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ALERT MEMORANDUM

CFTC Chairman Proposes Cross-Border Swaps Regulation Version 2.0

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On October 1, 2018, Chairman J. Christopher Giancarlo of the Commodity Futures Trading Commission (the "CFTC") released a white paper entitled "Cross-Border Swaps Regulation Version 2.0: A Risk-Based Approach with Deference to Comparable Non-U.S. Regulation" (the "White Paper").

The White Paper focuses on five areas: (1) registration of non-U.S. central counterparties ("CCPs"); (2) registration of non-U.S. trading venues; (3) registration of non-U.S. swap dealers ("SDs"); (4) cross-border application of mandatory clearing and trade execution requirements; and (5) regulation of swap transactions between non-U.S. counterparties that are arranged, negotiated, or executed by U.S.-located personnel or agents ("ANE Transactions"). Although the White Paper touches on some other rules as well, such as reporting rules, it does not make specific recommendations outside of these five areas.

Relative to cross-border guidance published by the CFTC in July 2013 (the "2013 Guidance")[1] and subsequent CFTC rulemakings, staff advisories, and staff no-action letters, the White Paper's recommendations would make significant changes in a few key respects:

- **Comparable Jurisdictions**. The CFTC would generally exercise greater deference to regulations in foreign jurisdictions that have adopted reforms comparable to the CFTC's regime ("Comparable Jurisdictions");
- **Non-Comparable Jurisdictions**. The CFTC would, however, expand its regulation of U.S.-related entities transacting in foreign jurisdictions lacking reforms comparable to the CFTC's regime ("Non-Comparable Jurisdictions"), although the White Paper's recommendations in this regard are more mixed and circumspect than its recommendations relating to Comparable Jurisdictions; and
- **ANE Transactions**. The CFTC would, in certain circumstances, apply clearing, trade execution, and SD registration requirements to ANE Transactions.

In addition, the White Paper rejects several aspects of an October 2016 proposal (the "2016 Proposal") by the CFTC to expand the extraterritorial application of SD and major swap participant ("MSP") registration requirements.[2]

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[1] Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations, 78 Fed. Reg. 45292 (July 26, 2013).

[2] Cross-Border Application of the Registration Thresholds and External Business Conduct Standards Applicable to [SDs] and [MSPs], 81 Fed. Reg. 71946 (Oct. 18, 2016).

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BACKGROUND

- The 2013 Guidance interpreted and applied Section 2(i) of the Commodity Exchange Act ("CEA"). Section 2(i) provides that the CEA's swaps-related provisions shall not apply to activities outside the United States unless those activities (1) have a direct and significant connection with activities in, or effect on, U.S. commerce or (2) contravene CFTC anti-evasion rules.

- In the 2013 Guidance, the extent to which the CFTC's swaps regulations apply to a swap depends on whether the swap is entered into by a U.S. person, a foreign branch of a U.S. bank ("Foreign Branch"), a guaranteed affiliate of a U.S. person, or a conduit affiliate of a U.S. person. The 2013 Guidance includes definitions for these categories of market participants, addresses how SD and MSP registration requirements apply to swaps entered into by each category, divides most of the remaining swaps regulations into "Entity-Level Requirements" or "Transaction-Level Requirements," and addresses how those requirements apply to swaps entered into by each category. The 2013 Guidance also addresses when the CFTC permits substituted compliance with comparable foreign regulation and how it determines comparability.

- In May 2016, the CFTC adopted rules ("Cross-Border Margin Rules") that supersede the 2013 Guidance with respect to the cross-border application of margin requirements for uncleared swaps of SDs and MSPs that do not have a prudential regulator.[3] The Cross-Border Margin Rules include a revised "U.S. person" definition, a revised "guarantee" definition, and a new category for foreign consolidated subsidiaries ("FCSs")[4] of U.S. persons. The Cross-Border Margin Rules also expand the extent to which margin requirements apply extraterritorially to non-U.S. persons guaranteed by U.S. persons ("Guaranteed Entities") and FCSs and revised the extent to which the CFTC permits substituted compliance with comparable foreign margin rules.

- In October 2016, the CFTC published the 2016 Proposal, which would (1) expand the extraterritorial application of SD and MSP registration requirements by treating Foreign Branches, Guaranteed Entities, and FCSs like U.S. persons and (2) apply a subset of SD/MSP external business conduct standards to ANE Transactions.

