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Cross-Border Regulation of Swaps/Derivatives
Discussions between the Commodity Futures Trading Commission and the European Union – A Path Forward

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Our common efforts and joint work

In response to the financial crisis, the G-20 nations agreed on a common goal: to protect the public at large from the financial risks that led to bailouts and economic recession. We agreed to lower risk and promote transparency in a market that is truly global by agreeing to report all over-the-counter derivatives to trade repositories, to centrally clear standardized OTC derivatives and, where appropriate, require trading on transparent and multilateral venues.

The United States (US) and the European Union (EU) share a common objective of an ambitious and rigorous implementation of these G-20 commitments.

The US and the EU have made significant progress in their regulatory reforms.

Close legislative and regulatory co-ordination and co-operation between the European Commission (EC) and the Commodity Futures Trading Commission (CFTC) has ensured that the rules in place pursue the same objectives and generate the same outcomes.

Both regimes will have strict legal requirements in place governing central clearing, trade reporting, and trade execution. The CFTC is in the process of implementing such regulations and the EC has adopted the regulations giving effect to these requirements.

Pursuant to our respective legislative frameworks and mandates, certain EU rules are stricter in some areas and certain US rules are stricter in others. The calendar of compliance dates is not always synchronized due to differences in our legislative and rulemaking processes, but that does not change our common goal or our common approach.

As a result of this joint collaborative effort, in many places certain final rules are already essentially identical.

We also fully recognize that the market subject to this regulation is international. The majority of the global swaps and derivatives business is conducted within or between the EU and the US. A significant amount of transactions take place between counterparties in different jurisdictions ('cross-border'). The US and the EU both have legitimate interests and concerns about an appropriate regulation of this activity and both could seek legal jurisdiction over the transactions and market participants, and both could subject them to their requirements.

Recognizing the high degree of similarity that already exists between our respective requirements, we seek to address conflicts of law, inconsistencies, and legal uncertainty that may arise from the simultaneous application of EU and US requirements. Thus, the CFTC, the EC, and the European Securities and Markets Authority (ESMA) have worked closely and collaboratively to fully understand each other's concerns and regulatory approaches. We have agreed to implement our rules and regulations in a manner that will address conflicts, inconsistencies, and uncertainty to the greatest extent possible and consistent with international legal principles.

As swap market/derivatives participants come into compliance with new regulatory regimes around the globe, a close working relationship between the US and EU with regard to cross-border swaps regulation is mutually beneficial. By coordinating our efforts, we are providing a model for other regulators and jurisdictions working to implement their G-20 commitments.

To whom we intend to apply our rules

Where a definition has to be given of market participants or infrastructure subject to US or EU jurisdiction, as a matter of principle, it will be construed on a territorial basis, to the extent appropriate. When foreign entities not affiliated with or guaranteed by US persons are required to register, transaction-level requirements will apply to transactions with US persons and guaranteed affiliates. For example, EU registered dealers who are neither affiliated with, nor guaranteed by, US persons, would be generally subject only to US transactional rules for their transactions with US persons or US guaranteed affiliates. Additionally, for market participants that are subject to the requirements of Title VII of the Dodd-Frank Act or EMIR, the CFTC's Division of Swap Dealer and Intermediary Oversight plans to issue a no-action letter specifying that where a swap/OTC derivative is subject to joint jurisdiction under US and EU risk mitigation rules, compliance under EMIR will achieve compliance with the relevant CFTC rules.

We will not seek to apply our rules (unreasonably) in the other jurisdiction, but will rely on the application and enforcement of the rules by the other jurisdiction. A possible requirement for certain market participants or infrastructures to register with an authority is acceptable to ensure recourse in the event of a failure to provide satisfactory application or enforcement of rules.

Our regulatory approaches

The EC and the CFTC believe that it is important they should be able to defer to each other when it is justified by the quality of their respective regulation and enforcement regimes.

The CFTC seeks to issue final guidance on the cross-border application of its requirements setting out how its rules apply to cross-border swaps activities. For requirements that are applicable at the entity level, the CFTC has proposed that substituted compliance will be permitted for the requirements applicable in the EU that are comparable to, and as comprehensive as, those applicable in the US.

