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Alert: Actions Required in Light of Derivatives Reforms

The OTC derivatives markets are undergoing significant change globally as a result of Title VII of Dodd-Frank[1], MiFID II[2], EMIR[3] and reforms in other jurisdictions. In particular, many OTC derivatives are moving to a centrally cleared environment and the manner in which financial institutions deal with their clients and take collateral will undergo various structural changes. This note is intended for all buy-side participants and corporates which use derivatives in their businesses. Various key aspects of the reforms that warrant particular attention are highlighted.[4]

Extraterritoriality

Both the new US and EU legislative regimes have an extraterritorial dimension in that they may capture over-the-counter ("**OTC**") trades which are executed outside their jurisdiction but have some sort of vaguely defined jurisdictional nexus. For example, EMIR subjects those trades to the clearing obligation within the EU that have been entered into between non-EU entities but which have a "direct, substantial and foreseeable effect" within the EU or because it is necessary to guard against anti-evasion of EMIR. What this provision means has not yet been clarified by ESMA, the EU authority responsible for drafting "technical standards" on these and other provisions in EMIR. Similarly, Title VII of Dodd-Frank purports to apply to activities outside the US which have a "direct and significant connection with activities in, or effect on, commerce in the US" or where they are intended to evade US requirements. The US Commodity Futures Trading Commission ("**CFTC**") has recently proposed guidance on the territorial reach of certain aspects of its rules, particularly those relating to swap dealer registration and the related regulatory requirements. Organizations or particular subsidiaries which have historically considered themselves not subject to either EU or US regulation may need to re-assess this and consider whether any steps should be taken, whether to avoid falling within the scope of new regulations, or to comply.

1 The Dodd–Frank Wall Street Reform and Consumer Protection Act.

2 EU proposals to reform the Markets in Financial Instruments Directive, dated 20 October 2011.

3 The European Market Infrastructure Regulation, which was published in the Official Journal of the European Union on 27 July 2012 and is known officially as "*Regulation (EU) NO 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories*".

4 If you wish to review further information regarding the various regulatory reforms, you may refer to our dedicated website http://www.shearman.com/dodd-frank/ and our client publications, which are available here.

US Registration and Related Requirements

Persons in the US who engage in swap dealing activity above a certain *de minimis* threshold (initially $8 billion in notional amount in a 12-month period) will be required to register as swap dealers. In its proposed cross-border guidance, the CFTC takes the view that, in most cases, a non-US entity need only count swap dealing activity with US persons to determine whether it exceeds the *de minimis* threshold (and requires to register). In parallel, a non-dealer whose swap trading exposure meets one of the specified thresholds is required to register as a major swap participant ("**MSP**"). In the context of a non-US person, however, the CFTC's proposed guidance states that only swaps with US persons as counterparties would count toward the relevant thresholds.

Clearly, a key aspect of the CFTC's guidance, and the analysis of whether US requirements may apply to a particular person, activity or transaction, is its definition of the term "US person". A non-US branch of a US person would be viewed as part of the same US person. Similarly, the US branch of a non-US person would generally be viewed as part of the same person and not a separate legal entity. The CFTC's guidance appears to take the position that a foreign person (including a subsidiary or affiliate) guaranteed by a US person is not itself automatically a US person (although transactions with foreign persons guaranteed by a US person may be subject to certain US requirements).

Another key aspect of determining whether dealer registration is required is the distinction between dealers and traders. Both the US Securities and Exchange Commission ("**SEC**") and CFTC have indicated that the so-called "dealer-trader" distinction, which has long been used in the context of securities dealer registration requirements, is also relevant for interpreting whether activity is swap dealing. Under this approach, evidence of swap dealing will include such activities as: (i) providing liquidity by accommodating demand for or facilitating interest in swaps, holding oneself out as willing to enter into swaps, or being known in the industry as being available to accommodate demand for swaps; (ii) advising a counterparty as to how to use swaps to meet the counterparty's hedging goals, or structuring swaps on behalf of a counterparty; (iii) having a regular clientele and actively advertising or soliciting clients in connection with swaps; (iv) acting in a market maker capacity on an organized exchange or trading system for swaps; and (v) helping to set the prices offered in the market (such as by acting as a market maker) rather than taking those prices (although the fact that a person regularly takes the market price for its swaps does not foreclose the possibility that the person may be a dealer).

