WHITE & CASE

Banking / Capital Markets

# The Delta Report

## Derivatives Newsletter

**In this issue…**




**June 2016**



**Authors: David Barwise, Ian Cuillerier, Rhys Bortignon, Erin Choo, Nathaniel Crowley, Lilian Ting**


White & Case LLP is proud to introduce the first edition of our derivatives newsletter, The Delta Report. In each issue, we will highlight recent key regulatory developments across the Americas, Europe and Asia and discuss various hot topics, in the derivatives space. This inaugural issue covers certain important recent developments within the previous year that impact derivatives trading and related compliance requirements.

# Regulatory Developments in the Americas

## SEC Issues Final Rules on Dealing Activity Conducted Within the US by a Non-US Person

### Introduction

On May 1, 2013, the Securities and Exchange Commission ("**SEC**") adopted and made public for comment proposed rules and interpretive guidance[1] (the "**2013 Cross-Border Proposing Release**") to address the application of the provisions of the Securities Exchange Act of 1934 (the "**Exchange Act**") added by Subtitle B of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") to govern cross-border security-based swaps ("**SBS**") activities.

On June 25, 2014, the SEC adopted finalised rules (the "**2014 SEC Cross-Border Rules**") and interpretative guidance[2] based on some, but not all, of the proposed rules set out in the 2013 Cross-Border Proposing Release. Importantly, the SEC did not include in the 2014 SEC Cross-Border Adopting Release the proposed rules dealing with the regulation of SBS transactions between two non-US persons where one or both are conducting dealing activity within the US. The SEC noted that these rules would be the subject of a separate rulemaking proposal.

On April 29, 2015, the SEC adopted and made public for comment proposed rules that reflected a modified approach to the application of certain requirements of the Dodd-Frank Act to SBS transactions between two non-US persons where one or both are conducting dealing activity within the US[3] (the "**2015 Cross-Border Proposing Release**").

On February 10, 2016, the SEC issued a release[4] (the "**2016 SEC Cross-Border Adopting Release**") adopting rule amendments (the "**2016 SEC Cross-Border Rules**") relating to one of the proposals in the 2015 Cross-Border Proposing Release, finalising the criteria for SBS transactions between two non-US persons that count toward the non-US person's requirement to register as a security-based swap dealer ("**SBSD**"). The 2016 SEC Cross-Border Rules require a non-US person to include in its *de minimis* threshold calculations any transactions related to its security-based swap dealing activity that are arranged, negotiated, or executed using its personnel located in a US branch or office, or using personnel of its agent located in a US branch or office.

This article outlines the important concepts and consequences of the 2016 SEC Cross-Border Rules and provides a summary of the final rules and interpretative guidance set out in the 2014 SEC Cross-Border Adopting Release in order to present a complete picture of the SEC's current rule-making with respect to cross-border SBS transactions.

### The CFTC's approach

Before we discuss the 2016 SEC Cross-Border Rules, it is useful to briefly set out how the CFTC currently handles the consequences of trading activity from the US. In November 2013, the CFTC issued a Staff Advisory[5] addressing the applicability of the CFTC's transaction level requirements to certain swap

---

1 Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Form Relating to the Registration of Security-Based Swap Participants, Release No. 69490 (May 1, 2013), 78 FR 30967 (May 23, 2013), available at https://federalregister.gov/a/2013-1083.

2 Application of "Security-Based Swap Dealer" and "Major Security-Based Swap Participant" Definitions to Cross-Border Security-Based Swap Activities, Release No. 72472 (June 25, 2014), 79 FR 47277 (August 12, 2014 (republication)), available at https://federalregister.gov/a/R1-2014-1533.

3 Application of Certain Title VII Requirements to Security-Based Swap Transactions Connected with a Non-US Person's Dealing Activities That are Arranged, Negotiated, or Executed by Personnel Located in a US Branch or Office or in a US Branch or Office of an Agent, Release No. 34-74834 (April 29, 2015), 80 FR 27443 (May 13, 2015), available at https://federalregister.gov/a/2015-10382.

4 Security-Based Swap Transactions Connected With a Non-US Person's Dealing Activity that are Arranged, Negotiated, or Executed by Personnel Located in a US Branch or Office or in a US Branch or Office of an Agent; Security-Based Swap Dealer *De Minimis* Exception, Release No. 77104 (February 10, 2016), 81 FR 8597 (February 19, 2016), available at https://www.federalregister.gov/d/2016-03178.

5 CFTC Staff Advisory 13-69. For further information on CFTC Staff Advisory 13-69 please refer to our client alert available here.

transactions of non-US registered swap dealers arranged, negotiated or executed by its personnel or agents in the US. In accordance with the Staff Advisory, non-US registered swap dealers regularly using personnel or agents located in the US to arrange, negotiate or execute a swap with a non-US person are generally required to comply with the certain "Transaction-Level Requirements." Transaction-Level Requirements, as defined by the CFTC, include clearing and swap processing, margining, mandatory trade execution, swap trading relationship documentation, portfolio reconciliation and compression, real-time public reporting, trade confirmation, daily trading records and external business conduct standards.[6] The CFTC considers such activity results in US located personnel or agents performing core front-office activities of that swap dealers dealing business, which warranted regulation by the CFTC.

The CFTC sought comment on whether the Staff Advisory should be adopted as policy, either in whole or in part. Following receipt of various comments, the CFTC subsequently extended no-action relief until the earlier of September 30, 2016 and when the CFTC takes action in this respect.[7]

As we will see below, the SEC has taken a similar approach in the context of SBSD registration.

## Definition of Security-Based Swap Dealer

The Exchange Act sets out certain activities that, if performed, would bring a person within the definition of SBSD. These activities are:

(a) holding oneself out as a dealer in SBS transactions;

(b) making a market in SBS transactions;

(c) regularly entering into SBS transactions with counterparties as an ordinary course of business for a person's own account; or

(d) engaging in any activity causing a person to be commonly known in the trade as a dealer in SBS transactions.

However, even if a person is engaged in any of the SBS activities listed above, it will not be designated as a SBSD if it engages in a *de minimis* level of SBS activity.

On May 23, 2012 the SEC and the CFTC published joint final rules in which they further defined various concepts relating to the regulation of swaps and SBS transactions and, relevantly, the SEC sets the thresholds that were applicable to the SBSD *de minimis* level as well as the types of SBS transactions that were to be counted in determining whether a person was above or below the applicable *de minimis* threshold. Currently, the thresholds are:

(a) US$8 billion in notional of credit default SBS transactions;

(b) US$400 million in notional of other types of SBS transactions; and

(c) US$25 million in notional of any type of SBS transaction with counterparties that are special entities (i.e., governments, government entities and certain benefit plans and endowments).

These thresholds represent the phase-in amounts and will be adjusted following further studies to be undertaken by the SEC.

The 2014 SEC Cross-Border Rules built on the joint final rules discussed above by requiring non-US persons to include in their *de minimis* threshold calculation any SBS transactions arising out of dealing activity with counterparties that are US persons and non-US persons if the non-US persons are a conduit affiliate or if a counterparty has a right of recourse against a US person under the SBS transaction.

The 2016 SEC Cross-Border Rules amend the existing rules governing the *de minimis* threshold calculation by including certain dealing activity by a non-US person that has the specified connection with the US.

---

6 Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations; Rule, 78 FR 45292 (July 26, 2013), available here https://federalregister.gov/a/2013-17958. For further information on the CFTC's cross-border guidance please see our client alert available here.

7 CFTC No-Action Letter No. 15-48. For further information on CFTC Staff Advisory 13-69 please refer to our client alert available here. For information on the CFTC's cross-border guidance please refer to our client alert available here.

## 2014 SEC Cross-Border Rules

### Definition of US Person

Under the 2014 SEC Cross-Border Rules, a "US person" is defined as:

(a) any natural person resident in the United States;

(b) any partnership, corporation, trust, investment vehicle, or other legal person organised, incorporated, or established under the laws of the United States or having its principal place of business in the United States;

(c) any account (whether discretionary or non-discretionary) of a US person; or

(d) any estate of a decedent who was a resident of the United States at the time of death.

Certain international organisations such as the World Bank, the International Monetary Fund and the United Nations as well as their agencies and pension plans are excluded from the definition of US person.[8]

The 2014 SEC Cross-Border Rules provide that a person may rely on a counterparty's representation regarding its status as a US person, unless such person knows, or has reason to know, that the representation is inaccurate.[9] Importantly, a counterparty's representations regarding a person's status as a US person for purposes of CFTC regulations cannot be relied on for this purpose, although they may be useful in certain circumstances.

### Registration and Regulations of SBSDs

As mentioned earlier, the Dodd-Frank Act introduced the concept of SBSDs, and requires entities that meet the definition of SBSD to register with the SEC.