EU law foresees a system of equivalence. It is based on a broad outcomes-based assessment of the regulatory framework of a third country. Once equivalence has been determined, infrastructures and firms from that country can access and provide their services across the 28 Member States of the EU under their home jurisdiction rules. This is expected to be provided for in the relevant forthcoming decisions that the EC can adopt.

Transparency and trading

The CFTC plans to clarify that where a swap is executed on an anonymous and cleared basis on a registered designated contract market (DCM), swap execution facility (SEF), or foreign board of trade (FBOT) the counterparties will be deemed to have met their transaction-level requirements, including the CFTC's trade-execution requirement.

To date, an FBOT operating pursuant to a direct access no-action relief letter may permit identified members or other participants located in the US to enter trades directly into the trade matching system of the FBOT only with respect to futures and option contracts. However, an FBOT registered pursuant to Part 48 of the CFTC's regulations also can list swap contracts for trading by direct access, subject to certain conditions. In view of the apparent interest on the part of certain FBOTs operating pursuant to the no-action relief in listing swaps for trading by direct access, the CFTC's Division of Market Oversight plans to amend the no-action letters to permit those FBOTs to list swap contracts, subject to certain conditions. In the future, registered FBOTs will be permitted to list swap contracts for trading by direct access, subject to the same conditions.

As the markets and regulatory regimes continue to evolve, and in order to ensure a level playing field, promote participation in transparent markets, and promote market efficiency, the CFTC will extend appropriate time-limited transitional relief to certain EU-regulated multilateral trading facilities (MTFs), in the event that the CFTC's trade execution requirement is triggered before March 15, 2014. Such relief would be available for MTFs that have multilateral trading schemes, a sufficient level of pre- and post-trade price transparency, non-discriminatory access by market participants, and an appropriate level of oversight. The CFTC staff will issue no-action letters to this effect. In addition, the CFTC will consult with the EC in giving consideration to extending regulatory relief to trading platforms that are subject to requirements that achieve regulatory outcomes that are comparable to those achieved by the requirements for SEFs. Both parties will in January 2014 assess progress.

While important EU rules on mandatory trade execution and trading platforms under the Markets in Financial Instruments Directive and Regulation are almost complete, we are working collaboratively to share ideas and ensure harmonization to the maximum extent possible.

We are also working together on similar approaches to straight-through-processing so that market participants and infrastructure in both jurisdictions can benefit from the operational improvements that lower risk to the system.

How we look at risk mitigation rules for uncleared trades

The CFTC and the EU have essentially identical rules in important areas of risk mitigation for the largest counterparty swap market participants. Under the European Market Infrastructure Regulation (EMIR), the EU has adopted risk mitigation rules that are essentially identical to some of the CFTC's business conduct standards for swap dealers and major swap participants. In areas such as confirmation, portfolio reconciliation, portfolio compression, valuation, and dispute resolution, our respective regimes are essentially identical.

To achieve that outcome for requirements applicable to transactions, the CFTC's Division of Swap Dealer and Intermediary Oversight plans to issue a no-action letter specifying that for market participants that are subject to the requirements of Title VII of the Dodd-Frank Act or EMIR, the staff will not recommend any enforcement action against certain covered market participants in cases where those participants comply with the relevant requirements under EMIR, which are deemed to be essentially identical to the requirements imposed by the CFTC. Where a swap/OTC derivative is subject to joint jurisdiction under US and EU risk mitigation rules, compliance under EMIR will achieve compliance with the relevant CFTC rules.

The EC is conducting, with ESMA, an equivalence assessment of the requirements applicable in the US under the jurisdiction of the CFTC. Where the EC finds the requirements to be equivalent it can allow market participants the choice to comply either with EMIR rules or with the equivalent CFTC rules.

We also are working together with other regulators from around the world to harmonize our rules on margin for uncleared swaps. In the expectation that those internationally agreed rules will be applied and enforced in a substantially identical manner, this can be reflected in an equivalence decision in the EU, and be the subject of substituted compliance by the CFTC.

Approach to Offshore Guaranteed Affiliates, Branches, and Collective Investment Vehicles

We have a shared goal of ensuring that the overseas guaranteed affiliates and branches of US and EU persons are not allowed to operate outside of important G-20 reforms.

