

CFTC chair authors white paper on cross-border swaps regulation reform

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Introduction

On 1 October 2018 Commodity Futures Trading Commission (CFTC) Chair J Christopher Giancarlo released a white paper recommending potential reforms to the agency's approach to the extra-territorial, or cross-border, application of its swaps trading rules.⁽¹⁾ The proposed reforms take into account criticism of the CFTC's current approach to the cross-border application of its rules, as well as regulatory developments in other jurisdictions. According to Giancarlo, the reforms are intended to create a territorial, risk-based approach that relies on greater deference to regulators in jurisdictions with comparable regulatory frameworks (comparable jurisdictions), where appropriate. The white paper makes general proposals in several areas, including registration requirements for non-US central counterparties (CCPs), trading venues and swap dealers, clearing and trade execution requirements and transactions between non-US persons that are arranged, negotiated or executed within the United States (ANE transactions).

Giancarlo noted that he expects CFTC staff to draft rule proposals based on the principles and recommendations set out in the white paper. However, no timeline has been provided and formal proposals will require action from the CFTC as a whole.

Background

While Giancarlo has expressed his general support for post-crisis swaps reforms implemented under Title VII of the Dodd-Frank Act and agreed to at the 2009 G20 Pittsburgh Summit, he has also expressed concern over the CFTC's implementation of such reforms in its 2013 Cross-Border Guidance⁽²⁾ and 2016 Proposed Cross-Border Rules.⁽³⁾ Specifically, he takes issue with the fact that the CFTC's approach to cross-border swaps regulation:

- is expressed in less-formal guidance rather than formal rulemakings;
- is unnecessarily complex;
- overlaps with regulation from foreign regulators; and
- insufficiently defers to foreign regulators, particularly those in comparable jurisdictions.

In the white paper, Giancarlo states that the CFTC's approach often forces global market participants to comply with burdensome CFTC regulations, even in situations where their activity does not present a systemic risk to the US markets. This, he argues, has led to the unintended consequences of driving global market participants away from transacting with entities subject to CFTC swaps regulation and fragmenting global swaps markets.

The white paper also complements another white paper published by Giancarlo and CFTC Chief Economist Bruce Tuckman in April 2018 on potential reforms to the CFTC's domestic swaps trading rules, which did not address the cross-border application of the rules (for further details please see

AUTHORS

[Donna M Parisi](#)



[Geoffrey B Goldman](#)



[Azam H Aziz](#)



[Jennifer Oosterbaan](#)



White paper

In the white paper, titled Cross-Border Swaps Regulation Version 2.0, Giancarlo sets out several guiding principles. These include:

- recognising the distinction between swaps reforms focused on systemic risk and reforms intended to address market and trading practices;
- pursuing multilateralism for swaps reforms intended to mitigate systemic risk;
- acting as a rulemaker overseeing US markets, in that the CFTC determines appropriate regulation for US swaps markets and market participants;
- acting with deference towards non-US regulators in comparable jurisdictions, with stricter comparability requirements for regulations that address systemic risk and more flexible substituted compliance standards for regulations relating to market and trading practices; and
- encouraging regulators in non-US markets to adopt G20 swaps reform for any significant swaps trading activity, if they have yet to do so.

Following these principles, Giancarlo breaks his suggested improvements down into five sections, including:

- non-US CCPs;
- non-US trading venues;
- non-US swap dealers;
- clearing and trade execution requirements; and
- ANE transactions.

Giancarlo generally advocates a different approach to each of these categories depending on whether swaps activity involves parties based in the United States, comparable jurisdictions or jurisdictions that do not have comparable regulatory standards to the United States (non-comparable jurisdictions).

Non-US CCPs

In the white paper, Giancarlo argues that overlapping regulation and supervision of CCPs on a cross-border basis creates inefficiencies that may limit access to CCPs and increase costs for market participants.

He recommends that the CFTC expand the use of its authority to exempt non-US CCPs in comparable jurisdictions from registration with the CFTC. Although the CFTC has granted certain such exemptions, it has to date limited clearing by such CCPs to proprietary positions of US clearing members and not positions of US customers. The approach taken in the white paper would expand exemptions to permit non-US CCPs to provide clearing services to US customers indirectly through non-US clearing members without the need for the CCP or clearing member to register with the CFTC as a derivatives clearing organisation or futures commission merchant, respectively. However, any non-US CCP that clears swaps for US persons and is deemed to pose substantial risk would still be subject to CFTC oversight and registration requirements.

