WASHINGTON **watch**

CFTC Issues Comparability Determinations for Six Jurisdictions

Shortly before the end of the year, the Commodity Futures Trading Commission took an important step towards clarifying how it will apply its regulations to cross-border trading in swaps.

The CFTC announced on Dec. 20 that six foreign jurisdictions have been deemed "comparable" with respect to certain swaps provisions of the Dodd-Frank Act—Australia, Canada, the European Union, Hong Kong, Japan and Switzerland. The CFTC said the determinations will permit "substituted compliance" with non-U.S. regulatory regimes, meaning that non-U.S. swap dealers can use compliance with home country regulations as a substitute for compliance with certain CFTC requirements.

The issuance of these determinations was part of a framework established by the CFTC in July for applying its regulations to cross-border trading. At that time, the CFTC issued "guidance" on this issue and worked toward a Dec. 21 deadline for determining which rules would be covered by substituted compliance. The six jurisdictions were chosen because swap dealers in those six jurisdictions have registered with the CFTC and therefore are subject to CFTC requirements as well as requirements in their home countries.

The CFTC said the comparability determinations cover "a broad range of entity-level requirements" in all six jurisdictions. The "entity-level" requirements include requirements related to swap data recordkeeping, the role and responsibilities of chief compliance officers, the monitoring of position limits, clearing conflicts and clearing member risk management.

The CFTC also approved substituted compliance for a small number of "transaction-level requirements" in just two jurisdictions—the EU and Japan—including requirements related to daily trading records and swap trading relationships. The EU determination also covered requirements related to swap confirmations, portfolio reconciliation and portfolio compression.

The comparability determinations were approved by a vote of three to one, with Commissioner Scott O'Malia dissenting. O'Malia explained that he could not support the determinations for three reasons: 1) the cross-border policy on which they were based was "legally unsound" because it was issued in the form of guidance rather than rules; 2) the process for reaching the determinations was flawed because it was based on a rule-by-rule comparison rather than a broad category-by-category comparison; and 3) the CFTC failed to provide a clear path for moving forward.

CFTC Chairman Gary Gensler and Commissioners Mark Wetjen and Bart Chilton issued a joint statement of support explaining that the CFTC carefully reviewed each regulatory provision of the six jurisdictions and compared the provision's intended outcome to the CFTC's own regulatory objectives. "The comparability findings for the entity-level requirements are a testament to the comparability of these regulatory systems as we work together in building a strong international regulatory framework," they said in their statement.

In separate but related actions, CFTC staff issued two no-action letters on Dec. 20. One provided temporary relief from CFTC swap reporting requirements for non-U.S. swap dealers located in five of the six jurisdictions: Australia, Canada, the EU, Japan and Switzerland. The relief will expire at various times during 2014, depending on the type of counterparty to the relevant swap. The other letter provided temporary relief from certain internal business conduct requirements for non-U.S. swap dealers

Gensler Clarifies SEF Framework

CFTC Chairman Gary Gensler in November clarified important details of the new regulatory framework for swap execution facilities through a series of policy actions and public statements. The clarifications require more substantial changes to swap trading practices than some market participants may have expected based on previous CFTC interpretations.

The clarifications covered the following issues, among others:

Made Available for Trading: Gensler said he expects the CFTC to adopt trade execution requirements by February for a "significant portion" of the interest rate and credit default index swap markets. He noted that four SEFs have filed MAT determinations and said he believes "sufficient liquidity exists across the entire interest rate curve" to support MAT determinations.

Foreign SEFs: Gensler said swap trading platforms outside the U.S. will have to register with the CFTC if they provide customers in the U.S. with the ability to trade on their platform, even if access to the platform is provided by an intermediary, and even if the platform is already registered with its home country regulator.

Impartial access: Gensler said SEFs cannot serve only dealer-to-dealer trading or only dealer-to-customer trading. SEFs must provide all market participants—dealers and non-dealers alike—with the ability to interact with their order books or request for quote systems.

Discriminatory Practices: Gensler identified several practices in use at SEFs that are "inconsistent" with CFTC rules. These include "enablement mechanisms" that can be used to restrict access, pre-execution breakage agreements in case swaps do not clear, and rules that require a market participant to be a swap dealer or a clearing member in order to respond to a request for quote.