Unlike the SBSD definition, the definition of major security-based swap participants ("**MSBSP**") does not focus on the quality of a person's swap market activities or on how the person "presents itself to the market." Rather, using objective numerical standards, the focus is on assessing the potential MSBSP's market impact and the risks associated with the person's SBS transaction positions. As with SBSDs, though, a person would not have to register as an MSBSP if the person's SBS transaction positions remain below certain thresholds. Due to the very limited application of this concept (the SEC estimates that there may only be five institutions that will be required to register as MSBSPs), this article does not provide any further information on MSBSPs.

### Which Cross-Border SBS Dealing Transactions Count Towards the SBSD De Minimis Threshold?

Whether a SBS transaction is included in a person's *de minimis* threshold determination for SBSDs depends on the regulatory status of the applicable person and of its counterparties. Please refer to part 6 of this article for the rules regarding the counting of additional SBS transactions towards the *de minimis* thresholds under the 2016 SEC Cross-Border Rules.

We set out below details on the types of transactions that are to be counted towards the *de minimis* threshold.

(a) **US person**

A US person is required to count all of its SBS dealing transactions with US persons and non-US persons, including transactions conducted through a foreign branch.[10]

(b) **Non-US person that is not a conduit affiliate**

A non-US person that is not a conduit affiliate (as defined below) is required to count all its SBS dealing transactions with:

(i) US persons (other than foreign branches of US registered SBSDs, see below); and

[8] Supra note 2 at 93-4.

[9] Supra note 2 at 94.

[10] Supra note 2 at 79.

(ii) non-US persons that have a right of recourse against a commonly controlled US affiliate of the counting entity. According to the SEC, a right of recourse exists "if the counterparty has a conditional or unconditional legally enforceable right, in whole or in part, to receive payments from, or otherwise collect from, a US person that is controlling, controlled by, or under common control with the counting entity in connection with the non-US Person's obligations under the SBS transaction."

(c) **Non-US person that is a conduit affiliate**

A conduit affiliate is required to count all their SBS dealing transactions against the de minimis threshold, regardless of the status of the counterparty.

Generally, a conduit affiliate is a non-US affiliate of a US person that enters into SBS transactions in the regular course of business with non-US persons, or with certain foreign branches of US banks that are registered SBSDs, on behalf of one or more of its US affiliates under common control, and enters into offsetting transactions with its US affiliates to transfer the risks and benefits of those SBS transactions. Affiliates registered as SBSDs or MSBSPs are not considered conduit affiliates.

In determining whether a person has met its *de minimis* threshold, a person is required to aggregate its positions with those of its affiliates (i.e., entities that it controls, that control it or with which it is under common control) to the extent such affiliates are also required to count SBS transactions towards their own *de minimis* thresholds. This requirement does not include an affiliate that is a registered SBSD (or a person that has exceeded the *de minimis* threshold and is in the process of registering as a SBSD).

With respect to SBS transactions with a foreign branch of a US person, the 2014 SEC Cross-Border Rules allow non-US persons to not count their SBS transactions with foreign branches of US persons against the *de minimis* thresholds only when the foreign branch is part of a registered SBSD (or a person that has exceeded the *de minimis* threshold and is in the process of registering as a SBSD). A SBS transaction is conducted through a foreign branch if (i) the foreign branch is the counterparty to the transaction; and (ii) the SBS transaction is arranged, negotiated and executed on behalf of the foreign branch solely by persons located outside the US.

The 2014 SEC Cross-Border Rules define a "foreign branch" of a US bank to mean a branch that is (a) located outside the United States, (b) operates for valid business reasons and (c) is engaged in the business of banking and is subject to substantive banking regulation in the jurisdiction where it is located.

**Exception for Cleared Anonymous Transactions**

SBS transactions that a non-US person enters into anonymously on an execution facility or national securities exchange and that are cleared through a clearing agency are excepted from being counted against the *de minimis* thresholds (unless the non-US person is a conduit affiliate).[11] The 2014 SEC Cross-Border Rules require that the transaction be actually "anonymous" (i.e., unknown to the non-US person prior to the transaction).[12] The cleared anonymous transactions exception was adopted to avoid the exclusion of US market participants with non-US members because of the prospect of dealer regulation.[13]

## 2015 Cross-Border Proposing Release

The 2015 Cross-Border Proposing Release broadly set out proposed rules in the following areas:

(a) application of the *de minimis* exception to SBS transactions connected with a non-US person's dealing activity that are arranged, negotiated or executed by the personnel of such person located in the United States;

(b) application of the external business conduct standards to such SBS transactions; and

(c) application of the regulatory reporting and public dissemination requirements to such SBS transactions.

11 Supra note 2 at 159.

12 Supra note 2 at 160.

13 Supra note 2 at 158.

The *de minimis* threshold calculation application in 2015 Cross-Border Proposing Release was a response to the significant concerns raised by market participants to the SEC's proposed approach in the 2013 Cross-Border Proposing Release. In the 2013 Cross-Border Proposing Release, the SEC sought to require a non-US person to include in its SBSD *de minimis* threshold calculation those transactions that fell within the definition of "transaction[s] conducted within the United States." The SEC had defined this phrase as any "security-based swap that is solicited, negotiated, executed or booked within the United States, by or on behalf of either counterparty to the transaction, regardless of location, domicile or residence status of either counterparty to the transaction." It would not have, however, included a transaction conducted through a foreign branch of a US bank. This would have required a person undertaking dealing activity to include in its *de minimis* threshold calculation any transaction where such person, its counterparty or their respective agents performed relevant SBS transaction dealing activity from within the United States. The approach set out in the 2016 Cross-Border Proposing Release captured a narrower range of activities than those initially proposed and therefore represented a softening of the original formulation set out under the 2013 Cross-Border Proposing Release.

Of the proposals made in the 2015 Cross-Border Proposing Release, only the first item addressing the application of the *de minimis* exception to non-US persons was generally adopted and finalised in the 2016 SEC Cross-Border Adopting Release.

## 2016 SEC Cross-Border Rules

The 2016 SEC Cross-Border Rules are consistent with the US activity test proposed in the 2015 Cross-Border Proposing Release, which focuses on whether the sales or trading personnel (or such personnel of its agent) carrying out market-facing SBS dealing activities for non-US persons are located in the United States.

### SBSD De Minimis Threshold Calculation

Pursuant to the 2016 SEC Cross-Border Rules set out in the 2016 SEC Cross-Border Adopting Release (and consistent with the 2015 Cross-Border Proposing Release), a non-US person would only be required to include in its SBSD *de minimis* threshold calculation any SBS transaction connected with its SBS dealing activities that it enters into with another non-US person when such SBS transaction is *arranged, negotiated or executed* by personnel of the non-US person located in a US branch or office, or by personnel of the non-US person's agent located in a US branch or office. This approach is consistent with that currently followed for the registration of brokers and dealers under the Exchange Act.

For the purposes of the 2016 SEC Cross-Border Rules, the SEC has provided the following guidance:

(a) "**arrange**" and "**negotiate**" indicate market-facing activity of sales or trading personnel (or personnel who engage in sales and trading even if they are not formally designated as sales persons or traders) in connection with a particular transaction, including interaction with counterparties or their agents, and does not include internal functions (such as design or processing of trades or other back-office activities). The final rules also do not include the preparation of underlying documentation for a transaction, including negotiation of a master agreement and related documentation.

(b) "**execute**" indicates the market-facing act that, in connection with a particular transaction, causes the person to become irrevocably bound under that transaction under applicable law.

(c) "**arranging, negotiating or executing**" includes directing other personnel to arrange, negotiate or execute a particular transaction, but does not include booking.

(d) "**located in a US branch or office**" only includes those personnel, whether of the non-US person or its agent, physically located in a US branch or office. This would generally include personnel assigned to, on an ongoing or temporary basis, or regularly working in a US branch or office, but would not include those only incidentally present in the US (e.g., due to attendance at an educational or industry conference). This would capture personnel located in a US branch or office that respond to inquiries from a non-US person counterparty because it was outside of business hours in the counterparty's jurisdiction.

(e) "**personnel**" should be interpreted, with respect to both the non-US person and its agent, in a manner consistent with the definition of "associated person of a security-based swap dealer" as contained in section 3(a)(70) of the Exchange Act,[14] regardless whether such non-US person or its agent is itself a SBSD.

