



Promoting U.S. Access to Non-U.S. Swaps Markets: A Roadmap to Reverse Fragmentation

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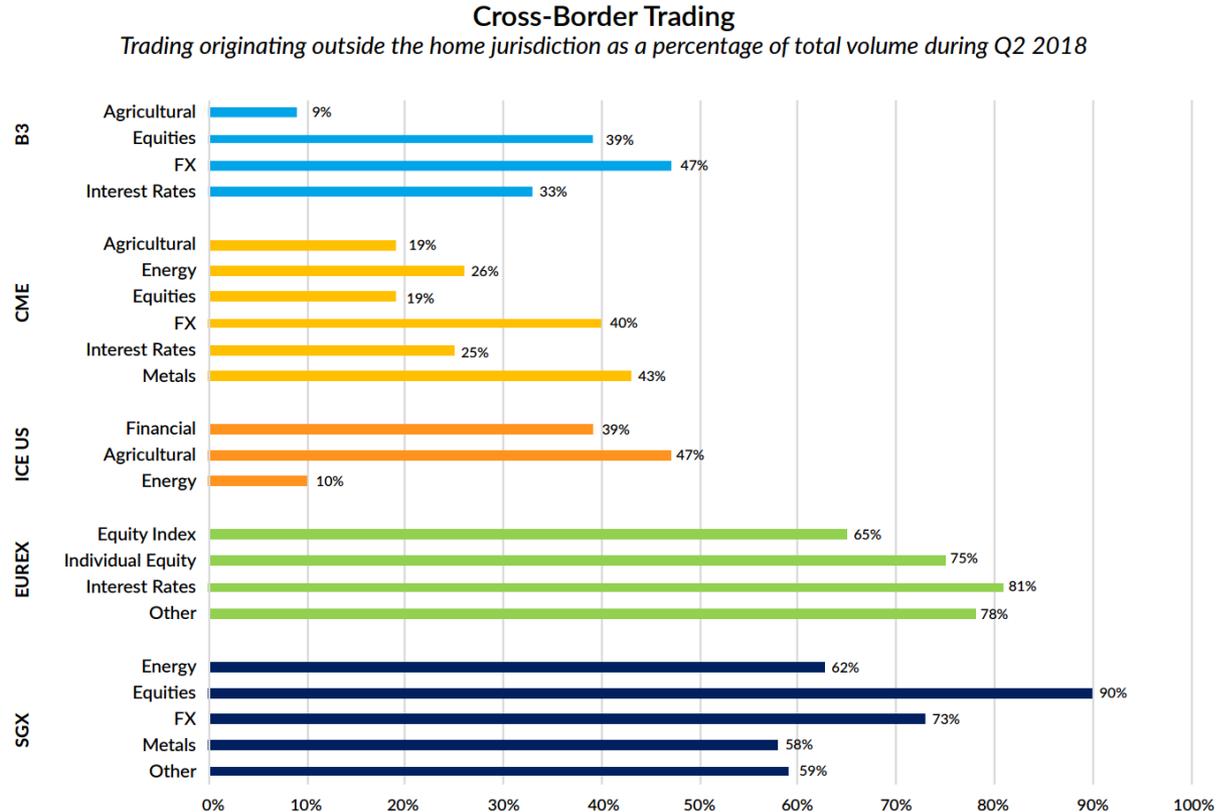
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Background: Cross-Border Trading in Listed Derivatives

Listed derivatives markets are global in nature, with cross-border trading making up a very significant percentage of total trading volume

This global market is underpinned by the Part 30 rules of the Commodity Futures Trading Commission (“CFTC”), which greatly facilitate U.S. access to foreign futures markets



Source: FIA, Mitigating the Risk of Market Fragmentation (2019)

Background: Cross-Border Trading in Cleared Swaps

CURRENTLY

Most cross-border trading in cleared swaps takes place between the U.S. and the European Union (“EU”)

IN THE FUTURE

Future changes in regulation can be expected to increase demand for U.S. access to additional non-U.S. central counterparties (“CCPs”), including those outside the EU:

- ▶ The coming expansion of initial margin requirements for uncleared swaps to cover additional buy-side firms will significantly increase incentives for central clearing, including for swaps not currently offered by U.S. or EU CCPs
- ▶ New mandatory clearing requirements in some foreign jurisdictions will require U.S. banks doing business in those jurisdictions to use local CCPs

