October 5, 2018

CFTC Chairman Releases White Paper on "Cross-Border Swaps Regulation Version 2.0"

White Paper Proposes New Approach to Providing Exemptions and Other Relief from CFTC's Dodd-Frank Swaps Rules for Certain Non-U.S. Clearinghouses, Trading Venues, and Swap Dealing Businesses

SUMMARY

On October 1, 2018, Commodity Futures Trading Commission ("CFTC") Chairman Christopher Giancarlo released a white paper titled "Cross-Border Swaps Regulation Version 2.0: A Risk-Based Approach with Deference to Comparable Non-U.S. Regulation" (the "White Paper"). The release of the White Paper follows Chairman Giancarlo's remarks at a City of London event on September 4, 2018 and directs the CFTC to modify its approach to cross-border regulation in a way that is "better calibrated to mitigate systemic risk" and that fosters "innovation, competition, and international cooperation."

The White Paper begins with a broad review of U.S. and global swaps reform efforts and then sets forth a set of principles to guide the cross-border application of the CFTC's Dodd-Frank swaps rules. Next, it reviews the CFTC's approach to applying its Dodd-Frank swaps rules in the cross-border context and recommends a series of improvements, exemptions and relief that would address non-U.S. clearinghouses, trading venues, and swap dealing businesses.

PRINCIPLES TO GUIDE THE CROSS-BORDER APPLICATION OF THE CFTC'S SWAPS RULES

The White Paper acknowledges that, among regulators of the world's major derivatives markets, the CFTC was the first regulatory agency to implement most of the swaps market reforms agreed upon by the G20. However, the White Paper goes on to observe that, as other jurisdictions have now adopted swap reforms, the CFTC's early approach and its over-expansive assertion of jurisdiction is resulting in increased transaction costs and a fragmented global swaps market. From these observations, the White Paper identifies six principles that it asserts should guide the reform of the cross-border application of the CFTC's Dodd-Frank swaps rules:

- **Principle 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.*

  The White Paper draws a distinction between swaps reforms that are "designed to mitigate systemic risk" – such as swaps clearing, margin for uncleared swaps, dealer capital, and recordkeeping and regulatory reporting – and swaps reforms that "address market and trading practices" – such as public trade reporting and price transparency, trading platform design, trade execution methodologies and mechanics, and personnel qualifications, examinations and regulatory oversight. Reforms in the former category seek to mitigate the type of risk that may have a "direct and significant" connection with the United States, while reforms in the latter category are adapted to each specific jurisdiction and thus lack such a "direct and significant" connection with the United States. Based upon this distinction, the White Paper recommends that regulations addressing market and trading practices should be of secondary importance when the CFTC determines the extraterritorial application of its swaps rules.

- **Principle 2:** *The CFTC should pursue multilateralism, not unilateralism, for swaps reforms that are designed to mitigate systemic risk.*

  The White Paper suggests that the CFTC pursue multilateralism in its cross-border approach and exercise deference to the regulatory frameworks of its non-U.S. counterparts. Comity, not uniformity, should inform the CFTC's approach and it should ensure that its rules do not unnecessarily conflict with the rules of its non-U.S. counterparts. Multilateralism also requires the CFTC to be committed to the work of international bodies, such as the International Organization of Securities Commissions (IOSCO) and Financial Stability Board (FSB) and other governmental or industry groups such as the committee on Payments and Market Infrastructures (CPMI)-IOSCO, the Basel Committee on Banking Supervision (BCBS)-IOSCO, and the OTC Derivatives Coordination Group, as high-quality international standards can facilitate regulatory coordination between the CFTC and non-U.S. regulatory bodies.

- **Principle 3:** *The current division of global swaps market 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 rules and under one competent regulator*.

  According to the White Paper, the implementation of the CFTC's swap execution facility (SEF) regime in 2013 and mandatory SEF trading in 2014 has caused fragmentation of global swaps markets. Major financial centers around the globe have been forced to create separate execution facilities for U.S. market participants and non-U.S. market participants to engage in swaps trading. Such fragmentation not only increases price and transaction volatility, but also diminishes these markets' resilience in the event of global market shocks. The White Paper advocates that this fragmentation should be reduced by having each regulatory jurisdiction that has adopted G20 swaps reforms function as a unified marketplace with one set of comparable trading rules.

- **Principle 4:** *The CFTC shall be a rule maker, not a rule taker, in overseeing U.S. markets*.