- In August 2018, the CFTC published a proposal to codify its current approach to the registration or exemption of non-U.S. CCPs, including prohibiting exempt non-U.S. CCPs from clearing swaps for U.S. customers.[5]

- In addition, the CFTC has issued comparability determinations, exemptions, staff no-action letters, and staff advisories that have supplemented the 2013 Guidance, including a November 2013 staff advisory ("Advisory 13-69")[6] and series of related no-action letters that address ANE Transactions.[7]

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3 Margin Requirements for Uncleared Swaps for [SDs] and [MSPs]—Cross-Border Application of the Margin Requirements, 81 Fed. Reg. 34818 (May 31, 2016).

4 As used in the White Paper, an FCS is a non-U.S. person in which an ultimate parent entity that is a U.S. person ("U.S. ultimate parent entity") has a controlling financial interest, in accordance with U.S. Generally Accepted Accounting Principles, such that the U.S. ultimate parent entity includes the non-U.S. person's operating results, financial position, and statement of cash flows in the U.S. ultimate parent entity's consolidated financial statements, in accordance with U.S. Generally Accepted Accounting Principles. This definition is consistent with the FCS definition used in the Cross-Border Margin Rules. *See* 17 C.F.R. § 23.160(a)(1).

5 83 Fed. Reg. 39923 (Aug. 13, 2018).

6 CFTC Staff Advisory No. 13-69 (Nov. 14, 2013).

7 *See, e.g.*, CFTC No-Action Letter No. 17-36 (July 25, 2017).

Guiding Principles of Cross-Border Swaps Regulation Version 2.0	
1	***The CFTC should recognize the distinction between swaps reforms intended to mitigate systemic risk and reforms designed to address particular market and trading practices that may be adapted appropriately to local market conditions.***
2	***The CFTC should pursue multilateralism, not unilateralism, for swaps reforms that are designed to mitigate systemic risk.***
3	***The current division of global swaps markets into separate U.S. person and non-U.S. person marketplaces should be ended. Markets in regulatory jurisdictions that have adopted the G20 swaps reforms should each function as a unified marketplace, under one set of comparable trading regulations and under one competent regulator.***
4	***The CFTC should be a rule maker, not a rule taker, in overseeing U.S. markets.***
5	***The CFTC should act with deference to non-U.S. regulators in jurisdictions that have adopted comparable G20 swaps reforms, seeking stricter comparability for substituted compliance for requirements intended to address systemic risk and more flexible comparability for substituted compliance for requirements intended to address market and trading practices.***
6	***The CFTC should act to encourage adoption of comparable swaps reform regulation in non-U.S. jurisdictions that have not adopted swaps reform for any significant swaps trading activity.***

THE WHITE PAPER

- The White Paper proposes to replace the patchwork of rules and guidance summarized above with a new cross-border framework, which is generally based on whether a person is located in the United States, a Comparable Jurisdiction, or a Non-Comparable Jurisdiction.

- The primary goal of the White Paper is to clarify and simplify the CFTC's approach to jurisdictions that have adopted G20 derivatives reforms, many of which are now Comparable Jurisdictions.

- The White Paper notes that, although the volume of swaps trading that occurs in Non-Comparable Jurisdictions is only a small portion of the total volume of global swaps trading, the CFTC staff should be aware of the possibility that market participants may move their swaps activity to such jurisdictions to evade having to comply with CFTC and comparable regulations. The White Paper accordingly indicates that formulating an approach to Non-Comparable Jurisdictions raises more difficult issues.

- Taking into account these considerations, the White Paper recommends an approach based on six guiding principles, laid out to the left.

(1) Registration of Non-U.S. CCPs

- The White Paper acknowledges that certain steps have been taken to reflect deference to other regulators who have comparable jurisdictions. In particular, it highlights an agreement in 2016 (the "2016 CFTC-EC Agreement") between the CFTC and the European Commission ("EC"). In the 2016 CFTC-EC Agreement, the two regulators agreed to a common approach to regulating cross-border swaps CCPs.

- The White Paper emphasizes, however, that more steps need to be taken. The White Paper

is especially critical of certain proposed amendments to the European Market Infrastructure Regulation ("EMIR"), which, according to the White Paper, disregard the 2016 CFTC-EC Agreement by providing the European Securities and Markets Authority the ability to require third-country CCPs to comply with all provisions of EMIR, including with respect to their domestic operations.

- The White Paper then goes on to support the principles of comity that were acknowledged in the 2016 CFTC-EC Agreement and argues that the CFTC should build upon the 2016 CFTC-EC Agreement.