From a CFTC perspective, Dodd-Frank cross-border transaction requirements generally cover swaps between non-US swap dealers and US-persons or guaranteed affiliates of US persons, as well as swaps between two guaranteed affiliates that are not swap dealers. Compliance with transaction requirements for these trades could be satisfied through substituted compliance. Similarly, foreign branches of US swap dealers may be able to comply with CFTC rules through substituted compliance, as long as the foreign branch is bona fide and the swap is actually entered into by that branch. Lastly, the definition of US person should include offshore hedge funds and collective investment vehicles that are majority-owned by US persons or that have their principal place of business in the United States.

From an EU perspective, it is equally essential that any unmitigated risks posed in the EU by non-EU entities do not escape regulation. EMIR will cover transactions undertaken between non-EU entities where those transactions pose unmitigated risk that would have a direct, substantial, and foreseeable effect in the EU. It will also cover transactions undertaken by non-EU entities where this is necessary to prevent regulatory evasion. ESMA will publicly consult this month on the types of entities and contracts that should be determined as meeting these criteria. In particular, ESMA will consider whether such unmitigated risks may exist in respect of transactions undertaken by non-EU entities that are guaranteed by EU entities or by EU branches of non EU entities. The EC will then adopt draft Regulatory Technical Standards determining which contracts should be covered by EMIR.

How we approach mandatory clearing

We have essentially identical processes with regard to adopting mandatory clearing obligations. When the EU adopts its first mandatory clearing determination beginning next year, it is likely to cover the same classes of interest rate swaps and credit default swap indices as the CFTC's determination. In terms of which market participants are covered by mandatory clearing, we have broadly similar approaches and have agreed to a 'stricter-rule-applies' approach to cross-border transactions where exemptions from mandatory clearing would exist in one jurisdiction but not in the other. This will prevent loopholes and any potential for regulatory arbitrage. With regard to intra-group swaps/derivatives, we have broadly similar approaches with regard to mandatory clearing.

The rules applicable to our DCOs/CCPs

With regard to derivatives clearing organizations (DCOs) and central counterparties (CCPs) that are registered in both the US and the EU, CFTC rules and EMIR are both based on international minimum standards. We have identified one material difference with regard to our regulatory regimes: initial margin coverage. We will work together to reduce any prudential concerns or

regulatory arbitrage opportunities and to reflect this in our respective decisions on registration and equivalence.

In order to avoid significant market fragmentation and uncertainty around clearing obligations, the EC and the CFTC will endeavour to ensure that those infrastructures will be able to clear swaps/derivatives for their clearing members until registration/recognition has been determined. The EU can achieve this through the EC's equivalence decisions and ESMA's recognition of foreign CCPs, while the CFTC can do this through targeted no-action relief.

Two EU CCPs (LCH.Clearnet Ltd. and ICE Clear Europe) are already registered with the CFTC as DCOs. Additionally, the CFTC's Division of Clearing and Risk plans to issue no-action letters to both Eurex Clearing AG and LCH.Clearnet SA (both of which have pending registration applications with the CFTC) to begin clearing interest rate swaps and/or credit default swap indices for US clearing members. The CFTC's Division of Clearing and Risk also has issued no-action letters to two other foreign-based clearing organizations, permitting them and their clearing members to clear, subject to specified conditions, certain swaps that must be cleared by a registered or exempt DCO. In each case, the time-limited no-action relief expires upon the earlier of December 31, 2013, or the DCO becoming registered with the CFTC. The CFTC will continue to consider granting no-action relief in similar circumstances where a clearing organization seeks to register as a DCO and has not yet completed the registration process.

Reporting of trades to our trade repositories

For reporting trades to trade repositories, we have determined that our approaches are very similar and we will continue to work with each other to resolve remaining issues, such as consistent data fields, access to data, and other issues related to privacy, blocking, and secrecy laws. We will seek to resolve any material issues that may arise in line with the conclusions that may be drawn from discussions in international forums on this subject.

Future collaborative efforts

The EC, ESMA, and the CFTC believe it is important that jurisdictions and regulators should be able to defer to each other where this is justified by the respective quality and enforcement of regulations.

Both sides aim to conclude these discussions as soon as possible, at which stage the substance of relevant relief as described herein will be reflected by the CFTC in its guidance relating to substituted compliance, as approved by its principals, while the EU equivalence decisions will have been in place, and where necessary, amended to reflect this partnership.