  The CFTC is statutorily empowered to oversee and regulate the U.S. derivatives trading markets, and therefore entitled to the deference of non-U.S. regulators for its regulation of activities conducted within the U.S. The White Paper observes that, while it should work cooperatively with international efforts and seek to reconcile its rules with those adopted by non-U.S. regulators, the CFTC has discretion to impose regulation different from that of its non-U.S. counterparts if the CFTC deems it appropriate to do so.

- **Principle 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*.

  Substituted compliance is a key component of the CFTC's cross-border approach, allowing non-U.S. entities to satisfy the CFTC's requirements by complying with comparable rules promulgated by regulatory bodies in their home jurisdictions. So far, however, the CFTC has conducted its substituted compliance analysis through "granular, rule-by-rule comparison," without tailoring its approach to different types of requirements. The White Paper recommends a bifurcated approach to substituted compliance analysis. For requirements that address jurisdiction-specific market and trading practices, the CFTC should adopt a more flexible standard, focusing on whether a non-U.S. regulator's regime, in the aggregate, can achieve comparable regulatory outcomes to CFTC regulation. By contrast, for requirements that address systemic risk, such as requirements for regulatory reporting, the standard should be stricter and the CFTC should look into the details of the regulation of its non-U.S. counterparts. The non-U.S. regulator must show a high degree of comparability to achieve substituted compliance for these requirements.

- **Principle 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 advocates deference for non-U.S. jurisdictions that have adopted G20 swaps reforms comparable to the CFTC's regime. For non-U.S. jurisdictions that have not adopted such reforms, the White Paper recommends applying U.S. rules to U.S.-related entities, subject to materiality thresholds, instead of taking a deferential approach.

SPECIFIC RECOMMENDATIONS

Based on the six principles set forth above, the White Paper makes certain recommendations for the CFTC's cross-border approach to non-U.S. central counterparties ("CCPs"), non-U.S. trading venues, non-U.S. swap dealers, clearing and trade execution requirements and ANE transactions. The recommendations follow a general framework that would seek to impose regulation based on whether the regulated entities or swap activities are based in (1) the United States, (2) a Comparable Jurisdiction (jurisdictions that have adopted reforms comparable to the CFTC's regime) or (3) a Non-Comparable Jurisdiction (jurisdictions that have not adopted reforms comparable to the CFTC's regime).

Key recommendations of the White Paper are described below, and the definitions of certain key terms used in the White Paper are attached to this Memorandum as Appendix A.

Non-U.S. Central Counterparties

In 2016, the CFTC and the European Commission (the "EC") agreed to a common approach to cross-border swaps CCPs (the "2016 Agreement"). The White Paper acknowledges the historical significance of the 2016 Agreement and recommends that the CFTC build upon the 2016 Agreement and its framework of comity to develop a new approach towards the cross-border regulation of non-U.S. CCPs.

1) United States

The CFTC should continue to require a CCP located within the United States that seeks to clear swaps to register with the CFTC and be subject to the CFTC's full oversight and regulation.

2) Comparable Jurisdictions

Title VII of the Dodd-Frank Act permits the CFTC to exempt a non-U.S. CCP from registration for the clearing of swaps if the CFTC determines that the CCP is subject to "comparable, comprehensive supervision and regulation" by appropriate government authorities in the CCP's home country. The comparability determination focuses on whether the home country's supervisory and regulatory framework can achieve a "comparable outcome" as the CFTC's regulation of registered Derivatives Clearing Organizations ("DCO"). In the past the CFTC has already exercised its authority to exempt certain non-U.S. CCPs, but the White Paper recommends that the CFTC expand the use of this authority for non-U.S. CCPs that do not pose substantial risk to the U.S. financial system. Under the proposed approach, exempted non-U.S. CCPs would be permitted to provide clearing services to U.S. customers indirectly through non-U.S. clearing members, without the non-U.S. CCP or its non-U.S. clearing members having to register as a DCO or Futures Commission Merchant ("FCM"), respectively.

However, non-U.S. CCPs that clear swaps for U.S. persons and are deemed by the CFTC to "pose substantial risk specific to the U.S. financial system" would continue to be required to register with and be regulated by the CFTC, even if they are located in a Comparable Jurisdiction.

3) Non-Comparable Jurisdictions

For non-U.S. CCPs in Non-Comparable Jurisdictions that seek to clear swaps for U.S. persons, the White Paper recommends that they be required to register as DCOs with the CFTC. The White Paper also suggests that the CFTC consider providing relief from DCO registration for non-U.S. CCPs whose members are foreign branches of U.S. banks that are registered as swap dealers (the "Foreign Branches"). The Foreign Branches would be required to limit their clearing activities to proprietary and affiliate accounts or clearing customers that are non-U.S. persons. The relief is also subject to reporting by the non-U.S. CCPs and the negotiation and execution of a Memorandum of Understanding (MOU) with the non-U.S. CCP's home country regulator.