The SEC stated in the accompanying interpretative guidance that the following activities undertaken by personnel located in the US would not, on their own, require a SBS transaction to be included in a non-US person's SBSD *de minimis* threshold calculation:

(a) submission of the SBS transaction for clearing in the US;

(b) reporting of the SBS transaction to a security-based swap data repository in the US;

(c) collateral management of an SBS transaction, such as the exchange of margin, that occurs in the US;

(d) preparation of underlying documentation for the SBS transaction, including negotiation of a master agreement and related documentation, or performing ministerial or clerical tasks in connection with the SBS transaction; and

(e) booking the SBS transaction in the non-US person.

In interpreting and applying the 2016 SEC Cross-Border Rules, it is helpful to understand the SEC's view on the appropriate territorial application of the Dodd-Frank Act. The SEC explained in the 2015 Cross-Border Proposing Release and reiterated in the 2016 SEC Cross-Border Adopting Release that the regulatory requirements applicable to SBS transactions under the Dodd-Frank Act are not solely focused on the risks to the US financial system. The SEC rejected the commenters' suggestion of assessing a SBS dealing activity's counterparty credit risk to judge if there is a nexus sufficient to warrant SBSD registration. With respect to the regulation of SBSDs, in the SEC's view, the appropriate analysis is whether a non-US person under a SBS transaction is engaged, in the US, in any of the activities set out in the definition of SBSD (see above) and, if so, it is appropriate under a territorial approach to require that non-US person to include such SBS transaction in its *de minimis* threshold calculation. The SEC is more broadly concerned with market stability and transparency and, as such, considers that any dealer activity being conducted in the US should be subject to appropriate regulatory oversight. The SEC anticipates that the significant proportion of dealing activity captured by the 2016 SEC Cross-Border Rules will likely be transactions carried out by foreign affiliates of US financial groups. The SEC noted that it expects the 2016 SEC Cross-Border Rules to reduce the likelihood of competitive disparities and market fragmentation between non-US-person dealers and US-person dealers.

The SEC stated that it does not intend for market participants to look beyond those personnel who are involved in, or directing, market-facing activities in connection with a particular SBS transaction. That is, the involvement of non-market-facing personnel located in a US branch or office in a transaction would not fall within the scope of the rules. The SEC's reasoning for taking this approach is consistent with its territorial approach discussed above–that is, activities in the US that do not involve the arrangement or negotiation of the economic terms of a SBS transaction are unlikely to raise the types of concerns addressed by the Dodd-Frank Act.

For example, it is for this reason that, unlike the original proposed rules set out in the 2013 Cross-Border Proposing Release that required a non-US person engaged in dealing activity to include in its *de minimis* threshold calculation any "transaction conducted within the United States", the finalised rule set out in the 2016 SEC Cross-Border Adopting Release does not include booking a trade as an activity that would result in a SBS transaction being counted in the *de minimis* threshold calculation, as the SEC considers booking activity to not be a market-facing activity.

**Exception for Cleared Anonymous Transactions**

A non-US person, other than a conduit affiliate (see paragraph 4.4), is not required to include in its *de minimis* threshold calculation a SBS transaction that is entered into anonymously and is cleared.

However, in the 2016 SEC Cross-Border Adopting Release, the SEC confirmed that this exception will not apply to non-US person transactions that are arranged, negotiated or executed by US personnel, primarily because a non-US person is only required to look to the location of its own SBS dealing activity and not that of the other party in determining whether to count SBS transactions in its *de minimis* threshold calculation. As such, the SEC has determined that applying this exception is inconsistent with the purposes underlying the

[14] This section is substantially similar to section 3(a)(18) of the Exchange Act.

exception, namely of only exempting non-US persons from having to determine the treatment of SBS transactions under the *de minimis* exception in circumstances where the information necessary to make that determination is unavailable.

## Substituted Compliance

In large part, the SEC expects to address the issue regarding the availability of substituted compliance as part of future rulemakings.[15] However, the 2014 SEC Cross-Border Rules include a final procedural rule regarding substituted compliance stating that a request for a substituted compliance order may be submitted either by a party that potentially would comply with requirements under the Exchange Act pursuant to a substitute compliance order, or by a relevant foreign financial regulatory authority or authorities.[16]

The 2014 SEC Cross-Border Rules further provide that a substituted compliance proposal should include supporting documentation regarding the methods that foreign financial regulators use to enforce compliance with the applicable rules.[17] The SEC requires such information because substitute compliance assessments will not be limited to comparison of underlying goals, but will include the capability of foreign regulators to monitor compliance and enforce actions in response to violations.[18]

Finally, since foreign regulators may submit substituted compliance proposals, the SEC has expanded the scope of the confidentiality requests to such proposals pursuant to any applicable provisions governing confidentiality under the Exchange Act.[19]

## Anti-fraud Rule

The provisions of the rules and guidance mentioned above do no limit the cross-border reach of the anti-fraud provisions or other provisions of the federal securities law that are not addressed in the 2014 SEC Cross-Border Rules and the 2016 SEC Cross-Border Rules.[20] The SEC interprets cross-border antifraud enforcement to include cross-border frauds that implicate US territory, US markets, US investments, other US market participants, and other US interests.[21] The SEC's anti-fraud enforcement authority includes the authority under the Exchange Act, the Securities Act and the Investment Advisers Act.[22]

## Looking Ahead

The 2016 SEC Cross-Border Rules became effective on April 19, 2016. The compliance date for the 2016 SEC Cross-Border Rules is the later of February 1, 2017, or the date that is two months prior to the compliance date for SBSD registration (as provided in the SEC's release[23] addressing SBSD and MSBSP registration requirements).

Other than the US activity test for *de minimis* threshold calculation discussed above, the 2016 SEC Cross-Border Adopting Release does not address the other proposals from the 2015 Cross-Border Proposing Release. The SEC anticipates addressing the application of external business conduct standards or clearing and trade execution requirements to certain SBS transactions in subsequent releases.

---

15 Supra note 2 at 278.

16 Supra note 2 at 279.

17 Supra note 2 at 280.

18 Supra note 2 at 280.

19 Supra note 2 at 281.

20 Supra note 2 at 285.

21 Supra note 2 at 288.

22 Supra note 2 at 286.

23 Registration Process for Security-Based Swap Dealers and Major Security-Based Swap Participants, 80 FR 48963 (August 4, 2015), available at https://federalregister.gov/a/2015-19661.

## Prudential Regulators and CFTC: Final Margin Rules for Uncleared Swaps

*The Prudential Regulators and the CFTC release final initial and variation margin rules for uncleared swaps and security-based swaps.*

### Introduction

On October 22, 2015, the Federal Deposit Insurance Corporation, the Department of the Treasury (the Office of the Comptroller of the Currency), the Board of Governors of the Federal Reserve System, the Farm Credit Administration and the Federal Housing Finance Agency (collectively, the "**Prudential Regulators**") released final rules and accompanying interpretive guidance setting out the Prudential Regulators' initial and variation margin requirements applicable to uncleared swaps and security-based swaps (the "**PR Final Margin Rules**").[24] Subsequently, on December 16, 2015, the Commodity Futures Trading Commission (the "**CFTC**") released final rules and accompanying interpretive guidance setting out the CFTC's initial and variation margin requirements applicable to uncleared swaps ("**CFTC Final Margin Rules**").[25]

The finalisation of these rules substantially implements one of the key regulatory reforms contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act by requiring each registered swap dealer ("**SD**"), major swap participant ("**MPS**"), security-based swap dealer ("**SBSD**") and major security-based swap participant ("**MSBSP**") that enters into uncleared swaps and security-based swaps to exchange both initial margin ("**IM**") and variation margin ("**VM**") with certain of their counterparties with the aim of protecting such entities from the risks arising from these transactions and to also generally cushion the US financial system at times of systemic stress.

We set out below a brief summary of these rules. For a more detailed explanation, please see our client alert on these rules available here.

### Covered Swap Entities

The PR Final Margin Rules apply to a registered SD, MSP, SBSD and MSBSP that is regulated by a Prudential Regulator. SDs and MSPs that are not regulated by a Prudential Regulator aresubject to the CFTC Final Margin Rules, whilst SBSDs and MSBSPs that are not regulated by a Prudential Regulator are subject to the initial and variation margin requirements of the Securities and Exchange Commission ("**SEC**"). Both the PR Final Margin Rules and the CFTC Final Margin Rules refer to such entities as a "covered swap entity" or "CSE". We have used the term "**CSE**" herein.

### Covered Swaps

The PR Final Margin Rules apply to swaps and security-based swaps that are not cleared with a derivatives clearing organisation registered with the CFTC (or exempted from such registration) or a clearing agency registered with the SEC (or exempted from such registration), subject to certain exceptions. The CFTC Final Margin Rules apply to swaps (not security-based swaps) that are not cleared with a derivatives clearing organisation registered with the CFTC (or exempted from such registration).

We have referred to swaps and security-based swaps that are subject to the PR Final Margin Rules or the CFTC Final Margin Rules as "**Covered Swaps**".