White Paper Recommendations:

- **United States**: A CCP located in the United States would continue to be required to register with the CFTC as a derivatives clearing organization ("DCO").
- **Comparable Jurisdictions**:
  - Currently, the CFTC assesses the comparability of home country regulation of non-U.S. CCPs based on consistency with the Principles for Financial Market Infrastructures ("PFMIs"). It also permits a PFMI-compliant non-U.S. CCP to qualify for an exemption from DCO registration when providing access to U.S. persons,[8] but such a CCP cannot permit access by U.S. "customers."[9] The CFTC also imposes a number of reporting and information sharing conditions.[10]
  - The White Paper recommends changing this approach by permitting a non-U.S. CCP that (a) is located in a Comparable Jurisdiction (*i.e.*, one that regulates the CCP in a manner consistent with the PFMIs) and (b) does not pose substantial risk to the U.S. financial system, to provide clearing services to U.S. customers through non-U.S. clearing members, without the non-U.S. CCP or the non-U.S. clearing member having to register as a DCO or futures commission merchant ("FCM"), respectively.[11]

This recommendation is similar to the CFTC's approach with respect to foreign futures under CFTC Rule 30.10. Such an approach would mean that only local bankruptcy laws would apply to U.S. customers accessing such an exempt non-U.S. CCP.

A non-U.S. CCP that wanted to offer U.S. bankruptcy law protections to U.S. customers would still need to register as a DCO and have registered FCMs clear customer transactions. The White Paper implies that the CFTC might consider a lighter regulatory regime for such non-U.S. CCPs in light of the fact that such non-U.S.

[8] The White Paper's "U.S. person" definition is the same as the one adopted by the CFTC in the Cross-Border Margin Rules, which is generally narrower than the definition contained in the 2013 Guidance.

[9] CFTC rules distinguish between "proprietary" accounts, *i.e.*, the account of the clearing member and certain closely related persons (such as affiliates), and "customer" accounts, with only the latter subject to segregation requirements.

[10] For more information about the CFTC's current approach to non-U.S. CCPs, see the proposal at Note 5, *supra*.

[11] Although not directly addressed by the White Paper, presumably the non-U.S. clearing member would also need to be subject to comparable regulation.

CCPs are already subject to comparable regulation.

The White Paper does not, however, recommend permitting FCMs to provide U.S. customers with indirect access to exempt non-U.S. CCPs through omnibus account structures like those permitted for foreign futures under CFTC Rule 30.7.[12] As a result, customers trading cleared swaps domestically and internationally would need to interface with multiple intermediaries, with resulting operational inefficiencies.

- The White Paper recommends that a non-U.S. CCP that the CFTC deems to pose substantial risk to the U.S. financial system should have to register as a DCO with the CFTC, with the CFTC's regulatory and supervisory focus on the CCP's U.S.-facing business.

Effectively, the White Paper recommends changing the test for when a comparably regulated non-U.S. CCP must register as a DCO to a risk-based test, rather than a test based on clearing for U.S. customers. Importantly, however, the White Paper focuses on risk to the U.S. financial system, not systemic importance generally, and accordingly tailors the extent to which CFTC regulation covers a non-U.S. CCP's business so as to focus on U.S.-facing clearing activity.

- **<u>Non-Comparable Jurisdictions</u>**:
  - Generally, the White Paper recommends that non-U.S. CCPs in Non-Comparable Jurisdictions should register with the CFTC if they provide clearing services for U.S. persons, either as self-clearing members or as customers.
  - However, the White Paper recommends that the CFTC provide relief from DCO registration to a non-U.S. CCP in a Non-Comparable Jurisdiction if the CCP's only U.S. members are Foreign Branches that are registered as SDs. Such relief would be conditioned upon (1) such Foreign Branches limiting their clearing activities to their own accounts or affiliates' accounts or clearing customers that are non-U.S. persons; (2) reporting by the non-U.S. CCP; and (3) the CFTC's entry into a memorandum of understanding ("MOU") with the home country regulator providing for information-sharing arrangements.

The White Paper argues that activity with such Foreign Branches should be given special consideration in light of the fact that they are (1) registered SDs, which means they are already subject to capital, margin, and risk management requirements and (2) incentivized to clear transactions though a CCP that is a "Qualifying Central Counterparty" (within the meaning of the capital rules adopted by the U.S. prudential regulators) since doing so would entail more favorable capital treatment.

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[12] Industry participants have advocated that the CFTC permit this structure. *See, e.g.*, FIA and SIFMA, Promoting U.S. Access to Non-U.S. Swaps Markets: A Roadmap to Reverse Fragmentation (Dec. 14, 2017).