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Meanwhile, three trade associations have challenged the CFTC's approach to cross-border trading. On Dec. 4, the Securities Industry and Financial Markets Association, the International Swaps and Derivatives Association and the Institute of International Bankers filed a lawsuit alleging that the CFTC violated federal rule-making requirements by calling its cross-border rules "guidance" and failed to conduct the necessary cost-benefit analysis. The three associations also alleged that the CFTC's approach to cross-border regulation could "undermine the global commitment to prevent contradictory, overlapping and duplicative requirements" and is causing foreign counterparties to avoid doing business with U.S. swap dealers. The lawsuit is currently pending in the U.S. District Court for the District of Columbia.

One reason for the lawsuit was the CFTC's expansive interpretation of its authority to regulate cross-border business. On Nov. 14, the CFTC published a staff letter asserting that its rules apply to transactions involving foreign swap dealers if they have personnel in the U.S. who "regularly arrange, negotiate or execute swaps." According to the letter, CFTC rules apply to such transactions even if neither side of the trade is a U.S. person and the contract is booked outside the U.S.

CFTC Chairman Gary Gensler said on Nov. 18 that the letter was intended to clarify that a U.S. swap dealer and a foreign-based swap dealer working out of the same office building in New York would be subject to the same rules. "One elevator bank, one set of rules," he said in a speech to the Wholesale Market Brokers Association in New York.

European officials commented on Nov. 21 that the CFTC's position on this issue violates the accord reached this summer between Gensler and Michel Barnier, the EU's Commissioner for Internal Market and Services. "We were very surprised by the latest CFTC rules, which seem to us to go against both the letter and spirit of the path forward agreement," a spokeswoman for Barnier told the press on Nov. 21.

It is not clear yet if the comparability determinations issued in December addressed this concern or not.

Ownership and Control Reports Rule Finalized

The CFTC on Oct. 30 unanimously approved a final rule that will require the industry to provide position-based reporting for futures and swaps through a number of reports, some of which are new and others of which are revised versions of existing reports. In particular, the final rule will expand the scope of the CFTC's ability to identify market participants by "looking through" account structures to the owners and controllers of underlying accounts.

The CFTC said the final rule will accomplish two goals: 1) to provide the agency with "enhanced visibility" into the identities of market participants and their positions and trading activity, and 2) to "modernize" the reporting process by requiring the reports to be submitted electronically rather than by mail or fax.

One key change is aimed at capturing more information about high-frequency trading. As described by the CFTC staff, the final rule will capture not only accounts that hold large positions at the end of the trading day but also accounts that engage in large amounts of trading during the day. Specifically, Form 102B will require clearing firms and certain markets to report accounts that have trading volume above a specified level over the course of a single day, even if their end-of-day positions are relatively small. Form 102B also requires identifying information with respect to the owners and controllers of these accounts. In addition, the final rule creates a new report, Form 71, that will be used to request information on the ultimate owners and controllers of omnibus accounts reported on Form 102B.

"This new information is critical in today's world of high frequency trading, as many accounts trade often throughout the day but end the day without reportable positions," Gensler commented. "Thus, with these reforms, the Commission will get additional tools to oversee the markets' largest day traders and high frequency traders."

The final rule will take effect on Feb. 18 but firms have a compliance date of Aug. 15, 2014. The CFTC said it will work with the industry before the compliance date to test and implement new information technology standards and systems associated with the new reporting requirements.

U.S. Regulators Approve Volcker Rule

On Dec. 10 five U.S. financial regulatory agencies approved final rules to implement the so-called Volcker Rule, one of the most complex and far-reaching reforms under the Dodd-Frank Act.

This measure, named after former Federal Reserve Chairman Paul Volcker, prohibits banks from engaging in proprietary trading and limits their ability to own and invest in hedge funds and private equity funds. The final implementing rules were written and approved by the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission and the Commodity Futures Trading Commission.

The CFTC approved the rules by a vote of three to one. Scott O'Malia, the agency's sole Republican commissioner, issued a dissenting statement over concerns about the drafting process and the lack of due process for market participants in enforcement of the rules.

CFTC Chairman Gary Gensler said the CFTC's authority to implement the Volcker Rule applies to approximately 110 registered swap dealers and futures commission merchants. Grouped by corporate affiliation, these represent about 45 different business enterprises, he said.