### Covered Counterparties

The nature of a CSE's obligations under the PR Final Margin Rules and the CFTC Final Margin Rules, as applicable, will depend on which of the following categories its counterparties fall into:

(a) Swap Entities;

(b) Financial End Users **with** a Material Swaps Exposure;

---

24 The text of the final rule is set out in Margin and Capital Requirements for Covered Swap Entities, 80 FR 74839 (November 30, 2015), available at https://federalregister.gov/a/2015-28671; the text of the interim final rule is set out in Margin and Capital Requirements for Covered Swap Entities, 80 FR 74915 (November 30, 2015), available at https://federalregister.gov/a/2015-28670.

25 Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 FR 635 (January 6, 2016), available at https://federalregister.gov/a/2015-32320.

(c) Financial End Users **without** a Material Swaps Exposure;

(d) Affiliates of a CSE; or

(e) Other Counterparties.

**Swap Entities**

A Swap Entity is, with respect to the PR Final Margin Rules, a registered SD, MSP, SBSD and MSBSP (irrespective of whether it is regulated by a Prudential Regulator, the CFTC or the SEC) and, with respect to the CFTC Final Margin Rules, a registered SD and MSP.

**Financial End Users**

The definition of Financial End User broadly captures entities that engage in financial activities that are subject to US Federal or State regulation, including deposit-taking and lending, securities and swaps dealing, investment advisory activities and asset management as well as certain non-bank lending and retail payment firms. It also includes commodity pools and other entities or arrangements that raise or accept money from investors or clients for investing or trading in loans, swaps, securities or other assets as well as any entity that would be a Swap Entity or Financial End User if it were organised in the US. Sovereign governments (including its agencies, departments and ministries), central banks, multilateral development banks, the Bank for International Settlements, certain captive finance companies and certain eligible treasury affiliates are excluded from the definition.

A Financial End User has a "Material Swaps Exposure" when it and its affiliates, together, have an average daily aggregate notional amount of uncleared swaps, security-security based swaps, foreign exchange forwards, and foreign exchange swaps that are not excluded under TRIPRA (see below) with all counterparties (including its affiliates but without double counting) for June, July and August of the previous calendar year that is more than US$8 billion.

**Other Counterparties**

The Final Margin Rules only apply to Covered Swaps entered into by a CSE with a Swap Entity or a Financial End User. Covered Swaps entered into by a CSE with any other counterparty (including those excluded under TRIPRA, see below) are not subject to the PR Final Margin Rules or the CFTC Final Margin Rules.

The Terrorism Risk Insurance Program Reauthorisation Act of 2015 ("**TRIPRA**") provides for additional exclusions similar to those provided to cleared transactions for certain commercial end users that enter into swaps and security-based swaps that are not subject to mandatory clearing but would otherwise have been subject to compliance with the PR Final Margin Rules or the CFTC Final Margin Rules. The effect of TRIPRA is to completely exclude certain swaps and security-based swaps entered into by a CSE with the applicable counterparties from the PR Final Margin Rules and the CFTC Final Margin Rules.

**Affiliates of a CSE**

Both the PR Final Margin Rules and the CFTC Final Margin Rules each include special rules that provide full or partial relief for certain affiliate transactions from the requirement to post and collect IM. However, as the special rules do not apply to VM, VM will need to be posted and collected with all affiliate counterparties in accordance with both the PR Final Margin Rules and the CFTC Final Margin Rules.

## Margin Requirements

**Initial Margin Requirements**

The Prudential Regulators and the CFTC have both adopted a collect and post approach which will require each CSE to:

(a) **collect** IM from each counterparty that is a Swap Entity and Financial End User with a Material Swaps Exposure; and

(b) **post** IM to each counterparty that is a Financial End User with a Material Swaps Exposure;

in each case, commencing on or before the end of the business day following the day of execution of the particular Covered Swap (which is adjusted to accommodate circumstances where the counterparties to a particular Covered Swap do not observe the same business day) and thereafter collect and post on a daily basis until the Covered Swap is terminated or expires.

A CSE is required to calculate IM for a Covered Swap using either an approved risk-based model or a table of standardised minimum gross initial margin requirements. The required amount of IM would be the amount calculated pursuant to the applicable approach minus a threshold amount of up to US$50 million (which is applied with respect to all Covered Swaps across the CSE's consolidated group, not individually to each entity). This IM amount would be a minimum requirement and the parties may negotiate a higher amount.

### Variation Margin Requirements

Each CSE must collect VM from, and post VM to, each counterparty that is a Swap Entity or a Financial End User (irrespective of whether the counterparty has a Material Swaps Exposure), commencing on or before the end of the business day following the day of execution for each Covered Swap with that counterparty and thereafter collect and post not less than daily until the termination or expiry of the Covered Swap. The amount of VM to be posted or collected with respect to a Covered Swap is the amount equal to:

(a) the cumulative mark-to-market change in value to a Covered Swap as determined pursuant to the applicable documentation (i.e., mid-market prices, if consistent with the agreement of the parties); *less*

(b) the value of all VM previously collected; *plus*

(c) the value of all VM previously posted.

The CSE must collect this amount if it is positive, and post this amount if it is negative.

### Minimum Transfer Amount

A CSE is only required to collect or post IM or VM when the combined amount of both IM and VM required to be collected or posted exceeds US$500,000. This requirement only affects the timing of margin transfers, not the amount—that is, once the threshold is crossed, the full amount of IM and VM is required to be transferred.

## Netting Arrangements

Where more than one Covered Swap is executed pursuant to an eligible master netting agreement (for example, a 1992 or 2002 ISDA Master Agreement), the CSE is permitted to calculate IM and VM on an aggregate basis with respect to all Covered Swaps governed by such agreement.

A CSE is entitled to maintain multiple netting portfolios under a single eligible master netting agreement (for example, through the use of multiple credit support annexes). This facilitates the ability of parties to document two separate netting sets, one for Covered Swaps and another for swaps and security-based swaps that are not subject to the PR Final Margin Rules and the CFTC Final Margin Rules.

## Collateral

### Eligibility

The types of collateral eligible for VM will depend on the type of counterparty, whilst eligible collateral for IM applies across all counterparty types. The table below sets out a summary of the eligibility requirements.

| Asset Class | Initial Margin | Variation Margin | |
|---|---|---|---|
| | All Counterparties | Swap Entities | Financial End Users |
| US dollars | ✓ | ✓ | ✓ |
| A currency in which the payment obligations under the Covered Swap are required to be settled | ✓ | ✓ | ✓ |

| Asset Class | Initial Margin | Variation Margin | |
|---|---|---|---|
| | All Counterparties | Swap Entities | Financial End Users |
| Other major currencies, including Canadian dollars, euros, United Kingdom pounds, Japanese yen, Swiss francs, New Zealand dollars, Australian dollar, Swedish kroner, Danish kroner, Norwegian krone and any other currency designated by the Prudential Regulators or the CFTC | ✓ | ✓ | ✓ |
| US Treasury securities | ✓ | ✗ | ✓ |
| Certain securities guaranteed by the US government | ✓ | ✗ | ✓ |
| Certain redeemable securities in a pooled investment fund | ✓ | ✗ | ✓ |
| Certain securities issued or guaranteed by the European Central Bank, a sovereign entity, the Bank for International Settlements, the International Monetary Fund or a multilateral development bank. | ✓ | ✗ | ✓ |
| Certain corporate debt securities | ✓ | ✗ | ✓ |
| Certain equity securities maintained in major indices | ✓ | ✗ | ✓ |
| Gold | ✓ | ✗ | ✓ |

The following assets are excluded as eligible collateral for both IM and VM:

(a) securities issued by a party (or any affiliate of that party) posting that security;

(b) securities issued by bank holding companies, depository institutions and market intermediaries; and

(c) securities issued by certain systemically important non-bank financial institutions.

**Haircuts**

All non-cash eligible collateral is subject to a haircut (or discount) that varies by the type of asset and, in some instances, the length of its maturity. There is also a cross-currency haircut of 8% that is applied (in addition to any other asset-specific haircut that might apply) whenever eligible collateral (including cash) posted as either IM or VM is denominated in a currency other than the currency in which regularly occurring payment obligations related to a Covered Swap are to be discharged under the applicable agreement.

## Segregation of Collateral

IM that is posted or collected by a CSE must be held by one or more custodians that are not the CSE, the counterparty, or any of their affiliates (subject to certain limited exceptions). The custodian must enter into a legal, valid, binding an enforceable agreement that (i) prohibits the custodian from re-hypothecating, re-pledging, reusing or otherwise transferring the custodied assets and (ii) limits the rights of substitution and reinvestment to assets that are eligible collateral (see above).These segregation requirements do not apply to any collateral collected or posted as VM.