Non-U.S. Trading Venues

Under the Commodity Exchange Act (the "CEA"), no person may operate a facility for the trading or processing of swaps unless the facility is registered as an SEF or designated contract market (DCM). The CFTC currently requires registration of all non-U.S. trading venues, and some non-U.S. trading platforms have excluded U.S. market participants in order to avoid compliance with this registration requirement. To remedy this situation, the White Paper proposes the following changes:

1) United States

For swap trading venues located within the United States that meet the definition of SEF in Section 1a(50) of the CEA, the CFTC should continue to require registration as an SEF or DCM with the CFTC.

2) Comparable Jurisdictions

Title VII of the Dodd-Frank Act permits the CFTC to exempt, conditionally or unconditionally, a non-U.S. swaps trading venue from registration based on the CFTC's comparability determination. The White Paper recommends a general exemption from SEF registration for non-U.S. trading venues that are regulated in Comparable Jurisdictions with respect to all types of swaps. This would permit non-U.S. trading venues to have U.S. participants without being required to register with the CFTC, and would also permit U.S. participants to satisfy their trade execution requirements on those platforms.

3) Non-Comparable Jurisdictions

The White Paper recommends the general approach of requiring non-U.S. trading venues in Non-Comparable Jurisdictions to register as SEFs or DCMs "if they provide U.S. persons access to the trading venue directly or indirectly through a non-U.S. intermediary, subject to an appropriate materiality threshold." While the precise standard for the materiality threshold should be determined by the CFTC based on appropriate data, it should be based on "a level of trading involving U.S. persons that does not meet the Section 2(i) 'direct and significant' standard," so as to allow non-U.S. trading venues in Non-Comparable Jurisdictions to provide trading services to U.S. persons on a limited basis without registration.

Non-U.S. Swap Dealers

A person is deemed to be a swap dealer as a result of its swap dealing activity if, during the preceding 12 months, the aggregate gross notional amount of the swap dealing exceeds the *de minimis* threshold. The rule's domestic application is relatively straightforward. Extraterritorially, the CFTC has divided non-U.S. swap dealers into three categories based on the different levels of risk they pose to the United States: Guaranteed Entities, Foreign Consolidated Subsidiaries (FCS) and Other Non-U.S. Persons. The White Paper points out that the current approach of the CFTC with respect to non-U.S. swap dealers fails to properly take into consideration whether the activity of non-U.S. swap dealers truly poses a "direct and significant" risk to the U.S. financial system and is therefore overly broad in its application. To properly assess whether an activity poses a "direct and significant" risk, the White Paper makes the following recommendations:

1) United States

The CFTC should continue to require U.S. persons to count all of their swap dealing transactions toward the *de minimis* threshold, including transactions conducted through a Foreign Branch, whether with U.S. or non-U.S. persons.

2) Comparable Jurisdictions

Guaranteed Entities should be required to count all of their swap dealing activity toward their *de minimis* threshold, regardless of the status of their counterparties. FCSs and Other Non-U.S. Persons should be required to count swap dealing activity with U.S. persons and Guaranteed Entities, except swaps with: (1) Guaranteed Entities that are registered as swap dealers (or are affiliated with a registered swap dealer); (2) Guaranteed Entities that are guaranteed by a non-financial guarantor; or (3) Foreign Branches of U.S. banks that are registered as swap dealers. Guaranteed Entities, FCSs and Other Non-U.S. Persons should be able to rely on substituted compliance with respect to applicable requirements. In addition, all non-U.S. dealers should be permitted to exclude from their *de minimis* threshold swaps executed anonymously on a registered or exempt SEF, DCM, or Foreign Boards of

Trade (FBOT) and cleared by a registered or exempt clearing organization, even if the dealing activity involves U.S. persons.

3) Non-Comparable Jurisdictions

For Guaranteed Entities and Other Non-U.S. Persons in Non-Comparable Jurisdictions, the recommended approach is the same as that in Comparable Jurisdictions. The treatment of FCSs is more complex, and depends on the status of an FCS. For example, FCSs that are part of bank holding companies and are subject to consolidated supervision and regulation by the Federal Reserve Board should be permitted to limit the swaps they would need to count toward its *de minimis* threshold (possibly subject to a materiality threshold). For FCSs that are part of non-financial organizations headquartered in the United States, it may be appropriate to treat them as Other Non-U.S. Persons as they do not pose systemic risk to the U.S. financial system.

