⁸ See e.g., CFTC Comparability Determination, *supra* note 7 at 14 (explaining that substituted compliance would not be available where a swap dealer entered into a transaction that is an uncleared swap under the CEA and the CFTC Final Margin Rule but is not a non-centrally cleared OTC derivative under the laws of the EU, or where a transaction is a non-centrally cleared OTC derivative but is not an uncleared swap); see also *id.* at 18 ("the Commission reiterates that no [swap dealer] may rely on substituted compliance unless it and its transaction are subject to both the [CFTC] Final Margin Rule and the EU's margin rules; a [swap dealer] may not voluntarily comply with the EU's margin rules where such law does not otherwise apply. Likewise, a [swap dealer] that is not seeking to rely on substituted compliance should understand that the EU's margin rules may apply to its counterparty irrespective of the [swap dealer's] decision to comply with the [CFTC] Final Margin Rule.") (emphasis added).

²⁹ G-20 Leaders' Statement, *The Pittsburgh Summit* (Sept. 24-25, 2009).

³⁰ See CEA Section 2(h)(8).

³¹ See CEA Section 5h(g).

³² See Council Regulation 600/2014, 2014 O.J. (L 173), 84, 122 Art. 28.

³³ See *id.*

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country must provide an effective equivalent system for the recognition of trading venues authorized under the Markets in Financial Instruments Directive.³⁴

Without action by the CFTC and EC, neither jurisdiction's market participants would satisfy the applicable trade execution mandate by transacting on the other jurisdiction's platforms. With January 3, 2018, fast approaching, the industry has expressed concern that without an agreement, swaps liquidity would be fragmented. According to Chairman Giancarlo, the Giancarlo-Dombrovskis Common Approach "will ensure that European firms and U.S. firms can trade on each other's registered derivatives platforms."³⁵

The Giancarlo-Dombrovskis Common Approach represents a significant step in preserving cross-border access to the derivatives markets, but the agreed approach must still be finalized. This process — the announcement of a common approach followed by more specific action by the two commissions — is consistent with the process the CFTC and the EC followed to address cross-border issues for central counterparties in 2016.³⁶

³⁴ See *id.*

³⁵ J. Christopher Giancarlo, chairman, U.S. Commodity Futures Trading Comm'n, [Prepared Remarks at Press Conference to Announce Comparability Determination on EU Margin Requirements and a Common Approach on Trading Venues](#) (Oct. 13, 2017).

³⁶ See "[Derivatives Regulators Reach Agreement on Cross-Border Harmonization for Central Clearing Counterparties](#)," Skadden client alert, Mar. 24, 2016.

Vice President Dombrovskis intends to propose that the EC adopt an equivalence decision to recognize CFTC-authorized SEFs and DCMs that operate in the United States as eligible venues for the execution of those derivatives transactions that will be subject to the EU trading obligation, provided the requirements of the Markets in Financial Instruments Regulation, the Markets in Financial Instruments Directive and the Market Abuse Regulation are met. Similarly, CFTC staff intends to propose, and Chairman Giancarlo will support putting before his fellow commissioners for a vote, an exemption by the CFTC of EU-authorized swap trading venues (for this purpose, multi-lateral trading facilities and organized trading facilities) from the requirement to register with the CFTC as SEFs, provided that they satisfy the comparability standard set forth in CEA Section 5h(g).³⁷ This will render the exempt EU venues operating in the EU eligible venues for purposes of complying with the CFTC trade execution requirement.

We will monitor the implementation of the Giancarlo-Dombrovskis Common Approach and provide updates as warranted.

³⁷ Under Section 5h(g) of the CEA, "The [CFTC] may exempt, conditionally or unconditionally, a swap execution facility from registration under this section if the [CFTC] finds that the facility is subject to comparable, comprehensive supervision and regulation on a consolidated basis by ... the appropriate governmental authorities in the home country of the facility."

Contacts

Mark D. Young

Partner / Washington, D.C.
202.371.7680
mark.d.young@skadden.com

Maureen A. Donley

Of Counsel / Washington, D.C.
202.371.7570
maureen.donley@skadden.com

Elizabeth A. Mastrogiacomo

Associate / Washington, D.C.
202.371.7312
elizabeth.mastrogiacomo@skadden.com

Shekida A. Smith

Associate / Washington, D.C.
202.371.7382
shekida.smith@skadden.com