## Documentation Requirements

A CSE and a counterparty that is a Swap Entity or Financial End User must enter into documentation that provides the CSE with a contractual right and obligation to exchange IM and VM in such amounts, in such form, and under such circumstances as are required by the PR Final Margin Rules and the CFTC Final Margin Rules. The documentation must include the methodology and data sources to be used to value positions and to calculate IM and VM, and the valuation dispute resolution procedures.

## Cross-Border Application

### PR Final Margin Rules

*Exclusion*

The PR Final Margin Rules exclude any "foreign non-cleared swap or foreign non-cleared security-based swap" of a "foreign covered swap entity" from the PR Final Margin Rule's requirements. A "foreign covered swap entity" means a CSE that is not:

(a) an entity organised under US or State law, including a US branch, agency, or subsidiary of a foreign bank;

(b) a branch or office of an entity organised under US or State law; or

(c) an entity controlled by an entity organised under US or State law

"Foreign non-cleared swap" means any non-cleared swap of a foreign covered swap entity to which neither the counterparty nor any guarantor (on either side) is:

(a) an entity organised under US or State law, including a US branch, agency, or subsidiary of a foreign bank;

(b) a branch or office of an entity organised under US or State law; or

(c) a CSE controlled by an entity organised under US or State law

This would not include a swap with a non-US branch of a US bank or a US branch or subsidiary of a non-US bank.

*Substituted Compliance*

A CSE may also be entitled to satisfy the requirements of the PR Final Margin Rules through substituted compliance with a non-US regulatory framework where the Prudential Regulators have made a substituted compliance determination.

### CFTC Final Margin Rules

On May 24, 2016 the CFTC adopted finalised rules and accompanying interpretative guidance setting forth the application of the CFTC Final Margin Rules to cross-border swap transactions.[26] A White & Case Client Alert detailing these final rules will be released in due course on www.whitecase.com.

## Implementation

The compliance date for the IM and VM requirements depends on the average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards and foreign exchange swaps in March, April and May of a given year for both:

(a) the applicable CSE combined with all of its affiliates; and

(b) its counterparty combined with all of its affiliates.

A CSE may well have multiple compliance dates as the triggers are dependent on both the CSE itself and its counterparties. Once a CSE and its counterparty are subject to the Final Margin Rules, they will both remain subject from that period forward.

[26] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants—Cross-Border Application of the Margin Requirements, 81 FR 34817 (May 31, 2016), available at https://federalregister.gov/a/2016-12612. For information on the CFTC's proposed cross-border rule please refer to our client alert available here.

| Compliance Date | Initial Margin | Variation Margin |
|---|---|---|
| September 1, 2016 | If average daily aggregate notional amount of uncleared instruments greater than US$3 Trillion in March, April and May of 2016 | If average daily aggregate notional amount of uncleared instruments greater than US$3 Trillion in March, April and May 2016 |
| March 1, 2017 | --- | For any other CSE with respect to uncleared instruments entered into with any other counterparty |
| September 1, 2017 | If average daily aggregate notional amount of uncleared instruments greater than US$2.25 Trillion in March, April and May 2017 | --- |
| September 1, 2018 | If average daily aggregate notional amount of uncleared instruments greater than US$1.5 Trillion in March, April and May 2018 | --- |
| September 1, 2019 | If average daily aggregate notional amount of uncleared instruments greater than US$0.75 Trillion in March, April and May 2019 | --- |
| September 1, 2020 | For any other CSE with respect to uncleared instruments entered into with any other counterparty | --- |

## No-Action Relief from CFTC Rule 3.10(c)(3) Clearing Requirement

*CFTC grants no-action relief regarding the application of the exemption in CFTC Rule 3.10(c)(3) to swaps that are not subject to a clearing requirement.*

### Introduction

On February 12, 2016 the Commodity Futures Trading Commission ("**CFTC**") issued CFTC No-Action Letter 16-08 which granted no-action relief to introducing brokers ("**IB**"), commodity trading advisors ("**CTA**") and commodity pool operators ("**CPO**") seeking to rely on the exemption in CFTC Rule 3.10(c)(3) with respect to activities involving swaps that are not subject to a clearing requirement.

### Background

As swaps became subject to regulation under the Commodity Exchange Act ("**CEA**") under the regulatory framework established by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"), the universe of entities that were required to register as IBs, CTAs or CPOs was significantly expanded. One of the primary exemptions from registration utilized by non-US entities that would otherwise be required to register in such a capacity is the exemption in CFTC Rule 3.10(c)(3).

CFTC Rule 3.10(c)(3) provides an exemption from registration as an IB, a CTA or a CPO where all of the following requirements are satisfied:

(1) the person seeking the exemption is located outside the US, its territories or possessions;

(2) the person seeking the exemption acts only on behalf of persons located outside of the US, its territories or possessions; and

(3) the commodity interest transaction (the definition of which now includes swaps following enactment of the Dodd-Frank Act) was submitted for clearing through a futures commission merchant registered under Section 4d of the CEA ("**FCM**").

CFTC Rule 3.10(c)(3) was adopted a number of years ago, well before the CEA was most recently amended under the Dodd-Frank Act, and originally only applied to futures and listed option contracts. Those contracts, unlike swaps, are cleared through an FCM. As the requirement to clear the commodity interest transaction through an FCM (see prong (3) above) was retained following the inclusion of swaps within the definition of "commodity interest transaction", there is a concern with the current drafting of CFTC Rule 3.10(c)(3) where a person that satisfies prongs (1) and (2) above transacts a swap (as opposed to a futures or listed option contract). The text provides that in such circumstances the person seeking exemption from registration under CFTC Rule 3.10(c)(3) would only be able to benefit from the exemption if the applicable swap was submitted for clearing through an FCM.

The problem with this requirement is that swaps which are executed bilaterally, subject to the rules of a swap execution facility (or SEF) or not yet accepted for clearing by any derivatives clearing organization would not satisfy the requirement in prong (3). Therefore, even if a person met all the other requirements for the exemption in CFTC Rule 3.10(c)(3), it would be unable to rely on the exemption where the applicable swap is not submitted for clearing through an FCM. The requestors of the no-action relief believed that the requirement in prong (3) was not reasonable given that neither the CEA nor the CFTC Rules require that all swaps be cleared and that some swaps are not yet accepted for clearing by any derivatives clearing organization.

## Exemptive Relief

The CFTC's Division of Swap Dealer and Intermediary Oversight ("**DSIO**") acknowledged in CFTC No-Action Letter 16-08 that CFTC Rule 3.10(c)(3) was not intended to impose an independent clearing requirement on commodity interest transactions and that therefore no-action relief was warranted.

Under the no-action relief, the DSIO will not recommend an enforcement action against a person located outside of the US, its territories or possessions engaged in an activity of an IB, a CTA or a CPO, in connection with swaps not subject to a clearing requirement only on behalf of person located outside the United States, its territories or possessions, for failure to register in such capacity. To put it another way, if a person that is engaged in an activity of an IB, a CTA or a CPO satisfies the requirements in prongs (1) and (2) but not prong (3) because the applicable swap was not subject to a clearing requirement, that person should be entitled to rely on the exemption in CFTC Rule 3.10(c)(3) and the DSIO will not recommend an enforcement action against that person for failing to register in the applicable capacity due to the fact that the requirement in prong (3) was not also satisfied.

This relief is available until the effective date or compliance date of any final rule amending CFTC Rule 3.10(c)(3).

# Regulatory Developments in Europe

## European Margin Rules for Non-Cleared OTC Derivatives – Final Draft RTS are adopted by the European Supervisory Authorities

### Introduction

On 8 March 2016, the European supervisory authorities (the "**ESAs**") adopted the long-awaited final draft RTS on margin requirements for non-cleared derivatives (the "**Margin Rules**"). The Margin Rules constitute the risk mitigation techniques related to the exchange of collateral to cover exposures arising from non-centrally cleared OTC derivatives and are a key block of the EMIR[27] regulatory framework. The Margin Rules include a number of helpful changes and clarifications from previous drafts[28] although the implementation timeline remains unchanged. The phase-in period will begin on 1 September 2016, after which the largest firms will have to comply with initial margin ("**IM**") and variation margin ("**VM**") requirements. Thereafter, until 2020, IM and VM requirements will be phased-in based on the notional volume of market participants' non-cleared derivatives books. Furthermore, concerns remain around settlement timings, the treatment of counterparties in non-netting jurisdictions and segregation requirements.