U.S. Customer Access to Non-U.S. Swaps CCPs: The Current Framework

THE CURRENT FRAMEWORK

- The CFTC requires that a U.S. customer clear swaps solely through a registered futures commission merchant (“**FCM**”) at a registered derivatives clearing organization (“**DCO**”)
- There are currently five non-U.S. CCPs that are dually registered as DCOs, only one of which is located outside the EU

ISSUES FOR U.S. FCMS AND NON- U.S. CCPS

- To provide access to these non-U.S. CCPs, a clearing firm typically must have both a U.S. FCM affiliate that clears U.S. customer business and a non-U.S. affiliate that clears non-U.S. customer business
- This structure directly exposes the U.S. FCM to the non-U.S. CCP’s risk mutualization framework and can increase the overall firm’s liquidity/funding risk and CCP exposure
- In addition, the non-U.S. CCP must directly satisfy U.S. customer protection requirements, which may not in all cases be consistent with local equivalents and has in some cases necessitated relief from the CFTC

U.S. Customer Access to Non-U.S. Swaps CCPs: FIA/SIFMA's Proposal

PROPOSED CUSTOMER ACCESS STRUCTURES

- FIA and SIFMA have proposed that the CFTC adopt an approach to foreign cleared swaps modeled on Part 30's approach to foreign futures
- Under this proposal, a U.S. customer could access a non-U.S. swaps CCP either:
 - ▶ Indirectly through a correspondent clearing structure involving the U.S. customer clearing through a U.S. FCM that in turn clears through an omnibus account carried by a non-U.S. clearing member of the non-U.S. CCP (similar to CFTC Rule 30.7)
 - ▶ Directly through an account carried by a comparably regulated non-U.S. clearing member of the non-U.S. CCP (similar to CFTC Rule 30.10)

IMPLICATIONS FOR NON-U.S. CCPS

- In connection with either structure, mere access by the U.S. customer would not require the non-U.S. CCP to register as a DCO because such access would take place indirectly through a non-U.S. clearing member
- However, if the U.S. customer wished to use the non-U.S. CCP to satisfy the CFTC's mandatory clearing requirement, the CCP would need to register as a DCO or obtain an exemption from registration

U.S. Customer Access to Non-U.S. Swaps CCPs: FIA/SIFMA's Proposal (cont'd)

IMPLEMENTATION OF FIA/SIFMA'S PROPOSAL

To implement FIA/SIFMA's proposal, the CFTC would:

- ▶ Adopt appropriate customer protection rules for swaps cleared by a U.S. FCM at a non-U.S. CCP that is not required to register as a DCO or is exempt from such registration, similar to Rule 30.7 (pursuant to CFTC authority under Commodity Exchange Act (“CEA”) Section 4d(f))
- ▶ Grant relief from FCM registration for non-U.S. clearing members that are comparably regulated or limiting their U.S. activities to carrying FCM omnibus accounts (pursuant to CFTC authority under CEA Section 4(c))
- ▶ Establish a separate account class in Part 190 of the CFTC's regulations for “foreign cleared swaps,” comprising swaps cleared by a registered FCM at a non-U.S. CCP not required to register as a DCO or exempt from such registration (pursuant to CFTC authority under CEA Sections 8a(5) and 20(a) and the Dodd-Frank Wall Street Reform and Consumer Protection Act (“**Dodd-Frank**”) Section 721(b))
- ▶ Amend Part 190 to clarify that a swap cleared by a DCO (whether registered or not) is considered a “commodity contract” under the Bankruptcy Code with regard to all money, securities and property of any swaps customer received by an FCM or a DCO (whether registered, exempt from registration or not required to register) to margin, guarantee or secure the swap (including money, securities, or property accruing to the customer as a result of the swap) (pursuant to CFTC authority under CEA Sections 8a(5) and 20(a) and Dodd-Frank Section 721(b))