For the future, we have agreed to continue to work collaboratively and to consider any unforeseen implementation effects that might arise in the application of our respective rules. We will continue discussions with other international partners with a view to establishing a more generalised system that would allow, on the basis of these countries' implementation of the G-20 commitments, an extension of the treatment the EU and the CFTC will grant to each other.

Brief summary

In response to the financial crisis, the G-20 nations agreed to lower risk and promote transparency in the over-the-counter (OTC) derivatives. The Commodity Futures Trading Commission (CFTC) and the European Commission (EC) share a common objective of a steadfast and rigorous implementation of these commitments.

We have both made significant progress in our regulatory reforms and, as a result of our joint collaborative effort in many places, our final rules are essentially identical. Nonetheless, our regulatory calendars are not always synchronized.

As the market subject to this regulation is international, we acknowledge that, notwithstanding the high degree of similarity that already exists between our respective requirements, without coordination between us, subjecting this global market to the simultaneous application of our requirements could lead to conflicts of law, inconsistencies, and legal uncertainty. The CFTC and the EC have worked closely and collaboratively to implement our rules and regulations to avoid this to the greatest extent possible and consistent with international legal principles.

Jurisdictions and regulators should be able to defer to each other when it is justified by the quality of their respective regulation and enforcement regimes. The CFTC's approach allows for compliance with entity-based rules through substituted compliance, as well as for transaction-based rules with guaranteed affiliates. Further, the CFTC plans to clarify that where a swap is executed on an anonymous and cleared basis on a registered designated contract market, swap execution facility, or foreign board of trade the counterparties will be deemed to have met their transaction-level requirements, including the CFTC's trade-execution requirement.

For bilateral uncleared swaps, because EU and US rules for risk mitigation are essentially identical, CFTC staff plans to issue no-action relief. In this regard, the EU's system of 'equivalence' can be applied to allow market participants to determine their own choice of rules.

For the trading-execution requirement, the CFTC plans to permit foreign boards of trade that have received direct access no-action relief to also list swap contracts for trading by direct access to avoid market and liquidity disruption.

As the markets and regulatory regimes continue to evolve, and in order to ensure a level playing field, promote participation in transparent markets, and promote market efficiency, the CFTC will extend appropriate time-limited transitional relief to certain EU-regulated multilateral trading facilities (MTFs), in the event that the CFTC's trade execution requirement is triggered before March 15, 2014. Such relief would be available for MTFs that have multilateral trading schemes, a sufficient level of pre- and post-trade price transparency, non-discriminatory access by market participants, and an appropriate level of oversight. The CFTC staff will issue no-action letters to this effect. In addition, the CFTC will consult with the EC in giving consideration to extending regulatory relief to trading platforms that are subject to requirements that achieve regulatory outcomes that are comparable to those achieved by the requirements for SEFs. Both parties will in January 2014 assess progress.

We continue to work together on similar approaches to straight-through-processing and harmonized international rules on margins for uncleared swaps and have essentially identical processes with regard to adopting mandatory clearing obligations and regulating intra-group swaps/derivatives trades. We also share common goals of ensuring that the overseas guaranteed affiliates and branches of US and EU persons are not allowed to operate outside of important G-20 reforms.

Our approaches for reporting to trade repositories are very similar and we will continue to work with each other to resolve remaining issues, such as consistent data fields, access to data, and other issues related to privacy, blocking, and secrecy laws. We will seek to resolve any material issues that may arise in line with the conclusions that may be drawn from discussions in international forums on this subject.

With respect to derivatives clearing organizations (DCOs) and central counterparties (CCPs), CFTC rules and the European Market Infrastructure Regulation are both based on international minimum

standards. CCP initial margin coverage is the only key material difference and we will work together to reduce any regulatory arbitrage opportunities. We will endeavour to ensure that our DCOs/CCPs that have not yet been recognised or registered will be permitted to continue their business operations.

The EC, the European Securities and Markets Authority, and the CFTC believe it is important that jurisdictions and regulators should be able to defer to each other where this is justified by the respective quality and enforcement of regulations. Both sides aim to conclude these discussions as soon as possible, at which stage the substance of relevant relief as described herein will be reflected by the CFTC in its guidance relating to substituted compliance, as approved by its principals, while the EU equivalence decisions will have been in place, and where necessary, amended to reflect this partnership.

For the future, we have agreed to continue to work collaboratively and to consider any unforeseen implementation effects that might arise in the application of our respective rules.