In terms of the cross-border application of the rules, regulatory officials said they apply to U.S. banking entities with operations outside the U.S. as well as foreign banking entities that have dealings with U.S. entities. Activities among foreign banking entities conducted entirely outside the U.S. are not subject to the rules.

The rules become effective April 1, 2014. However, banking entities will have until July 21, 2015 to come into compliance.

The final rules provide exemptions for activities including market making, underwriting, hedging, trading in certain government obligations, and organizing and offering a hedge fund or private equity fund, among others. However, the final rules limit these exemptions if they involve a material conflict of interest, a material exposure to high-risk assets or trading strategies, or a threat to the safety and soundness of the banking entity or to U.S. financial stability.

The final rules also clarify which activities are not considered proprietary trading. For example, trades conducted as an agent, broker, or custodian are excluded from the proprietary trading ban as are repurchase and securities lending agreements. Transactions conducted for "liquidity management" and transactions related to certain clearing activities are also excluded from the ban.

In order to be exempt as a market-maker, bank trading desks are required to routinely stand ready to purchase and sell one or more types of financial instruments. The rules state that a bank trading desk's inventory in these types of financial instruments must not exceed, on an ongoing basis, the "reasonably expected near-term demands of customers."

The exemption for hedging applies to activity that demonstrably reduces or significantly mitigates specific, identifiable risks of individual or aggregated positions of the banking entity. Under the rules, banks are required to conduct an analysis to support their hedging strategies and the effectiveness of hedges must be monitored and recalibrated as necessary on an ongoing basis. In addition, the final rules require banks to document, contemporaneously with hedging transactions their "hedging rationale" for certain transactions that present heightened compliance risks.

CFTC Re-Proposes Position Limit and Aggregation Rules

The Commodity Futures Trading Commission on Nov. 5 approved a proposed position limits rule. If finalized, the rule would establish speculative position limits for futures and options on 28 physical commodities and several hundred economically equivalent swaps.

The proposed position limits rule was drafted after a previous version was struck down by a federal court in September 2012. The CFTC initially decided to appeal the court ruling, but in October 2013 it voted to abandon the appeal and instead move forward with a new proposal.

CFTC Chairman Gary Gensler said the proposal was "consistent with Congressional intent" as well as the agency's historical interpretation of its obligation to promote market integrity. He noted that the proposal built on more than four years of "significant public input," including more than 23,000 comments received from the public as well as several public meetings.

CFTC Commissioner Scott O'Malia, a Republican, voted against the re-proposed position limits rule. O'Malia said the agency had failed to use current data and other empirical evidence to justify position limits and he emphasized the problems that the proposal would create for end-users. "Regrettably, this proposal continues to chip away at the commercial and business operations of end-users and the vital hedging function of the futures and swaps markets," he said.

The position limit proposal calls for CFTC-administered speculative position limits on 28 core referenced physical commodity contracts in agricultural, energy and metals markets and economically equivalent swaps. Spot-month position limit levels generally would be set at 25% of estimated deliverable supply. These spot-month limits would be applied separately to physically delivered contracts and cash-settled contracts in the same commodity.

The proposed rule also would establish limits for non-spot months and would apply the same size limit to positions in any single month and positions on an all-months-combined basis. The proposed initial levels would be based on open interest in futures and swaps that are "significant price discovery" contracts. Subsequent levels would be adjusted at least every two years based on the open interest for a calendar year. The levels would be set using a formula based on 10% of the first 25,000 of open interest and 2.5% thereafter. Open interest used in determining subsequent limits would be the sum of futures open interest, cleared swaps open interest and uncleared swaps open interest.

The proposal includes a list of specified exemptions for bona fide hedging positions in physical commodities. To request an exemption that is not on this list, a market participant would have to submit a petition. Comments on the proposal are due by Feb. 10.

At the same meeting, the CFTC unanimously approved proposed aggregation rules that establish standards for determining when positions held by two or more related entities should be aggregated for the purpose for compliance with position limits. CFTC staff described the proposal as being similar to the version proposed in May 2012, with some modifications to reflect comments received on the earlier proposal. For example, the proposal provides a process for firms to apply for an exception from aggregation, even in cases where one firm owns more than 50% of another, if the owned entity is not consolidated on the balance sheet of the firm under U.S. generally accepted accounting principles as well as certain other conditions.

