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OTC Derivatives Regulation and Extraterritoriality

The US and EU are currently introducing comprehensive new measures to regulate over-the-counter derivatives. Both the US and EU measures have some degree of extraterritorial application. In the absence of agreement between the US and EU regulators, extraterritoriality has the potential to cause intractable and irreconcilable conflicts for the derivatives industry. This note sets out some of the situations in which extraterritoriality is likely to result in such conflicts.

Introduction

On 21 July 2010, The Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**") was enacted in the USA. Title VII of Dodd-Frank sets out a comprehensive reform of the over-the-counter ("**OTC**") derivatives market. Shortly afterwards, on 15 September 2010, the European Commission published a proposal for a new regulation on OTC derivatives, known as the European Market Infrastructure Regulation ("**EMIR**") and various further drafts have subsequently been published.[1] Both Dodd-Frank and EMIR seek to implement the commitments made by G20 leaders for the standardisation and clearing of all OTC derivatives contracts by the end of 2012. Certain provisions of Dodd-Frank took effect on 16 July 2011,[2] although most provisions will be effective once the required rules have been made by federal regulators. EMIR currently has no timeframe for enactment, although the European Commission has committed to meet the G20 timeframe. Unlike in the US, many aspects of OTC derivatives trading, advice and dealing are already regulated in Europe, so this measure focuses on clearing. Certain EU reforms in relation to OTC derivatives, including an exchange trading requirement for standardised OTC derivatives, will be implemented though a set of amendments to the Markets in Financial Instruments Directive (Directive 2004/39/EC, "**MiFID**"), generally referred to as MiFID II.[3]

Both Dodd-Frank and EMIR are likely to have some extraterritorial effect. The provisions of Title VII of Dodd-Frank (including rules and regulations made under it) relating to CFTC-governed swaps will not apply to activities outside the United States unless those activities either (a) have a direct and significant connection with activities in, or effect on, commerce in the United States; or (b) contravene CFTC rules intended to prevent evasion of US requirements.[4] Similarly, the provisions of Title VII (including any rules and regulations made under it) relating to SEC-governed security-based swaps will not apply to such swaps entered into outside the US, unless this contravenes SEC rules

1 This note discusses current versions of rule proposals under Dodd-Frank and the European Council's compromise text of the EMIR proposal. The final, definitive versions of the Dodd-Frank rules and EMIR, which will affect how the regimes eventually operate, are likely to differ from the versions discussed in this note.

2 Pending further rulemaking, the CFTC has granted temporary exemptive relief for the majority of those Title VII provisions that were scheduled to do so through the Effective Date for Swap Regulation [Final Order], 76 Fed. Reg. 42508 (19 July 2011).

3 The MiFID II proposals have been set out by the Commission in a Public Consultation (European Commission, Public Consultation, Review of the Markets in Financial Instruments Directive (MiFID), 8 December 2010). A legislative proposal is expected to be published in October 2011.

4 Dodd-Frank, section 722(d).

intended to prevent the evasion of US requirements.[5] It is currently unclear how EMIR will apply to foreign branches of EU-incorporated entities and EU branches of non-EU entities. Dodd-Frank and EMIR both impose a framework of clearing and reporting requirements on certain OTC derivatives transactions. Significant differences between the two regimes exist, however, particularly in relation to the application of the clearing requirement to non-financial institutions, margin and collateral rules, registration requirements for clearing houses, exchange trading and reporting requirements. Compliance with both sets of requirements is therefore a concern, although it is hoped that regulators on both sides of the Atlantic will continue to consider the need for global harmonisation. It is expected that the CFTC and SEC will provide some further guidance as to the extraterritorial application of US requirements, although the details and timing are uncertain. Legislators have also expressed concern about extraterritorial implications (and the possibility of disadvantaging US institutions (and their non-US subsidiaries) as compared to their non-US counterparts).[6] In the meantime, this note is intended to alert our clients to practical issues that may arise from overlapping US and EU regulatory jurisdiction.

5 Dodd-Frank, section 772(c).

6 See, e.g. Letter, dated 4 October 2011, from Sen. Johnson and Rep. Frank to the chairmen of the CFTC, SEC, Federal Reserve and FDIC.

A glossary of terms not previously defined is set out on page 7 below.