Registered swap dealers and MSPs are subject to a number of regulatory requirements under the Commodity Exchange Act and CFTC regulations, some of which are "transaction-level" requirements while others are "entity-level" requirements. Recognizing that the application of either type of requirement may result in overlapping and potentially conflicting regulation, the CFTC has proposed permitting non-US swap dealers and MSPs to satisfy certain of those requirements through "substituted compliance" with their home jurisdiction's regulations, provided certain conditions are met. The possibility of relying on substituted compliance may relieve some burdens of duplicative or inconsistent regulations for non-US swap dealers and MSPs, at least for their transactions with non-US persons. The SEC is yet to issue guidance on its territorial reach in this area.

Mandatory Clearing and Exemptions

The CFTC has proposed the first wave of products that will be subject to a mandatory clearing requirement, including "plain vanilla" fixed-for-floating interest rate swaps, forward rate agreements and basis swaps denominated or settled in US dollars, Euro, pounds sterling or Yen; and CDX and iTraxx index credit default swaps. In Europe, the products to be subject to mandatory clearing have yet to be defined, but are expected to include these products and possibly others referencing commodities. If adopted, mandatory clearing for these products will be phased in over a period of 3-9 months, starting with trades among dealers and active funds. A number of these products are already cleared by central counterparties ("**CCPs**"). End-users that trade these products will need to determine if they are eligible for the exemption from mandatory clearing for non-financial end-users that are entering into transactions to hedge or mitigate commercial risk; or, if a clearing obligations applies, whether they use brokers which are members of relevant central counterparties. End-users taking advantage of the exemption will have certain reporting and in the case of public companies and their subsidiaries, board approval requirements.

Collateral Issues

There is as yet no international harmonisation on the precise requirements or capital consequences of using collateral for either cleared or non-cleared trades. End-users and buy-side participants should consider the differing collateral requirements and their impact on where trades should be carried. At any rate, there will likely be significant additional collateral required to support trades and an increased burden in funding and sourcing such collateral in the future. This is because increased capital and collateral requirements on clearing members will undoubtedly be sought to be passed on to the end client by financial institutions.

In addition, both CCPs and (in the context of indirect clearing) clearing members will have to offer, at least in Europe and in the context of cleared derivatives, segregation of positions and assets on a *per* client basis. Whether this is operationally or legally viable and whether there are any real benefits to this remains to be seen, given that national insolvency laws have yet fully to recognise either the integrity of individual client assets, or the loss of netting and collateral efficiencies, when positions and collateral are not pooled. In addition, European collateral requirements for non-cleared swaps are likely to require full segregation of margin.

In the US, new legal segregation requirements for customer collateral for cleared swaps, known as “LSOC” (legal segregation with operational commingling), will go into effect in Q3-4 of 2012. New segregation options will need to be offered for non-cleared swaps as well. Existing derivatives trading and clearing arrangements will need to be restructured to address the new segregation requirements, potentially both at clearing member level and at client level, especially if the client itself has a further “indirect client”.

One potential consequence of the various different collateral requirements is that clearing members and clients may end up using different collateral structures for cleared and non-cleared swaps and for indirect clearing, with consequential legal and operational risk implications.

Documentation

Industry groups, including the Futures Industry Association (“**FIA**”) in the US and International Swaps and Derivatives Association (“**ISDA**”) and Futures and Options Association (“**FOA**”) principally in Europe, are developing standardised client cleared OTC derivatives addendum to facilitate clearing arrangements. Similarly, CCPs are effecting numerous changes to their rulebooks and related documentation to facilitate additional segregation and the clearing of new products. New requirements for swap dealers will require changes in ISDA and any other client-facing documentation for uncleared swaps.

Both dealers and buy-side market participants will need to review and reconfigure their OTC businesses and documentation in readiness for these changes. These reforms throw up a whole host of other issues which require careful analysis. For example, many end-users will wish to negotiate bespoke documentation and will wish to understand more about the application of insolvency laws to individual segregation arrangements, including issues relating to custody and the location of collateral. Dealers may wish to relocate certain derivatives businesses to new or different jurisdictions. The appropriateness of particular financial counterparties to trades within group structures will need to be reappraised. Issues relating to the applicable governing law for agreements, and potential registration, reporting, recordkeeping and other requirements for existing and new arrangements should also be revisited by all market participants.

Shearman & Sterling has been extensively involved in both regulatory and documentation developments on behalf of our CCP, clearing member, buy-side and end-user clients. We will continue to monitor and report on ongoing legislative and regulatory developments as they arise.

This memorandum 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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