The relevant CCPs might not, however, be willing or able to satisfy the reporting and MOU conditions proposed by the White Paper, and it is not clear what information the CFTC would seek to obtain from the CCPs or their regulators that the CFTC could not obtain and compile from the U.S. SDs whose Foreign Branches are members of the CCPs, other than confidential supervisory or examination information pertaining to the CCP.

(2) Registration of Non-U.S. Swaps Trading Venues

- Currently, the CFTC staff takes the position that a multilateral swaps trading platform located outside the U.S. generally must register as a swap execution facility ("SEF") or a designated contract market ("DCM") if the platform allows U.S. persons or persons located in the United States, including U.S.-located personnel and agents of non-U.S. persons, to trade or execute swaps on the platform, either directly or indirectly through an intermediary.[13] This position applies even if the platform limits trading to swaps that are not subject to the CEA's mandatory trade execution requirement.[14]

- Noting that this position has caused enormous consternation for non-U.S. trading venues, the White Paper instead recommends that the CFTC follow the model reflected in a 2017 agreement with the EC pursuant to which the CFTC exempted certain EU-regulated trading venues from SEF registration and the EC concluded that CFTC regulation of SEFs and DCMs is equivalent to relevant EU requirements.

<u>White Paper Recommendations</u>**:**

- **<u>United States</u>**: Multilateral swaps trading venues located in the United States would continue to be required to register as SEFs or DCMs.

- **<u>Comparable Jurisdictions</u>**:
  - Non-U.S. trading venues in Comparable Jurisdictions would be exempt from registration as SEFs. Such venues would be allowed to have U.S. participants, although such U.S. participants would still need to be eligible contract participants.
  - The White Paper notes that the rationale behind SEF registration is not to alleviate systemic risk concerns. Therefore, such overseas trading venues in Comparable Jurisdictions would not need to be subject to identical CFTC rules regarding trading methodologies and mechanics.[15]
  - Since exempt trading venues may be used by U.S. persons to satisfy the CEA's mandatory trade execution requirement, the White Paper argues that these exemptions would help alleviate the bifurcated liquidity pools (*i.e.*, local trading venues would not need to decide between serving only

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[13] CFTC Division of Market Oversight, Guidance on Application of Certain Commission Regulations to [SEFs] (Nov. 15, 2013).

[14] *See* Core Principles and Other Requirements for [SEFs], 78 Fed. Reg. 33476, 33481 n.88 (June 4, 2013). Separately, Chairman Giancarlo has proposed that the CFTC expand the trade execution requirement to cover all swaps that it requires to be cleared and which are listed by a SEF or DCM. *See* CFTC Chairman J. Christopher Giancarlo, "Swap Regulation Version 2.0: An Assessment of the Current Implementation of Reform and Proposals for Next Steps" (Apr. 26, 2018) at 55-56 (the "Swaps 2.0 Paper"). Our alert memorandum regarding the Swaps 2.0 Paper can be found here.

[15] Chairman Giancarlo has also recommended that the CFTC permit U.S. SEFs to offer more flexible methods of execution. *See* Swaps 2.0 Paper at 52-55.

U.S. participants or only non-U.S. participants).

Notably, the proposed exemptions would be available to non-U.S. trading venues that do not list swaps that are subject to the CEA's mandatory trade execution requirement, which is not currently the case under the exemption granted by the CFTC following the 2017 CFTC-EC agreement noted above. Expanding exemptions in this manner would help alleviate fragmentation of the foreign exchange market by permitting U.S. persons to access offshore foreign exchange trading venues.

- **<u>Non-Comparable Jurisdictions</u>**:
  - The White Paper recommends that non-U.S. trading venues located in Non-Comparable Jurisdictions be required to register as SEFs or DCMs if U.S. persons have access, either directly or indirectly through a non-U.S. intermediary, to the trading venue, <u>subject to</u> a materiality threshold. The White Paper generally leaves open the question of which criteria should be considered in setting such a threshold, but it points to CFTC research into entity-net notionals as a potential input.[16]

The White Paper does not recommend that the CFTC extend relief permitting Foreign Branches to access trading venues in Non-Comparable Jurisdictions, despite acknowledging that operating a trading venue does not raise systemic risk concerns. This approach seems inconsistent with the proposal to provide such relief in connection with Foreign Branch access to non-U.S. CCPs. Preventing Foreign Branches from accessing trading venues in Non-Comparable Jurisdictions would perpetuate fragmentation of overseas swaps markets and disadvantages for U.S. banks.