CFTC Approves Final Customer Protection Rules

The Commodity Futures Trading Commission on Oct. 30 approved a package of customer protection rules ranging from the use of standardized acknowledgement letters for customer collateral held in bank and custodial accounts to new standards for audited financial reports and standards and practices for moving funds from customer segregated accounts.

Many of these protections have been implemented already by the industry and self-regulatory organizations and the CFTC approved these protections with little discussion. Two provisions, however, were discussed in great detail during the CFTC meeting: one that changes how FCMs calculate the residual interest they must maintain in customer accounts to cover margin deficits, and another that shortens the time period within which FCMs must collect margin.

The residual interest rule takes effect in November 2014 and will initially require FCMs to use their own funds to cover any individual customer margin deficits outstanding as of 6:00 p.m. (Eastern Time) the business day following the trade date. This was modified from an earlier proposal that would have required FCMs to maintain enough residual interest in their segregated accounts to cover each customer's margin deficits "at all times."

The timing element in the residual interest calculation changes after five years. It accelerates from 6:00 p.m. to the time of the first daily settlement, which is typically the morning following the trade date.

The agricultural sector has opposed this requirement, saying it will make hedging more costly and risky. "We strongly support efforts to enhance customer protection, but we cannot support action by the Commission in the name of customer protection that is funded on the backs of America's farmers, ranchers and agribusiness hedgers," wrote a coalition of agricultural groups in an Oct. 28 letter.

Stephen Kane, an official in the CFTC's office of the chief economist, acknowledged that the residual interest rule would be a bigger burden for smaller FCMs, which tend to serve agricultural customers. "It could force them to become introducing brokers," he said.

Another provision in the customer protection rule imposes a capital charge on FCMs for unmet margin one day after the initial margin call rather than the current three day period. The coalition of agricultural groups cautioned that this one-day time period is not sufficient, especially for FCMs who serve farmers, ranchers and smaller agribusiness hedgers who still send margin by check. "One day is infeasible and would lead FCMs to require pre-margining," the groups warned.

The residual interest and capital charge rules take effect in November 2014, at which time margin must be collected by 6:00 p.m. the day after the trade date. If no further CFTC action is taken after a study is conducted, the initial "phase-in period" expires on Dec. 31, 2018, after which the time for collecting margin is accelerated to the time of final settlement, which is typically the next morning.

One other customer protection provision approved by the CFTC amended regulations governing the acknowledgement letters that FCMs and derivatives clearing organizations must obtain from depositories holding customer funds. The purpose of acknowledgment letters is to put the depository on notice that the funds held in the customer account must be treated in accordance with applicable segregation requirements.

The rule requires the use of a template letter and the CFTC has made available six versions of this template to accommodate differing customer accounts. In addition to acknowledging the segregation requirements, the letter includes language intended to enhance the CFTC's ability to identify and respond to potential problems in the treatment of customer funds.

With respect to liens on the customer account, the final template letters have been modified to incorporate certain recommendations from industry comments, according to the CFTC. For example, the final letters now provide that the depository has the right to recover funds advanced in the form of cash transfers, repurchase agreements, or other similar liquidity arrangements the depository makes.

The CFTC reaffirmed its position that a depository may not extend intraday credit to the FCM and take a lien on the customer account. "This includes extending credit to the FCMs to fulfill the FCM's obligation to a DCO to post customer margin," said Phyllis Dietz, an official in the CFTC's division of clearing and risk.

ICAP Gets CFTC Approval for Basis Risk Facility

ICAP will be able to continue offering Reset, its basis risk management service for the interest rate swaps market, thanks to an approval granted by the Commodity Futures Trading Commission in December.

Under the CFTC's rules, certain types of interest rate swaps have to be traded on swap execution facilities and only certain types of execution methodologies are allowed, namely request-for-quote and order book. The CFTC approval provides an exception to those rules in that it allows ICAP to use a specific type of trade matching process for traders using the Reset service.

Reset provides banks with a way to manage timing mismatches in a portfolio of interest rate swaps by executing forward rate agreements, single period swaps, and non-deliverable forwards through a periodic scheduled "run" rather than a continuous process.

In its approval, the CFTC explained that the service provides benefits that are "consistent" with the objectives of the Dodd-Frank Act by helping market participants manage their risks. The CFTC specified that this type of service can only be provided under certain conditions. For example, access must be granted impartially, each run must include a minimum number of participants, and participant can use the service only to reduce or mitigate risks.