SCENARIO	APPLICABLE DODD-FRANK REQUIREMENTS	APPLICABLE EUROPEAN REQUIREMENTS	ASSOCIATED ISSUES
A non-US bank with a branch in the US operates a global booking model (whereby all swaps or security-based swaps executed by the bank or its affiliates are booked to the bank's home state branch).	The non-US bank may be required to register as a swap dealer or security-based swap dealer and thereby become subject to CFTC/SEC conduct of business regulation and prudential regulation, including capital and margin requirements. The applicability of these requirements to the non-US directed activities of a non-US bank is uncertain. It is unclear whether different branches and agencies of a foreign bank should be treated as the same person for purposes of swap dealer/security-based swap dealer designation. Other US legislation distinguishes between an agency, a branch and a foreign bank.[7]	If the foreign bank is established in the EU, it is likely that it will be subject to licensing under the various EU financial services directives such as the MiFID or the Banking Consolidation Directive (Directive 2006/48/EC). These directives, together with the Capital Adequacy Directive (Directive 93/6/EEC, as amended by Directive 98/31/EEC), impose conduct of business and prudential rules and regulations on EU investment firms and banks. These rules will apply to the foreign bank's activities in the EU and may in some cases also apply to activities outside the EU (e.g. in the case of prudential rules).	If the foreign bank has to register in the US, triggering US regulatory supervision over the foreign bank's activities in the EU, a conflict with EU competent authorities may arise. EU home state regulators are unlikely to defer to the assumption of jurisdiction by US regulators over activities to which local regulatory requirements apply. EU entities falling within the scope of Dodd-Frank capital requirements would also be subject to EU capital requirements. Duplicative calculation of capital could be required, even though the international standards agreed under Basel III are to be implemented in the EU (through CRD IV) and US. To avoid duplication of regulation, a foreign entity might create a separate subsidiary to handle US-based activity. The use of a subsidiary would require repapering of clients and transactions; it could also increase inefficiencies and systemic risk, as US customers of foreign banks may have a more thinly capitalised subsidiary as their counterparty. This would be a particular concern if separate subsidiaries were used across multiple jurisdictions. Extraterritorial laws often give rise to jurisdictional problems and spark responses from legislators elsewhere to prevent the extraterritorial application of those laws.[8] Given the global nature of financial sector businesses, the EU could take measures in response to the extraterritoriality of US regulations, which could be counterproductive. For example, the European Parliament proposed to require third country entities requesting information from an EU trade repository to indemnify the trade repository and EU authorities in respect of any legal costs arising from the provision of the information, apparently in response to a similar Dodd-Frank requirement.

7 See e.g. International Banking Act 1978, section 1(b).

8 For example, the extraterritorial application of US sanctions against Cuba so that any entity, wherever organised, that is owned or controlled by a US person is subject to such sanctions led to the EU adopting Regulation 2271/96 prohibiting EU entities from complying with certain extraterritorial US laws. No such measures exist in the financial regulatory sector, though this is possible in the future.