In addition, while the White Paper does not expressly address the matter, its later proposal regarding ANE Transactions could suggest a desire to require trading venues in Non-Comparable Jurisdictions to register as SEFs if they permit access by U.S.-located personnel or agents of non-U.S. persons.

(3) <u>Registration of Non-U.S. Swap Dealers</u>

- The White Paper sets out a framework for the cross-border application of SD registration rules that divides SDs into four categories: (1) U.S. persons; (2) Guaranteed Entities;[17] (3) non-U.S. persons that are FCSs but not Guaranteed Entities; and (4) non-U.S. persons that are neither Guaranteed Entities nor FCSs ("Other Non-U.S. Persons").

[16] *See* Richard Haynes, John Roberts, Rajiv Sharma, and Bruce Tuckman, "Introducing ENNs: A Measure of the Size of Interest Rate Swap Markets" (Jan. 2018).

[17] The White Paper uses the definition of "guarantee" from the Cross-Border Margin Rules, which, unlike the 2013 Guidance, requires that a guarantee provide a counterparty with recourse to the guarantor. The White Paper generally describes Guaranteed Entities as though all their swaps are guaranteed, but its use of the definition from the Cross-Border Margin Rules suggests that a non-U.S. person would be considered a Guaranteed Entity only with respect to its swaps that are actually guaranteed by a U.S. person.

- The 2013 Guidance requires U.S. persons (including Foreign Branches), guaranteed affiliates of U.S. persons, and another category, conduit affiliates of U.S. persons,[18] to count all their dealing swaps toward the SD *de minimis* threshold. The 2013 Guidance requires non-U.S. persons that are not guaranteed or conduit affiliates, in turn, only to count their swaps with U.S. persons and guaranteed affiliates and further provides exceptions for swaps with (1) a Foreign Branch of a registered SD; (2) a guaranteed affiliate that is registered as an SD or operating under the *de mimimis* threshold and affiliated with a registered SD; and (3) a guaranteed affiliate whose U.S. guarantor is a non-financial entity. The 2013 Guidance also provides an exception for swaps executed anonymously on a registered SEF, DCM, or foreign board of trade ("FBOT") and cleared by a registered or exempt DCO.

- The 2016 Proposal, in contrast, would have treated Foreign Branches, Guaranteed Entities, and FCSs like U.S. persons for purposes of determining which swaps entered into by them and their counterparties count toward the SD *de minimis* threshold.

  ***White Paper Recommendations*:**

- **United States**: U.S. persons would continue to count all dealing swaps, including swaps that are booked at a Foreign Branch, toward the *de minimis* threshold, subject to otherwise applicable exceptions (*e.g.*, swaps used to hedge physical positions).

- **Comparable Jurisdictions**:

  - *Definition of Comparable Jurisdictions*. Comparable Jurisdictions would be non-U.S. jurisdictions in which local regulators have established comparable requirements for entities engaged in swap dealing activity, with a focus on risk mitigation requirements, specifically capital, margin, and risk management requirements (*e.g.*, Basel-compliant capital oversight by another G20 prudential regulator).

  - *Registration of Non-U.S. SDs in Comparable Jurisdictions*:

    - Guaranteed Entities would continue counting all their dealing swaps toward their *de minimis* thresholds;

    - FCSs and Other Non-U.S. Persons would be treated the same, would only be required to count dealing swaps with U.S. persons and Guaranteed Entities, and would further benefit from exceptions from counting swaps with: (1) a Foreign Branch of a registered SD; (2) a

[18] The 2013 Guidance defines a "conduit affiliate" to mean a non-U.S. person: (1) that is a majority-owned affiliate of a U.S. person; (2) that is controlling, controlled by or under common control with the U.S. person; (3) whose financial results are included in the consolidated financial statements of the U.S. person; and (4) in the regular course of business, engages in swaps with non-U.S. third-party(ies) for the purpose of hedging or mitigating risks faced by, or to take positions on behalf of, its U.S. affiliate(s), and enters into offsetting swaps or other arrangements with its U.S. affiliate(s) in order to transfer the risks and benefits of such swaps with third-party(ies) to its U.S. affiliates. 2013 Guidance, 78 Fed. Reg, at 45359. The CFTC eliminated this concept when it introduced the concept of FCS and did not propose to apply this definition in the 2016 Proposal. The White Paper does not address this concept.

Guaranteed Entity that is registered as, or affiliated with a registered, SD; and (3) a Guaranteed Entity whose U.S. guarantor is a non-financial entity.[19]

- There would continue to be an exception for swaps executed anonymously on a registered or exempt SEF, DCM, or FBOT and cleared by a registered or exempt DCO.