### Background

The Initial Consultations (see footnote 2 below) set out a framework of rules for the exchange of collateral for non-centrally cleared OTC derivatives in Europe. Such framework can be summarised as follows:

(a) all non-cleared, OTC derivatives would be covered except for indirectly cleared transactions, physically settled FX transactions and covered bond swap transactions;

(b) it would be recognised in the rules that intragroup transactions do not raise the same systemic and counterparty risks as transactions with third parties and, therefore, there would be an exemption applicable for such transactions, subject to certain criteria being met;

(c) both FCs and NFC+s[29] would be required to comply with the obligations under the rules and this would also apply (a) whether or not the facing entity was established in the European Union ("**EU**") (assuming it would be subject to the rules were it based in the EU) and (b) to a situation where both entities were established outside of the EU but the transactions would have a direct, substantial and foreseeable effect within the EU or application of the rules was necessary to prevent the evasion of any provision of EMIR;

(d) the rules would include mandated methods of calculating IM (either by way of a standard method or an approved model);

(e) collateral posted subject to the rules would be subject to certain minimum requirements as to eligibility, mandated valuation percentages, FX haircuts and concentration limits;

(f) operational processes would need to be revised to comply with mandated settlement timings, documentation requirements and periodic reviews of legal enforceability of netting and segregation arrangements; and

(g) any IM collected would need to be segregated from proprietary assets and immediately available following a default by the collateral taker.

The Margin Rules have built on this initial framework following extensive consultation between industry groups, market participants and the ESAs. A number of the key concerns raised with the ESAs have been addressed, principally in the areas of eligibility requirements, segregation, the use of cash as collateral and

27 Regulation No 648/2012 of the European Parliament and of the Council.

28 Joint Consultation on draft RTS on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP (JC/CP/2014/03), issued by the EBA, EIOPA and ESMA on 14 April 2014 and Second Joint Consultation on draft RTS on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP (EBA/JC/CP/2015/002) (together the "**Initial Consultations**").

29 Each as defined under EMIR.

the workings of the key intragroup exemption. This article seeks to summarise these important changes and also highlight the areas in which further clarification is required.

## Intragroup Transactions Exemption

The Initial Consultations provided for an exemption for all intra-group transactions, provided that:

(a) the conditions for the clearing exemption had been met;

(b) there was no "practical or legal impediment" to the transfer of funds or repayment of liabilities;

(c) if an entity was not established in the European Union, that it was established in an "equivalent jurisdiction"[30]; and

(d) a notification/ approval regime was complied with dependent on whether the counterparty was an FC or NFC+.

It was hoped that the ESAs may introduce a general exemption for intragroup transactions from the IM requirements. While this has not been included in the Margin Rules, intragroup trades involving group entities in non-EU jurisdictions are now waived from margin requirements for three years following the relevant effective date.[31] This is intended to allow time for the necessary equivalence decisions to be adopted by the ESAs. Likewise, the ESAs have also clarified how the thresholds determining when parties are required to comply with the Margin Rules will operate regarding intragroup transactions by stating that each notional amount need only be accounted for once.[32]

## Calculations and Thresholds

Useful clarifications have been made around when margin is required to be posted. The "Minimum Transfer Amount" provided that where the total margin to be exchanged between the counterparties is equal to or lower than EUR 500,000, no margin (IM or VM) needs to be exchanged. The Margin Rules clarify that separate Minimum Transfer Amounts can be agreed for IM and VM provided that they do not exceed the EUR 500,000 total.[33]

The calculation of the Threshold Amount[34] (which will apply at the end of the phase-in period) has also been amended as follows (a) the aggregate month-end notional amounts shall now be based on those for March, April and May of the previous year (as opposed to June, July and August) and (b) it is confirmed the calculation of the Threshold Amount at group level will include all intragroup non-centrally cleared OTC derivatives (accounted for once).

## Treatment of Physically-settled FX Swaps and Forwards and Options

It is confirmed in the Margin Rules that physically settled FX forwards and swaps (including those associated with the exchange of principal of cross-currency swaps) will be excluded from IM requirements. Furthermore, there is a new derogation[35] included delaying application of VM requirements to FX forwards (although not swaps) until 31 December 2018 (or earlier in the event separate delegated legislation is brought into force).

The Initial Consultations also left unclear the treatment of derivatives that present credit risk for only one of the two counterparties (i.e. options). It has been clarified that where a netting set consists solely of option positions, the option seller may choose not to collect additional IM or VM for such derivatives, whereas the option buyer should collect both IM and VM as long as the option seller is not exposed to any credit risk.[36]

---

[30] As defined by reference to the equivalence regime under EMIR.

[31] See Article 39(9) of the Margin Rules.

[32] See Article 8(1) of the Margin Rules.

[33] See Article 4(3) of the Margin Rules.

[34] This provides that IM is not required where one of the two counterparties has (or belongs to a group that has) an aggregate-month-end average notional amount of non-centrally cleared OTC derivatives below EUR 8 billion.

[35] See Article 39(6) of the Margin Rules.

[36] See Recital (6) of the Margin Rules.

## Eligibility of Collateral

This section of the Margin Rules contains the most important changes from the Initial Consultations and is an area where the feedback from industry participants has most clearly been adopted.

### Wrong-way Risk

Avoidance of wrong-way risk ensures that the collateral collected is sufficiently diversified and not subject to the risk that exposure increases with the increased risk of counterparty default. Previously, a range of collateral types from sovereign linked public sector entity debt to equities and corporate bonds were all subject to the requirement that they were not issued by the same posting counterparty (nor issued by entities in the same group) and also that they did not have "close links". This was concerning given "close-links" could mean as little as 20 per cent. common ownership. This requirement has now been removed.[37]

### Concentration Limits

In the Initial Consultations, concentration limits in relation to the collateral posted were included as applicable to all in-scope counterparties with percentage limits varying from 10 to 50 per cent. (of the collateral collected) depending on the type of collateral posted and the entities posting such collateral[38]. While it was accepted by industry participants that such limits were workable in the IM context, there were concerns the application of such limits to VM would lead to liquidity issues. The applicability of the concentration limits has now been removed for VM under the Margin Rules.

The method of calculating the concentration limits has also been amended in two key ways. Firstly, the concentration limit applicable to (among other types of collateral) corporate bonds, gold, debt securities issued by regional governments of sovereigns and senior securitisation tranches was previously 10 per cent. and is now 15 per cent[39]. Secondly, it was thought that the concentration limits may result in required transfers of small amounts of collateral. To avoid non-material transfers, the Margin Rules now include a requirement that the amount of collateral posted must be greater than EUR 10 million before the concentration limits apply.[40]

Two helpful derogations from the concentration limits have also now been included. Firstly, such limits are required to be assessed on the basis of the standard frequencies for calculating IM[41] (e.g. each time a new contract is added or expires in a netting set), which at a minimum would mean every 10 business days. In recognition that compliance at such a frequency may represent a burden on certain organisations, a derogation for pension scheme arrangements[42] is included in the Margin Rules, provided that the total amount of collateral collected for such entities is below EUR 800 million.[43]

Secondly, Article 28(6) of the Margin Rules also provides that any collateral collected that is in the form of an asset class that is the same as the underlying asset class of the OTC derivative (for example, an equity option), the collecting counterparty need not apply the concentration limits. A key reason for including this change arose from market participants noting that risks in certain derivatives (e.g. equity derivatives) are often best mitigated by collateral in the form of the relevant underlying asset. It was thought concentration limits in such instances would increase risk rather than reduce it.

---

37 See Article 27 of the Margin Rules.

38 Two categories of concentration limits are applicable across the various types of eligible collateral depending on the entities posting that collateral. For "Category A" entities (i.e. any entity that is within the scope of the Margin Rules), the concentration limits have limited applicability and do not exceed 10 (now 15) per cent. (except in relation to senior securitisation tranches, equities and certain other types of collateral where the sum of collateral collected may not exceed 40 per cent. of a single issuer). For "Category B" entities (those for where the collateral collected exceeds EUR 1 billion and both counterparties are G-SIIs or O-IIs (as defined by reference to Regulation (EU) No 575/2013 "CRD IV")), additional limits apply to assets such as debt securities issued by central governments and regional governments and debt securities issued by credit institutions where a 50 per cent.(of the total collateral collected) limit has been imposed.

39 See Article 28 of the Margin Rules.

40 See Article 28 of the Margin Rules.

41 See Article 14(3) of the Margin Rules.

42 As defined by reference to Article 2(1) of EMIR.

43 See Article 28(7) of the Margin Rules.

**FX Haircuts**

A number of important clarifications have been made to the requirements for FX haircuts applicable to IM and VM, which were previously of major concern to market participants. First, it has been confirmed that for VM, collateral posted in cash will not be subject to any FX haircut and non-cash collateral will only be subject to an FX haircut (of 8 per cent.) if it is posted in a currency that has not been previously agreed between the parties[44]. The latter requirement can easily be resolved by specifying any currencies the parties wish to exchange in the relevant credit support document.