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Non-US branch of a US entity engages in a swap or security-based swap with a non-US entity.	US entities may be required to register as swap dealers or security-based swap dealers for all swaps or security-based swaps activities, respectively, and may be subjected to US regulation regardless of where they are carried out.[9] Activities of foreign branches of US entities with non-US persons could be subject to the Dodd-Frank requirements if they are subsidiaries or affiliates of US entities or have US clients. US regulators are likely to view the entity as a whole (including foreign branches) as subject to US jurisdiction. The PR Rules provide that transactions between a foreign dealer or MSP and a foreign counterparty are exempt from the requirement to post margin. However, foreign branches, offices, or subsidiaries of US persons and counterparties receiving a guarantee from US affiliates would not fall within the exclusion. Margin requirements apply to transactions between US bank dealers/MSPs and their counterparties regardless of location. The CFTC Rules do not distinguish between entities located inside or outside the US. The rules could therefore cover transactions between a foreign swap entity subject to the CFTC Rules and a foreign counterparty. Under the proposed margin rules, initial margin would need to be segregated[10] with an independent third-party custodian based in a jurisdiction applying the same insolvency regime as the posting (under PR Rules) or receiving (under CFTC Rules) swap participant.	Derivatives transactions between an EU person and a foreign branch of a US entity may be subject to EMIR. The extraterritorial scope of the clearing obligation in the most recent version of EMIR mirrors the Dodd-Frank wording. The obligation now applies to a transaction between a financial counterparty (or a non financial counterparty meeting the clearing threshold) and a non-EU entity that would be subject to the clearing obligation if it were established in the EU, or between two non-EU entities "*provided that the contract has a direct, substantial and foreseeable effect within the EU or where such obligation is necessary or appropriate to prevent the evasion of any provisions of*" EMIR. The contracts considered to fall within these categories will be specified in technical standards. The MiFID II proposal for a mandatory exchange-trading requirement for clearing-eligible and sufficiently liquid derivatives may also apply to contracts with non-EU persons where they are subject to the EMIR clearing obligation. The EMIR risk mitigation provisions for OTC transactions not cleared by a CCP include a requirement for financial counterparties (or non financial counterparties meeting the clearing threshold) to "*require the timely, accurate and appropriate exchange of collateral with respect to OTC derivatives contracts*". If requested by the other party to the transaction, the collateral must be segregated (separate recording in accounts is deemed sufficient) from the entity's own assets. These requirements will apply to non-EU entities on the same basis as the revised clearing obligation described above, resulting in potential duplication between EMIR and Dodd-Frank. Outside the EU, other local requirements will apply. In Japan, for example, certain OTC derivatives transactions must be cleared by a licensed domestic CCP.	Foreign branches of US entities may be subject to local regulation in the EU as well as US regulation of the overall entity. Local competent authorities are unlikely to defer to US regulators' jurisdiction over the affairs of branches in the EU, especially as regards conduct of business matters. Under MiFID II, a mechanism for harmonising access to EU markets for non-EU entities is proposed, subject to a strict equivalence regime. If a transaction is subject to both the EMIR mandatory clearing requirements and the Dodd-Frank clearing requirements, it may be difficult for parties to comply with both sets of requirements. If a swap is required to be executed under Dodd-Frank on a swap execution facility and on an EU-regulated trading platform under EU legislation, the platform would have to be approved under both pieces of legislation. Similar issues with conflicting local requirements could also arise for non-US persons incorporated outside the EU. It is usually possible to comply with differing requirements in relation to levels and acceptable forms of margin, but it may be difficult or impracticable for non-US entities to comply with aspects of the Dodd-Frank margin requirements, particularly in relation to segregation and appropriate custodians. The US segregation requirement may conflict with the EU practice of title transfer collateral arrangements. The potential for the ESMA technical standards to impose conflicting requirements could make matters more problematic. Non-US entities may have to avoid entering into transactions with branches of US entities in order to avoid becoming subject to Dodd Frank margin requirements.

9 Under Dodd-Frank, section 722(c) and (d).

10 Under the CFTC Rules this would be at the option of the counterparty.

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Foreign branch of a US entity engages in a swap with a non-US sovereign.	The proposed margin rules classify non-US sovereigns as financial end-users, and therefore subject to the margin requirement.	An exemption from the scope of EMIR applies to central banks of non-EU states in which derivatives contracts entered into with members of the European System of Central Banks are not subject to the clearing and reporting obligation. This means that where a non-EU state imposes clearing and reporting obligations on the central banks of countries within the Eurozone, EMIR will impose reciprocal obligations.	Non-US sovereigns may be reluctant to enter into derivatives transactions with US banks if this obliges them to post collateral. The EU appears to have responded to this in its more recent versions of EMIR by imposing similar requirements on third country sovereigns and public bodies.
Non-US entity deals in swaps with a US person.	The foreign entity (depending on its own US-related activities) could be subject to the Dodd-Frank requirements, either through the requirement to register as a swap dealer or security-based swap dealer, or classification as an MSP.	The foreign entity is likely to be subject to regulation in its home state as a bank or investment firm.	This is effectively the converse of the situation discussed at page 4 above and parallels the situation discussed on page 3 above. There is a clear imbalance where foreign entities are subject to US registration requirements, but US persons may not be subject to equivalent requirements in the jurisdictions of those foreign entities. This is likely to impose onerous burdens on such foreign entities and may deter them from transacting with US persons. The jurisdictions of those foreign entities may respond with retaliatory measures.
EU entity deals in swaps with US persons, or US entity transacts with an EU entity, in circumstances where the swap is subject to the EMIR clearing obligation.	The swap may be subject to the US mandatory clearing obligation as well as reporting requirements.	The EMIR mandatory clearing and reporting obligations apply to the transaction where the non-EU entity would be subject to the clearing obligation if incorporated in the EU.	If the swap must be cleared both by a registered EU CCP and by a US clearing house, the CCP would need to be both registered with ESMA and have DCO and/or SEC clearing agency status. If a swap is required to be executed under Dodd-Frank at a swap execution facility and on an EU-regulated trading platform under EU legislation, dual regulation for the execution venue would be required. EMIR contains mechanisms for recognising third country CCPs (e.g. US CCPs) and for grandfathering existing UK recognised overseas clearing houses. CCPs and platforms are presently facing considerable challenges in complying with conflicting US and EU regulatory requirements and supervisory processes. Under EMIR, a swap must be reported to an ESMA-registered trade repository, and under Dodd-Frank to a registered swap data repository. The parties will therefore need to report separately, leading to duplicative data submissions. Some repositories may consider providing a "one-stop shop" for reporting and holding data through different legal entities in both jurisdictions.