Accordingly, the White Paper would generally treat non-U.S. SDs in Comparable Jurisdictions—including FCSs—in a consistent manner with the 2013 Guidance.

- **Non-Comparable Jurisdictions**:
  - The White Paper generally recommends taking the same approach for Guaranteed Entities and Other Non-U.S. Persons in Non-Comparable Jurisdictions as those in Comparable Jurisdictions, but suggests a different approach with respect to FCSs and ANE Transactions.
  - The White Paper notes that FCSs in Non-Comparable Jurisdictions raise more complex issues. It states that consolidated supervision and regulation by the Federal Reserve Board of FCSs that are part of bank holding companies could provide a basis for limiting the swaps that such an FCS would need to count toward its *de minimis* threshold (possibly subject to a materiality threshold). It also suggests similar treatment for FCSs that are part of non-financial organizations headquartered in the United States, since they may not pose systemic risk on the U.S. financial system. It also suggests that the CFTC staff should facilitate access to emerging markets.

Ultimately, the White Paper does not take as firm a position on FCSs in Non-Comparable Jurisdictions as it does on FCSs in Comparable Jurisdictions. However, many of the arguments that the White Paper makes against the 2016 Proposal's requirement that FCSs count all their dealing swaps toward the *de minimis* threshold apply to all FCSs regardless of whether they are located in Comparable Jurisdictions or Non-Comparable Jurisdictions.

In addition, as noted in Part 5 below, the White Paper implies that non-U.S. SDs in Non-Comparable Jurisdictions should count ANE Transactions toward their *de minimis* thresholds.

(4) MANDATORY CLEARING AND TRADE EXECUTION REQUIREMENTS

- Unless a clearing exception applies, a swap that is subject to the CEA's mandatory clearing requirement (a "Rule 50.4 Swap") must be executed on a registered DCM or a registered or exempt

[19] As an alternative, the White Paper proposes allowing Other Non-U.S. Persons to exclude all dealing swaps with Guaranteed Entities, on the basis that Guaranteed Entities would otherwise be required to count such swaps toward their own *de minimis* thresholds.

SEF so long as any DCM or SEF makes the swap available to trade. Therefore, the CFTC has treated the mandatory clearing and trade execution requirements as integrally linked.

- The White Paper, however, distinguishes between regulatory requirements that are intended to mitigate systemic risk and those that are intended to address market and trading practices. The White Paper concludes that, while the mandatory clearing requirement is intended to address the former, the mandatory trade execution requirement is intended to address the latter.[20] Thus, it criticizes the common treatment of these two requirements in the 2013 Guidance.

***White Paper Recommendations*:**

- **United States**: Rule 50.4 Swaps engaged in by a U.S. person would be subject to the CEA's mandatory clearing and trade execution requirements, regardless of the extent of its counterparty's U.S nexus, unless another exception or exemption applies (such as the non-financial entity exception).

- **Comparable Jurisdictions**:

    - In Comparable Jurisdictions, Guaranteed Entities, FCSs, and Other Non-U.S. Persons could rely on substituted compliance with respect to mandatory clearing and trade execution requirements.

    The White Paper does not expressly address the treatment of Foreign Branches transacting with non-U.S. persons in Comparable Jurisdictions. Instead, it appears to treat Foreign Branches that transact with non-U.S. persons like it treats U.S. persons that transact with non-U.S. persons, *i.e.*, by requiring them directly to satisfy the CEA's mandatory clearing and trade execution requirements by clearing at a registered or exempt DCO and trading on a DCM or registered or exempt SEF. If Foreign Branches could not rely on substituted compliance to the same extent as Guaranteed Entities, FCSs, and Other Non-U.S. Persons, non-U.S. markets would continue to be fragmented and Foreign Branches would continue to face a significant competitive disadvantage, neither of which seems to be an intended effect of the White Paper's recommendations.

    - Given that mandatory clearing is focused on systemic risk, the White Paper argues that there should be a "stricter" degree of comparability before permitting substituted compliance with the mandatory clearing requirement than with the mandatory trade execution requirement. On the other hand, the White Paper states that non-U.S. persons should look to local rules in determining whether a particular swap needs to be cleared or executed on a trading venue.

    Although it is not entirely clear from the face of the White

[20] The White Paper also suggests that public trade reporting requirements should be applied similarly to the mandatory trade execution requirement.