Clearing and Trade Execution Requirements

The White Paper points out that swaps clearing and trade execution requirements have different policy objectives – "swaps clearing is focused primarily on managing and mutualizing the accumulation of counterparty credit risk; whereas swaps trade execution is primarily concerned with market integrity and trade practice issues." Based on this distinction, the White Paper recommends the following approach:

1) United States

For U.S. persons (including Foreign Branches), the CFTC's swaps clearing and trade execution requirements should remain unchanged for all applicable swaps, unless an exception or exemption applies.

2) Comparable Jurisdictions

Substituted compliance would allow a non-U.S. person, including a Guaranteed Entity and an FCS, in Comparable Jurisdictions to satisfy the CFTC's clearing and trade execution requirements by complying with the rules of its home jurisdiction. Because of the different policy objectives of clearing and trade execution requirements, the CFTC must apply different standards when engaging in substituted compliance analysis – a stricter standard for reviewing clearing requirements and a more flexible, outcome-focused standard for reviewing trade execution requirements.

3) Non-Comparable Jurisdictions

The application of the CFTC's swap clearing requirements in Non-Comparable Jurisdictions is more complex. All swaps of Foreign Branches that are subject to the clearing requirements should continue to be subject to such requirements, except for swaps with Other Non-U.S. Persons in Non-Comparable Jurisdictions, which are subject to the clearing requirements only if they meet a materiality threshold. The CFTC's clearing requirements would also apply to all applicable swaps between Guaranteed Entities and: (1) U.S. persons, including Foreign Branches; (2) Guaranteed Entities; and (3) Other Non-U.S. Persons, unless the swaps are subject to initial and variation margin requirements for uncleared swaps that are consistent with the standards established by the BCBS-IOSCO Working Group on Margining Requirements. The same treatment applies to all applicable swaps between Other Non-U.S. Persons and (1) U.S. persons, including Foreign Branches and (2) Guaranteed Entities. The White Paper notes that the clearing requirements for FCSs will need to be developed by the CFTC at a later time, as the correct approach will depend on the treatment of FCSs under other CFTC cross-border rules.

ANE Transactions

The White Paper advocates a territorial approach to the regulation of ANE Transactions (swap transactions between two non-U.S. counterparties that are "arranged, negotiated, or executed" within the United States by personnel or agents of a non-U.S. person located in the United States). The White Paper notes that its suggestions for ANE Transactions should be read in conjunction with the proposals put forth in the April 2018 CFTC White Paper, written by Chairman Giancarlo and Bruce Tuckman, titled "Swaps Regulation Version 2.0: An Assessment of the Current Implementation of Reform and Proposals for Next Steps."

Chairman Giancarlo sets forth two preliminary points for the proposed approach to regulating ANE Transactions: first, if a swap is executed in the United States, the territorial approach would require the counterparties to follow the CFTC trade execution rules; second, ANE Transactions, by their definition, do not pose systemic risk to the U.S. financial system and should not be counted toward the *de minimis* threshold for non-U.S. dealers in Comparable Jurisdictions. The White Paper then analyzes two scenarios where ANE Transactions may occur:

1. A third-party U.S. intermediary located in the United States, such as an Introducing Broker (IB), arranges or negotiates swaps among multiple non-U.S. participants.

   In this scenario, the U.S. intermediary should be an SEF under the approach to SEF registration advocated in the April 2018 White Paper, and the execution of the trade would be subject to the rules of the SEF.

2. A U.S.-based agent/employee of a non-U.S. swap dealer arranges or negotiates a swap by the non-U.S. swap dealer with a non-U.S. person, where the trade is executed and booked outside the United States.

   The U.S.-based agent/employee's activity happens within the United States, which makes this transaction a U.S. trade and subject to U.S. execution rules under the White Paper's territorial approach.

Based on the principles set forth in the White Paper, Chairman Giancarlo intends to direct the CFTC staff to develop and publish new rule proposals to address a range of cross-border issues in swaps reform – from the registration and regulation of swap dealers and major swap participants to the registration of non-U.S. CCPs and swaps trading venues. The resulting rulemakings would replace the cross-border guidance issued by the CFTC in 2013 and the cross-border rules proposed by the CFTC in 2016, as well as address certain positions taken in CFTC staff advisories and no-action letters.