The white paper reiterates concerns previously expressed⁽⁵⁾ regarding a European Commission proposal that would provide European regulators with greater regulatory and supervisory authority over third-country CCPs, including those located in the United States, in certain circumstances. Giancarlo criticises the European Commission for seeking to apply European law to US financial markets and for failing to honour the common approach to cross-border swaps that was agreed to by the CFTC and the European Commission in 2016.⁽⁶⁾ He instead calls on the European Commission to build on the 2016 agreement and practice deference to regulators in comparable jurisdictions.

In respect of CCPs in non-comparable jurisdictions, Giancarlo generally recommends that they should be required to register with the CFTC as derivatives clearing organisations in order to provide access to US persons. However, he added that he would like to provide temporary relief from derivatives clearing organisation registration to non-US CCPs whose members are foreign branches of US banks that are registered with the CFTC as swap dealers.

Non-US trading venues

Giancarlo claims that the CFTC's current requirement that non-US swap trading venues with US participants register with the CFTC has led to non-US trading venues denying service to US firms, which he believes has fragmented global swaps markets. To remedy this, Giancarlo proposes generally exempting non-US trading venues regulated in comparable jurisdictions from the CFTC's swap execution facility (SEF) registration requirements for all types of swap. This would allow non-US trading venues to have US participants without being subject to such requirements. Further, he would permit the execution of swaps that are subject to the trade execution requirement on such venues. With respect to rules addressing market and trading practices, the CFTC would defer to the trading venue's local regulator.

Swap trading venues in non-comparable jurisdictions would still have to register with the CFTC as SEFs or designated contract markets if they provide access to US persons directly or indirectly through a non-US intermediary. However, the white paper suggests that this requirement should be subject to a materiality threshold, which would permit trading venues in non-comparable jurisdictions to provide services to US persons on a limited basis without having to register with the CFTC.

Non-US swap dealers

The white paper also proposes certain changes to the application of the CFTC's registration requirements and the *de minimis* exemption from registration for non-US swap dealers. The paper would retain the requirement that dealing activity by a non-US person with US persons counts towards the registration threshold. However, the proposal would change the approach to dealing activity with certain classes of non-US persons that have a US connection.

Specifically, Giancarlo criticises the current approach of counting a range of activity that may be connected to a US person, regardless of whether that activity poses a substantial risk to the US financial markets. He also criticises the 2016 Proposed Cross-Border Rules as potentially exacerbating that problem, as they would have required non-US persons to count towards their *de minimis* threshold all of their swaps activity with non-US persons that are foreign consolidated subsidiaries of US persons (FCS), subject only to limited exceptions.

Giancarlo instead recommends that the registration requirement should apply as follows:

- US persons and non-US persons whose swaps are guaranteed by a US person (guaranteed entities) should have to count all of their swap dealing activity towards the *de minimis* threshold, as under the current approach.
- In comparable jurisdictions, non-US persons (including FCS) that are not guaranteed entities should count all of their swap dealing activity with US persons and guaranteed entities, except swaps with:
 - guaranteed entities registered as, or affiliated with, a registered swap dealer;
 - guaranteed entities that are guaranteed by a non-financial guarantor; or
 - foreign branches of US banks that are registered as swap dealers.
- Swaps executed anonymously on registered trading venues and cleared should be exempt from all non-US persons' *de minimis* threshold calculations, even if the dealing activity involves US persons.
- For non-comparable jurisdictions, the same approach would generally apply, but the white paper leaves open the question of how transactions involving FCS should be treated.

Clearing and trade execution requirements

Giancarlo's approach to the application of clearing and trade execution requirements on a cross-border basis centres on the idea that swaps clearing manages systemic risk, whereas swaps execution is more concerned with market and trading practice issues. Accordingly, while he contemplates greater reliance on the use of substituted compliance with respect to the clearing and trade execution requirements, standards for the clearing requirement should be stricter than those for the trade execution requirement.

The white paper sets out a revised framework for the application of the clearing and trade execution requirements, based on the types of entity and jurisdiction involved:

- US persons would remain subject to the CFTC mandatory clearing and trade execution requirements for covered transactions, unless an exemption (eg, the end-user exemption) is otherwise available. A transaction between a US person and a non-US person could be cleared on a non-US CCP that had been exempted by the CFTC and could be traded on a non-US facility exempt from SEF registration.
- In comparable jurisdictions, non-US persons (including guaranteed entities and FCS) should be eligible for substituted compliance with local clearing and trade execution requirements. As noted above, the white paper argues for a stricter comparability analysis for clearing than for exchange trade requirements.
- In non-comparable jurisdictions, the CFTC clearing requirement should generally apply to covered swaps of:
 - foreign branches of US swap dealers, subject to a materiality threshold;
 - guaranteed entities if the counterparty is a US person (including foreign branches), another guaranteed entity or a non-US person, unless the swaps are subject to initial and variation margin requirements; and
 - other non-US persons if the counterparty is a US person or guaranteed entity, unless those swaps are subject to similar margin requirements.
- The treatment of FCS is left undetermined and may depend on how they end up being treated for other purposes (eg, the swap dealer registration requirements).