Paper, one approach for reconciling these two statements might be for the CFTC, when assessing comparability, to evaluate quantitatively the aggregate risk-mitigating effect of a non-U.S. clearing requirement, as opposed to its current approach of permitting substituted compliance only when a particular swap is covered by both the foreign jurisdiction's clearing requirement and the CFTC's clearing requirement.

- **Non-Comparable Jurisdictions**:
  - *Mandatory Clearing*:
    - Rule 50.4 Swaps engaged in by a Foreign Branch in a Non-Comparable Jurisdiction would be subject to the CEA's mandatory clearing requirement, regardless of the extent of its counterparty's U.S nexus, unless (1) another exception or exemption applies (such as the non-financial entity exception) or (2) the swaps are with an Other Non-U.S. Person and fall below a materiality threshold.

This approach is similar to the 2013 Guidance, under which Foreign Branches can rely on an exception from the mandatory clearing requirement in connection with swaps entered into outside of Australia, Canada, the EU, Hong Kong, Japan, and Switzerland with non-U.S. persons that are not guaranteed or conduit affiliates if, in the aggregate, those swaps fall below 5 percent of the aggregate notional value of swaps entered into by the U.S. bank as a whole.[21]

- Rule 50.4 Swaps engaged in by a Guaranteed Entity in a Non-Comparable Jurisdiction would be subject to the CEA's mandatory clearing requirement, regardless of the extent of its counterparty's U.S nexus, unless (1) another exception or exemption applies (such as the non-financial entity exception) or (2) the swaps are with an Other Non-U.S. Person and either (a) are subject to uncleared swap initial and variation margin requirements that are consistent with the standards issued by the Basel Committee on Banking Supervision – International Organization of Securities Commissions Working Group on Margining Requirements ("WGMR

[21] The main difference is that the White Paper's proposed materiality exception would not appear to be available for swaps with FCSs, which is a broader category than the conduit affiliate category in the 2013 Guidance. It is not clear that this difference was intended, however.

Margin Requirements") or (b) fall below a materiality threshold.

Relative to the 2013 Guidance, the White Paper would expand the extraterritorial application of the mandatory clearing requirement to Guaranteed Entities to cover Rule 50.4 Swaps with Other Non-U.S. Persons, but Guaranteed Entities could rely on an exception for these swaps to the extent that they are subject to WGMR Margin Requirements or fall below a materiality threshold.[22]

In addition, because Guaranteed Entities would benefit from an exception from clearing Rule 50.4 Swaps that are subject to WGMR Margin Requirements, but Foreign Branches would not, the White Paper's framework would, if adopted, continue to put Foreign Branches at a competitive disadvantage relative to Guaranteed Entities.

- Other Non-U.S. Persons would be subject to the clearing requirement for Rule 50.4 Swaps with: (1) U.S. persons, including Foreign Branches, unless such swaps fall below a Foreign Branch's materiality threshold; and (2) Guaranteed Entities, unless such swaps are subject to WGMR Margin Requirements or fall below a Guaranteed Entity's materiality threshold.
- Notably, the White Paper omits recommendations for the treatment of FCSs in Non-Comparable Jurisdictions, noting that the right approach will depend on how other cross-border rules, such as the SD registration rules, develop.

- *Mandatory Trade Execution*: The White Paper holds off on recommending approaches with respect to the mandatory trade execution requirement in Non-Comparable Jurisdictions, noting that it may not be proper to apply that requirement to the same extent as the mandatory clearing requirement due to their different policy objectives. Given the fact that jurisdictions take different approaches to market practice issues and trade execution requirements, the White Paper suggests perhaps dealing with the trade execution requirement on a case by case basis instead of formulating a general approach.

[22] These exceptions would not apply, however, to swaps with FCSs, which as noted above is a broader category than the conduit affiliate category in the 2013 Guidance.

The White Paper does not explain what principles would guide its "case by case" approach to the trade execution requirement in Non-Comparable Jurisdictions.