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Foreign dealer deals in swaps with a non-US person, but the transaction has some US connection.	A transaction may be deemed to have a "*direct and significant connection with activities in, or effect on*," commerce of the United States. Questions as to the scope of Dodd-Frank may arise in a variety of cross-border situations, including where: a) US persons are involved in activity related to a swap (potentially including sales, marketing, operations, back-office or similar functions) even if the party to the swap is not a US person); or b) A non-US person contacts a US-domiciled professional fiduciary that acts for a counterparty located outside the US. Questions have also been raised as to whether there could also be a US connection (although it is less likely), where there is a reference to a US underlier or reference entity in a transaction between non-US counterparties located outside the US. Where such a connection is identified, the Dodd-Frank registration, mandatory clearing/execution, and trade reporting requirements could apply.	If the swap is transacted between EU entities, it is likely to be subject to EMIR and MiFID II requirements.	See the conflicts noted above in relation to complying with both regimes. Applying the requirements of Dodd-Frank to US persons who merely provide administrative support could result in entities moving back-office or other operations away from the US or no longer locating administrative or support personnel in the US, even though such US persons do not create any risk for the US financial markets.

Glossary

The following definitions are for ease of reference only and are not intended to provide a complete definition of the relevant concepts.

US	CFTC	Commodity Futures Trading Commission.
	CFTC Rules	Rules proposed by the CFTC under Dodd-Frank, including sections 731 and 764 (Margin Requirements for Non-bank Swap Dealers and Major Swap Participants).
	DCO	Derivatives Clearing Organization, as defined in the Commodity Exchange Act.
	Financial end-user	An end-user (as opposed to a dealer) that is a financial entity.
	Major security-based swap participant	A person other than a security-based swap dealer who maintains a substantial position in security-based swaps (as defined in Dodd-Frank, section 721, subject to further definition by the SEC and CFTC).
	MSP	Major Swap Participant: a person other than a swap dealer who maintains a substantial position in swaps (as defined in Dodd-Frank, section 721, subject to further definition by the SEC and CFTC).
	PR Rules	Rules proposed by the Prudential Regulators under Dodd-Frank, sections 731 and 764, applicable to swap dealers, security-based swap dealers, major swap participants and major security-based swap participants that are banks and bank holding companies (Margin and Capital Requirements for Covered Swap Entities, 12 April 2011).
	SEC	Securities and Exchange Commission.
	Security-based swap	A swap based on an index that is a narrow-based security index, a single security or loan or on the occurrence, non-occurrence or extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index (as defined in Dodd-Frank, section 721, subject to further definition by the SEC and CFTC).
	Security-based swap dealer	A person which holds itself out as a dealer in security-based swaps, makes a market in security-based swaps, regularly enters into security-based swaps with counterparties for its own account in the ordinary course of business or is commonly known as a dealer or market maker in security-based swaps (as defined in Dodd-Frank, section 721, subject to further definition by the SEC and CFTC).
	Swap	A non-security based derivatives transaction (including interest rate, currency and commodity derivatives) as well as derivatives on broad-based security indices (such as index based credit default swaps) (as defined in Dodd-Frank, section 721, subject to further definition by the SEC and CFTC).
	Swap data repository	A centralised recordkeeping facility for swaps (as defined in Dodd-Frank, section 721).
	Swap dealer	A person which holds itself out as a dealer in swaps, makes a market in swaps, regularly enters into swaps with counterparties for its own account in the ordinary course of business or is commonly known as a dealer or market maker in security-based swaps (as defined in Dodd-Frank, section 721, subject to further definition by the SEC and CFTC).
	Swap execution facility	A trading system/platform that facilitates the execution of swaps (as defined in Dodd-Frank, section 721).
EU	ESMA	European Securities and Markets Authority.
	CRD IV	Capital Requirements Directive IV.
	Financial counterparty	As defined in EMIR, article 2 (includes banks, investment firms, credit institutions, insurers, registered UCITS funds, pension funds and alternative investment fund managers).
	Non-financial counterparty	As defined in EMIR, article 2, an entity established in the EU other than a financial counterparty.
	Trade repository	As defined in EMIR, article 2, a legal entity that centrally collects and maintains the records of OTC derivatives.
Miscellaneous	CCP	A central counterparty (also defined in EMIR, article 2).

This publication is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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