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CONTACTING SULLIVAN & CROMWELL LLP

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CONTACTS

New York		
Whitney A. Chatterjee	+1-212-558-4883	chatterjeew@sullcrom.com
David J. Gilberg	+1-212-558-4680	gilbergd@sullcrom.com
Kenneth M. Raisler	+1-212-558-4675	raislerk@sullcrom.com
Rebecca J. Simmons	+1-212-558-3175	simmonsr@sullcrom.com
William D. Torchiana	+1-212-558-4056	torchianaw@sullcrom.com
Christine Trent Parker	+1-212-558-3631	parkerc@sullcrom.com
Ryne V. Miller	+1-212-558-3268	millerry@sullcrom.com
Daniel M. Wolf	+1-212-558-4815	wolfd@sullcrom.com
Washington, D.C.		
Eric J. Kadel, Jr.	+1-202-956-7640	kadelej@sullcrom.com
Samuel R. Woodall III	+1-202-956-7584	woodalls@sullcrom.com
Australia		
Robert Chu	+61-3-9635-1506	chur@sullcrom.com
Waldo D. Jones Jr.	+61-2-8227-6702	jonesw@sullcrom.com
Beijing		
Gwen Wong	+86-10-5923-5967	wonggw@sullcrom.com
Frankfurt		
Krystian Czerniecki	+49-69-4272-5525	czernieckik@sullcrom.com
Wolfgang Feuring	+49-69-4272-5511	feuringw@sullcrom.com
Hong Kong		
Michael G. DeSombre	+852-2826-8696	desombrem@sullcrom.com

London		
Vanessa K. Blackmore	+44-20-7959-8480	blackmorev@sullcrom.com
Paris		
William D. Torchiana	+33-1-7304-5890	torchianaw@sullcrom.com
Tokyo		
Izumi Akai	+81-3-3213-6145	akaii@sullcrom.com

Appendix: Core Definitions

U.S. Person Definition

"U.S. person" is defined to mean:

1. A natural person who is a resident of the United States;
2. An estate of a decedent who was a resident of the United States at the time of death;
3. A corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund or any form of entity similar to any of the foregoing (other than an entity described in paragraph (1) or (5) (legal entity), in each case that is organized or incorporated under the laws of the United States or that has its principal place of business in the United States, including any branch of the legal entity;
4. A pension plan for the employees, officers or principals of a legal entity described in paragraph (3) above, unless the pension plan is primarily for foreign employees of such entity;
5. A trust governed by the laws of a state or other jurisdiction in the United States, if a court within the United States is able to exercise primary supervision over the administration of the trust;
6. A legal entity (other than a limited liability company, limited liability partnership or similar entity where all of the owners of the entity have limited liability) that is owned by one or more persons described in paragraphs (1) through (5) above and for which such person(s) bears unlimited responsibility for the obligations and liabilities of the legal entity, including any branch of the legal entity; or
7. An individual account or joint account (discretionary or not) where the beneficial owner (or one of the beneficial owners in the case of a joint account) is a person described in paragraphs (1) through (6) above.

Definition of Foreign Branch

A "foreign branch" is a non-U.S. branch of a U.S. swap dealer that:

1. Is a "foreign branch," as defined in the applicable banking regulation, of a U.S. bank that is subject to Regulation K or the FDIC International Banking Regulation;
2. Maintains accounts independently of the home office and of the accounts of other foreign branches, with the profit or loss accrued at each branch determined as a separate item for each foreign branch; and
3. Is subject to substantive regulation in banking or financing in the jurisdiction where it is located.

The CFTC also will consider other relevant facts and circumstances.

Meaning of the Term "Guaranteed"

A "guarantee" would include arrangements, pursuant to which one party to a swap has rights of recourse against a guarantor, with respect to its counterparty's obligations under the swap. For these purposes, a party to a swap has rights of recourse against a guarantor if the party has a conditional or unconditional legally enforceable right to receive or otherwise collect, in whole or in part, payments from the guarantor with respect to its counterparty's obligations under the swap.

This "guarantee" definition also encompasses any arrangement pursuant to which the guarantor itself has a conditional or unconditional legally enforceable right to receive or otherwise collect, in whole or in part, payments from any other guarantor with respect to the counterparty's obligations under the swap.

The Definition of "Foreign Consolidated Subsidiary"

"Foreign consolidated subsidiary" is defined to mean 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.

The term "U.S. ultimate parent entity" is defined to mean the parent entity in a consolidated group in which none of the other entities in the consolidated group has a controlling interest, in accordance with U.S. generally accepted accounting principles.