(5) ANE TRANSACTIONS

- In prior statements, Chairman Giancarlo has been critical of applying CFTC rules to ANE Transactions, noting that Advisory 13-69 is "causing many overseas trading firms to consider cutting off all activity with U.S.-based trade support personnel to avoid subjecting themselves to the CFTC's flawed swaps trading rules."[23]

- In the White Paper, however, he argues for a "territorial approach" that would apply these rules to certain ANE Transactions. This seeming change in view appears related to Chairman Giancarlo's separate proposal to overhaul the CFTC's approach to regulating SEFs and applying the mandatory trade execution requirement, which would permit more flexible methods of executing swaps subject to that requirement.[24]

***White Paper Recommendations*:**

- **Definition of ANE Transactions**:
  - Consistent with the 2016 Proposal, the White Paper recommends that the terms "arranging" and "negotiating" only encompass market-facing activity and not internal, back-office activities performed by personnel not involved with the sale or trading of the swap (*e.g.*, swap processing, preparation of documentation, and providing research information to sales and trading personnel).
  - The White Paper additionally recommends that, in working out the details of an approach to ANE Transactions, the CFTC staff attempt to "capture activity that has a direct and significant effect on the U.S. financial system and exclude other more incidental activity."

The White Paper does not provide more guidance on what activity should be considered "incidental," although market participants have previously argued that such activity should include providing market color or "passing the book" to execute an order outside a non-U.S. counterparty's local market hours.

- **Application of SD Registration Requirements**: The White Paper recommends that ANE Transactions not count toward a non-U.S. SD's *de minimis* threshold if such SD is in a Comparable Jurisdiction, given the fact that ANE Transactions, by definition, do not pose systemic risk to the U.S. financial system simply because they are arranged, negotiated, or executed in the United States.

Although the White Paper does not expressly address the matter, one might infer that, under its framework, ANE Transactions would count toward the *de minimis*

[23] Statement of Commissioner J. Christopher Giancarlo on Cross-Border Margin (Jun. 29, 2015).

[24] *See* Note 15, *supra*.

threshold for a non-U.S. SD in a Non-Comparable Jurisdiction.

- **<u>Application of Mandatory Clearing and Trade Execution Requirements</u>**:
  - The White Paper recommends that, if swap is "executed" (the "E" in "ANE") in the United States, then the non-U.S. counterparties to such swap should be required to follow the CEA's mandatory clearing and trade execution requirements. The White Paper argues that without such a policy, the swaps market in the United States would be bifurcated based on whether or not the counterparties are foreign, with non-U.S. counterparties being able to trade off SEFs.
  - The White Paper then considers two scenarios:

    (1) A third-party U.S. intermediary located in the United States arranges or negotiates swaps among multiple non-U.S. participants. The White Paper argues that this intermediary should be a SEF, and therefore, the execution of the trade would be subject to the rules of the SEF. Under this territorial approach, the relevant fact is that the actual activity of price formation occurs in the United States.

    (2) A U.S.-based agent and/or employee of a non-U.S. SD located in the United States arranges or negotiates a swap with a non-U.S. person. Again, under a territorial approach, since the person located in the United States is engaging in the swaps trading activity, the CEA's mandatory clearing and trade execution rules should apply. However, if the non-U.S. SD is subject to regulation in a Comparable Jurisdiction, the White Paper notes there may be a basis to defer to the non-U.S. jurisdiction.

The White Paper generally takes the same approach as Advisory 13-69 to applying mandatory clearing and trade execution requirements to ANE Transactions, except for permitting substituted compliance in connection with transactions that are "arranged" or "negotiated"—but not "executed"—by U.S.-located agents or employees of a non-U.S. SD.

But the White Paper does not address how, as a practical matter, to distinguish between "arranging" or "negotiating" a swap, on the one hand, and "executing" a swap, on the other hand.

Moreover, the White Paper's consistent recognition that mandatory clearing serves a systemic risk mitigation objective suggests that the mandatory clearing requirement should not apply to ANE Transactions, which do not present a risk to the U.S. financial system. In addition, where non-U.S. counterparties can, under home country rules, execute a Rule 50.4 swap without clearing it, and they choose to do so, subjecting that swap to the CEA's mandatory clearing and trade execution requirements due to the involvement of U.S. personnel is more likely to

discourage the parties from involving such personnel than it is to encourage them to execute the swap on a SEF and clear it because clearing the swap would introduce a different credit risk and funding profile relative to executing an uncleared swap. Alternatively, permitting the parties to execute the swap bilaterally would not fragment the U.S. market for Rule 50.4 Swaps because these differences make cleared and uncleared swaps non-fungible, with a different mix of price-forming characteristics.

(6) PROCESS AND NEXT STEPS

- The White Paper is highly critical of the CFTC's departure from the Administrative Procedure Act when adopting the 2013 Guidance. Accordingly, the White Paper indicates that Chairman Giancarlo intends to direct the CFTC staff to issue new rule proposals to address the matters discussed in the White Paper.

- Given other matters on the CFTC's near-term agenda, it seems likely that these proposals will not be ready until the first part of 2019.

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