In respect of FX haircuts applicable to IM, both non-cash and cash collateral that are posted will only be subject to an FX haircut (of 8 per cent.) where the assets posted by a party are in a currency that is different from the "termination currency" applicable to that party.[45] The Margin Rules also confirm that each party may have a separate termination currency. These clarifications are a significant improvement on the previous provisions, which were much broader.

Provision has also been made for currencies that may differ, for example, from the termination currency, but are pegged to such currency. Article 29(2) of the Margin Rules provides that counterparties may disregard positions in currencies which are subject to a legally binding intergovernmental agreement to limit the variance between them.

## Trading Documentation

Amendments have also been made in this section regarding the independent legal review that parties are required to undertake of the legal enforceability of netting and segregation arrangements. Previously, this was required to be conducted by an independent organisation on a yearly basis. Noting the administrative and cost burdens of this exercise, it has now been confirmed that such review need only take place on entry into the trade, with policies put in place to ensure ongoing compliance[46]. The review may be carried out by an internal independent unit as opposed to requiring external organisations to undertake such reviews. Furthermore, there is also a new overlap with CRD IV; Article 32(3) provides that any reviews conducted for the purposes of obtaining the relevant regulatory capital relief under CRD IV shall be recognised for the purposes of compliance with the Margin Rules. However, issues remain in the context of non-netting jurisdictions (see further below).

## Segregation

Important changes have likewise been made regarding the requirement to segregate IM once collected. Most importantly, the de facto ban on using cash collateral for IM has been removed. This effective ban arose from the requirement that cash be protected via segregation from the default or insolvency of the third party holder or custodian (which is not possible as a custodian acts as banker and not trustee). Article 34 now confirms that although the collecting counterparty may not re-hypothecate, re-pledge or re-use collateral collected as IM, this requirement shall be deemed satisfied where a third party holder or custodian reinvests IM received in cash[47]. However, issues remain with this approach linked to the assessments the counterparty collecting the collateral must make as to the third party holder or custodian's creditworthiness. These requirements are set out in Article 23 of the Margin Rules; (d)(ii) of which requires that they are authorised in accordance with CRD IV. This would imply that the third party holder or custodian not only must be separate from the group of the collecting and posting counterparties, but that they are also established in the EU. Alongside the separate concentration limit applicable to G-SIIs and O-SIIs, these requirements still mean there are difficulties for counterparties seeking to use cash IM.

## Practical Considerations and Outstanding Issues

In summary, while a number of helpful changes and clarifications have been made in the Margin Rules, issues remain outstanding with interpretation and their workability. These are likely to be raised with the ESAs prior to

---

44 See Annex II of the Margin Rules.

45 See Annex II of the Margin Rules.

46 See Articles 32 and 33(5) of the Margin Rules.

47 However, it should be noted that this provision is subject to a separate concentration limit, which provides that G-SII's and O-SII's must ensure that where they collect IM from a counterparty that is also a G-SII or O-SII, not more than 20 per cent. of such IM is held in cash by a single third party custodian (See Article 28(5) of the Margin Rules).

final publication by the European Commission (which has three months to review them) but some issues, particularly surrounding settlement timings are likely to remain logistically difficult for market participants.

(a) **Article 11. Treatment of Counterparties in non-netting jurisdictions.** The Margin Rules have sought to reflect (in part) a request from market participants that there be a blanket exemption from margin requirements when dealing with counterparties in a non-netting jurisdiction, provided that such dealings did not exceed a certain percentage of the relevant counterparty's OTC derivatives portfolio. Article 11(3) provides for this although does include a requirement that no more than 2.5 per cent. of the total notional amounts of OTC derivatives contracts for a counterparty's group are made up of such transactions. However, it is not clear from Article 11 what the difference is between this requirement and that in Article 11(1) which simply states that if netting enforceability comfort cannot be obtained, exchange of IM and VM is not required. It is unclear whether this would mean trading is prohibited, collateral should be collected on a gross basis or trading may take place without collection of margins even if this was potentially possible (despite not being able to obtain the appropriate netting enforceability comfort). This would also seem to contradict the recitals of the Margin Rules which state that collateral should be collected wherever possible. Clarification on the interaction between Article 11(1) and (2) will hopefully be forthcoming to explain this discrepancy.

(b) **Settlement Timings for IM and VM.** Market participants have repeatedly raised concerns around calculation and settlement timings and had requested that the requirements for both IM and VM reflect the standard settlement cycles in the market (according to asset type). The Margin Rules provide that, for IM, calculation is still required the day after an OTC derivative is entered into or executed, matures, triggers a payment or delivery (other than the posting of margins) and, by way of fallback, where no calculation has been performed in the preceding 10 business days, with collection to follow on the next business day[48] and, for VM, that collateral is also collected within 1 business day of calculation (or two if there is no requirement to collect IM)[49]. To address concerns market participants raised over time-zone differences presenting issues with collateral collection, the concept of a "calculation date" has also been included in Article 12[50]. This is predicated on where a counterparty is "located". It is unclear what "located" means in this context and it is likely industry groups will need to work to find a common approach, subject to further clarification from the ESAs. Furthermore, notwithstanding the addition of the "calculation date" and clarifications around collection date requirements, the Margin Rules do not fully address the concerns market participants have raised. Should the Margin Rules be published in their current form, it may imply prohibitively increased costs to enable compliance on an ongoing basis.

(c) **Segregation of IM cash.** As mentioned above, it remains unclear whether third party holders or the custodian holding cash IM need to be based in the EU (i.e. authorised in accordance with CRD IV) and whether there are currently sufficient numbers of suitable organisations in the market (given the third party holder or custodian may also not be part of the same group of either party).

(d) **Phase-in timetable.** Despite the Margin Rules only being released in final form this month, in September 2016, the largest market participants will be required to begin compliance with both the IM and VM requirements and from March 2017, all counterparties within the scope of the Margin Rules will be required to comply with the VM requirements. Market participants should ensure that their counterparties are made aware of these highly significant changes, particularly those based in third country jurisdictions who may not be aware that such requirements will apply to them by the end of the year. Market participants should also note that The International Swaps and Derivatives Association Inc. ("**ISDA**") has set up a working group to facilitate the implementation of these rules from a documentation perspective. Release of this documentation and the subsequent adoption of it in the market will be the next major development this year in the implementation of these requirements.

---

[48] See Article 14(5) of the Margin Rules.

[49] See Article 13(3) of the Margin Rules.

[50] Article 12(2) provides that for the purposes of setting dates for IM and VM calculation, (a) for counterparties located in the same time zone, the calculation shall be based on the netting set existing as of the previous business day and (b) for counterparties not located in the same time zone, the calculation shall be based on the netting set of transactions existing and entered into before 16:00 hours of the previous business day in the time zone where it is first 16:00 hours.

## The SFTR – The EU Expands its Rulebook to Cover Securities Financing Transactions and the Reuse of Collateral

### Introduction

The Regulation on Transparency of Securities Financing Transactions and of Reuse (2015/2365) (the "SFTR") entered into force on 12 January 2016 following publication in the Official Journal of the European Union on 23 December 2015. As part of a wider EU initiative on shadow banking, a key aim of the SFTR is to improve transparency in securities and commodities lending, repurchase transactions, margin loans and certain collateral arrangements. While the regulation, transparency and monitoring of securities financing transactions ("SFTs") did not fall within the extensive ambit of EMIR[51], the SFTR now extends requirements similar to those found in EMIR to such transactions.

The SFTR will require:

(a) reporting of all SFTs to trade repositories by both parties to the trade and mandatory record keeping (the "**Reporting Obligation**");

(b) detailed disclosure by certain investment funds of their use of SFTs and total return swaps ("**TRS**") to investors in pre-investment documentation and ongoing reporting (the "**Disclosure Obligation**"); and

(c) the obtaining of consent from, and disclosure of, risks to SFT counterparties entering into rights of use and title transfer collateral arrangements (the "**Reuse Obligation**").

The SFTR has been broadly drafted and further detail on the activities covered and the related requirements is needed. As well as the provisions subject to delegated legislation in the SFTR itself, it also seems likely that further initiatives (for example, in relation to risk mitigation requirements surrounding SFTs) will be brought into force down the line. Market participants and industry bodies will need to turn their attention to achieving standardised methods of compliance, updates to legal opinions and addressing issues such as confidentiality and the delegation of reporting.