The white paper also does not reach a conclusion on how the trade execution requirement should apply for transactions involving non-comparable jurisdictions and suggests that it may be best to deal with entities in such jurisdictions on a case-by-case basis.

ANE transactions

The white paper addresses a longstanding question as to whether, and how, ANE transactions should be subject to US requirements. Controversially, CFTC staff suggested in 2013 that such transactions should be subject to US transaction-level requirements, but implementation of that approach has been repeatedly postponed following significant market criticism.

The white paper generally supports the view that if a swap is executed in the United States, even between two non-US persons, the US swap execution rules (including clearing and trade execution) should apply. The paper thus takes a territorial approach to US jurisdiction, in furtherance of a general view that there should be a single US market place under one set of trading rules with one regulator (the CFTC).

The white paper does contemplate certain potential exceptions. For example, it argues that ANE transactions should not count towards a non-US entity's swap dealer *de minimis* threshold if the entity is located in a comparable jurisdiction, as such transactions should not pose a systemic risk to the US financial system.

Giancarlo also discusses two scenarios to clarify his stance on ANE transactions. First, if a third-party US intermediary (ie, an introducing broker) arranges or negotiates swaps among multiple non-US participants, he argues that the US intermediary should be required to register with the CFTC as a SEF on the basis that price formation occurs within the United States. Second, if a US-based agent or employee of a non-US swap dealer arranges or negotiates a swap with a non-US person, Giancarlo believes that the activity of the US-based agent or employee makes the swap a US trade subject to CFTC requirements. However, in the latter scenario, he leaves open the possibility, without elaboration, of potential deference to a foreign regulator if the entity is located in a comparable jurisdiction. The white paper suggests that CFTC staff must consider the range of ANE transaction situations further in the development of proposed rules, with the goal of avoiding fragmenting swaps markets within the United States and imposing unnecessary costs on market participants.

Comment

Giancarlo's white paper consolidates a number of positions that he has expressed from time to time as to the proper scope of US regulation of the global swap markets. It also reflects both a goal of greater deference to regulators in comparable jurisdictions and at the same time a clear assertion of authority (and exclusive authority) over activity in the US market. He has said that he hopes that

rules proposed in light of these recommendations will supplant the CFTC's 2013 Cross-Border Guidance and the 2016 Proposed Cross-Border Rules. Such rulemakings will require action by the full CFTC, and the views of the other commissioners on these matters (including new Commissioners Dan Berkovitz and Dawn Stump) are uncertain. The views of market participants and other regulators will also likely be taken into account. As a result, it could be some time before new rulemakings are proposed or finalised.

For further information on this topic please contact [Donna M Parisi](mailto:dparisi@shearman.com), [Geoffrey B Goldman](mailto:geoffrey.goldman@shearman.com), [Azam H Aziz](mailto:aaziz@shearman.com) or [Jennifer Oosterbaan](mailto:jennifer.oosterbaan@shearman.com) at Shearman & Sterling LLP by telephone (+1 212 848 4000) or email (dparisi@shearman.com, geoffrey.goldman@shearman.com, aaziz@shearman.com or jennifer.oosterbaan@shearman.com). The Shearman & Sterling LLP website can be accessed at www.shearman.com.

Endnotes

(1) See CFTC, "Chairman Giancarlo Releases Cross-Border White Paper" (1 October 2018), available [here](#).

(2) Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed Reg 45292 (26 July 2013), available [here](#).

(3) Cross-Border Application of the Registration Thresholds and External Business Conduct Standards Applicable to Swap Dealers and Major Swap Participants, 81 Fed Reg 71946 (18 October 2016), available [here](#).

(4) See CFTC, "CFTC Chairman Unveils Reg Reform 2.0 Agenda" (26 April 2018), available [here](#).

(5) See Giancarlo, "Deference is the Path Forward in Cross-Border Supervision of CCPs" (11 September 2017), available [here](#) and Quintenz, "Keynote Address of Commissioner Brian Quintenz before FIA Annual Meeting, Boca Raton, Florida" (14 March 2018), available [here](#).

(6) See Joint Statement from CFTC Chair Timothy Massad and European Commissioner Jonathan Hill, "The United States Commodity Futures Trading Commission and the European Commission: Common Approach for Transatlantic CCPs (10 February 2016)", available [here](#).

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