U.S. Customer Access to Non-U.S. Swaps CCPs: Chairman's Cross-Border White Paper

- In October 2018, CFTC Chairman J. Christopher Giancarlo published a white paper proposing a new approach to the CFTC's regulation of cross-border swaps activity (the “**Cross-Border 2.0 Paper**”)
- The Cross-Border 2.0 Paper addressed certain aspects of FIA/SIFMA's proposal regarding U.S. customer access to non-U.S. CCPs:
 - Specifically, the Cross-Border 2.0 Paper proposed to permit U.S. customers to access non-U.S. swaps CCPs in comparable jurisdictions through a comparably regulated non-U.S. clearing member (similar to Rule 30.10)
 - However, the Cross-Border 2.0 Paper would not permit:
 - ❑ a correspondent clearing structure similar to Rule 30.7; or
 - ❑ U.S. customers to access unregistered swaps CCPs in non-comparable foreign jurisdictions
 - In addition, the Cross-Border 2.0 Paper proposed to require any non-U.S. swaps CCP that poses a substantial risk to the U.S. financial system to register as a DCO regardless of whether it is subject to regulation in a comparable jurisdiction

U.S. Proprietary Access to Non-U.S. Swaps CCPs: the Current Framework

DCO REGISTRATION

Currently, a non-U.S. swaps CCP triggers DCO registration if it permits proprietary clearing by a U.S. person (including a foreign branch of a U.S. bank) for itself or its affiliates

DCO EXEMPTIONS

Dodd-Frank authorizes the CFTC to exempt a non-U.S. swaps CCP if it determines it is subject to “comparable, comprehensive supervision and regulation” in its home country

The CFTC has exercised this authority to exempt four non-U.S. CCPs, subject to conditions relating to, among other things, observance of the Principles for Financial Market Infrastructures (“**PFMIs**”), satisfaction of CFTC reporting requirements, CFTC access to information, and prohibiting clearing by U.S. customers

AUGUST 2018 PROPOSAL

In August 2018, the CFTC proposed rules that would codify this approach to granting DCO registration exemptions to non-U.S. CCPs

U.S. Proprietary Access to Non-U.S. Swaps CCPs: FIA/SIFMA's Proposal

ISSUES WITH THE CURRENT FRAMEWORK

Some non-U.S. CCPs have been reluctant to apply for exemptions from the CFTC due to the costs of complying with CFTC reporting requirements or unable to obtain exemptions from the CFTC because, for example, they are subject to home country rules restricting access to information by foreign regulators

U.S. banks may nonetheless be forced to access these CCPs in order to satisfy local clearing mandates

To do so, U.S. banks are currently forced to subsidiarize their operations in the relevant non-U.S. jurisdiction

POTENTIAL MITIGANTS

Even absent requiring the non-U.S. CCP to register as a DCO or obtain an exemption, there are significant protections afforded by U.S. regulation of a U.S. bank accessing the CCP, including:

- U.S. prudential banking regulation, including significantly higher capital requirements for exposures to a CCP not subject to PFMI-compliant regulation
- CFTC swap dealer regulation, including reporting and risk management requirements

Similar considerations led the CFTC, in its 2013 cross-border guidance, to exclude swaps with the foreign branch of a U.S. bank swap dealer from counting towards a non-U.S. person's swap dealer *de minimis* threshold

FIA/SIFMA'S PROPOSAL

For similar reasons, FIA and SIFMA proposed that a non-U.S. swaps CCP should not trigger DCO registration merely because it permits participation by foreign branches of U.S. bank swap dealers

However, if the U.S. bank wished to use the non-U.S. CCP to satisfy the CFTC's mandatory clearing requirement, the CCP would need to register as a DCO or obtain an exemption from registration

U.S. Proprietary Access to Non-U.S. Swaps CCPs: Chairman's Cross-Border White Paper

- The Cross-Border 2.0 Paper would also address certain aspects of FIA/SIFMA's proposal regarding U.S. proprietary access to non-U.S. CCPs
- Specifically, the Cross-Border 2.0 Paper would provide a non-U.S. swaps CCP in a non-comparable jurisdiction with relief from DCO registration under certain conditions:
 - Limiting U.S. participation to the foreign branches of U.S. bank swap dealers, clearing for themselves, their affiliates, and/or non-U.S. customers (but not U.S. customers)
 - Requiring the non-U.S. CCP to satisfy CFTC reporting requirements; and
 - Requiring the home country regulator of the non-U.S. CCP to negotiate and execute a memorandum of understanding with the CFTC
- The second and third conditions noted above could limit the number of non-U.S. CCPs willing or able to rely on the relief

Q&A