### Who is affected by the SFTR?

Article 2 of the SFTR states that the following entities will be covered:

(a) counterparties to an SFT that are established (a) in the EU (including all branches irrespective of location (i.e. non-EU branches)) or (b) outside of the EU if the SFT is concluded in the course of business of an EU branch of that counterparty;

(b) UCITS funds (and their management companies) and AIFMs authorised or registered in accordance with AIFMD[52], irrespective of where they are established; and

in relation to the Reuse Obligation only, counterparties established outside the EU, in either of the following situations: (a) the reuse is effected in the course of business of an EU branch or (b) the reuse concerns 'financial instruments'53 provided as collateral by a counterparty established in the EU (or an EU branch of a third country entity (i.e. a non-EU entity reuses an EU entity's collateral)).

### Which Transactions are covered?

**SFTs.** The disclosure and reporting requirements of the SFTR apply to SFTs[54], which include the following:

(a) repurchase transactions (including reverse repurchase transactions) relating to securities or commodities;

(b) securities lending and securities or commodities borrowing (where there is a commitment to return equivalent securities or commodities);

---

51 *Regulation No 648/2012 of the European Parliament and of the Council*.

52 *Directive 2011/61/EU.*

53 As defined in accordance with MiFID II and thus includes government and corporate bonds, shares, derivatives and emissions allowances.

54 "Derivative" transactions are excluded as these are covered by EMIR.

(c) buy-sell back or sell-buy back transactions relating to securities or commodities; and

(d) margin lending transactions (which is likely to cover prime brokerage agreements).

**TRSs.** Those provisions of the SFTR which require disclosure to investors in certain funds such as UCITS and AIFMs also apply to TRSs.

**Collateral Arrangements.** Provisions relating to reuse of collateral will apply to "collateral arrangements" (both title transfer financial collateral and security financial collateral arrangements), as defined by reference to the pre-existing (and subject of much vexed analysis) Financial Collateral Directive[55] (the "**FCD**"). Both title transfer financial collateral arrangements and security financial collateral arrangements (each as described and defined in the FCD) are covered.

Those definitions will overlap with SFTs to the extent that an SFT constitutes a "collateral arrangement". However, the obligations are not limited to "collateral arrangements" that are SFTs and could apply to collateral provided in connection with a transaction that is not an SFT (for example, the provision of collateral under an ISDA credit support annex or credit support deeds) where such arrangement falls within the definition of a financial collateral arrangement under the FCD. Such arrangements, to the extent they contain a right of reuse, will be covered by the disclosure and consent requirements, as explained further below.

## Reporting Obligation (Article 4)

The Reporting Obligation for SFT counterparties requires that reports of the details of any SFT concluded, modified or terminated will need to be submitted to a trade repository[56] on a T+1 basis. Counterparties must also maintain records of SFTs for at least five years following the termination of the relevant transaction.

As with reporting under EMIR, the obligation may be delegated, subject to certain mandatory rules, although the ultimate responsibility for compliance rests with the counterparty. Financial Counterparties entering into SFTs with Non-Financial Counterparties[57] that qualify as 'small or medium sized enterprises' will be required to report on behalf of these counterparties and UCITS managers and AIFMs will have to report on behalf of their funds.

The details to be reported will be documented in RTS to be developed in due course by the European authorities (they are required to be submitted in draft by 13 January 2017). For pools of assets, it is likely that the position level collateral data should be sufficient.

A phase-in for the Reporting Obligation has been included in the SFTR which, in summary (and assuming timely progress) will mean that banks and investment firms will need to start reporting trades from mid-2018.

The Reporting Obligation also applies to SFTs existing at the relevant effective date of the phase-in, provided that they either have a remaining maturity in excess of 180 days or an open maturity and remain outstanding 180 days after that date.

## Disclosure Obligation (Articles 13 and 14)

Under Articles 13 and 14 of the SFTR UCITS funds (and their management companies) and EU-authorised managers of AIFs will be required from 13 January 2017 to disclose to their investors their uses of SFTs and TRSs in their annual (and half yearly) reports. From 12 January 2016, prospectuses (or similar disclosure documents) for an AIF or UCITS are also required to specify the SFTs and TRSs that the manager is authorised to use and must contain detailed disclosure on the nature, uses and rationale of such transactions. Any funds pre-existing prior to 12 January 2016 will also be covered by such requirements (although the effective date is postponed to 13 July 2017).

---

[55] *Directive 2002/47/EC*

[56] Such Trade Repository must have been registered under Article 5 of the SFTR or recognised in accordance with Article 19 of the SFTR. If a trade repository is not available, or in the event no repository has been registered or recognised in time for the start of reporting, counterparties are to report directly to ESMA.

[57] Financial Counterparties and Non-Financial Counterparties are defined in Article 3(3) and (4), respectively, of the SFTR and track the classifications outlined in EMIR.

## Reuse Obligation (Article 15)

The SFTR restricts the instances in which counterparties have the right to 'reuse' 'financial instruments' received as collateral under collateral arrangements[58]. Compliance with this obligation (for new and existing collateral arrangements) is required by 13 July 2016.

Broadly, there are two conditions which will need to be satisfied for the collateral taker to reuse collateral. Firstly, the collateral provider must be notified in writing by the collateral taker of the risks and consequences involved in (a) granting consent to reuse of collateral and/or (b) concluding a title transfer agreement. The notification must include the risks and consequences that may arise on a default of the collateral taker. Secondly, the collateral provider is required to have granted its prior express consent in writing (or a legally equivalent manner), to a security collateral arrangement which provides for a right of reuse (in accordance with Article 5 of the FCD) or has expressly agreed to provide collateral by way of a title transfer agreement. These requirements will need to be dealt with by specific disclosures in master agreements/ related credit support documents or disclosure through standard terms of business and the execution of market standard securities financing/ related credit support documentation, amended as necessary.

Where the right of reuse is exercised, the reuse must also be undertaken in accordance with the prior written agreement between the parties and the 'financial instruments' received under the collateral arrangement must be transferred from the account of the collateral provider.

After industry bodies raised concerns over the issue, a safeguard has been included which provides that Article 15 shall not affect national law concerning the validity or effectiveness of the collateral arrangement. This protection means that a breach of the requirements outlined above should not render a transfer of collateral invalid (as this would be a matter for the applicable law where the transfer takes place). Crucially, this should mean that the enforceability of security and/or the operation of close-out netting in related transactions should be unaffected.

## Sanctions for Non-compliance

EU Member States are required to set proportionate sanctions and measures that can be applied for breaches of the SFTR. Minimum suggested sanctions include withdrawal of authorisation, public warnings, dismissal of management, restitution of profits and administrative fines. Member States may also choose to apply criminal sanctions alongside these on notification to ESMA.

## Next steps?

While there are no provisions for risk mitigation in the SFTR equivalent to those in EMIR, Article 29 requires that further consideration is given to this in the SFT context and a report is required to be submitted to the European Parliament by 13 October 2017. Specifically, this includes the Financial Stability Board recommendations for haircuts on certain non-centrally cleared SFTs. The BCBS also issued a consultation paper in November 2015 outlining similar proposals as well as suggesting high regulatory capital charges where the transactions do not meet minimum haircuts. It is therefore likely that further rules may be introduced in this area in due course.

## Conclusions and Considerations

Much remains to be settled following the coming into force of the SFTR although the following points should be noted:

(a) As mentioned, in relation to the written consent requirement, we generally expect this to be satisfied through using signed legal documents to effect the reuse (notably industry standard GMRAs, GMSLAs and ISDAs (amended as appropriate)).

(b) The Reporting Obligation will apply in addition to existing disclosure requirements that may be triggered by SFTs[59]. These reporting requirements may be onerous, expensive to implement and

58 'Reuse' is defined under Article 3(12) of the SFTR as the use by a receiving counterparty, in its own name and on its own account or on the account of another counterparty, including any natural person, of financial instruments received under a collateral arrangement. Under this definition, 'reuse' includes transfer of title or exercise of a right of use in accordance with Article 5 of the FCD but does not include "the liquidation of a financial instrument in the event of default of the providing counterparty".

59 For example, the Transparency Amending Directive (2013/50/EU).

comply with (particularly given the detailed nature of the disclosure). SPVs, pension fund and other institutions will likely to need to delegate to third parties to report on their behalf. Risk factor updates (where relevant) should be considered in respect of such obligations, the associated costs and potential sanctions for breach.

(c) The need for express consent from a collateral provider under a security financial collateral arrangement with a right of reuse may be straightforward to address in certain contexts (e.g. prime brokerage) but it may be necessary to carry out due diligence to identify other such arrangements that may include rights of reuse.

(d) Amendments to standard form documentation and developments in market practice will be required to and should be addressed alongside those needed for compliance with the margin rules (*see article "Update: The EU Margin Rules"*). It is also likely that "Next steps" outlined above will encourage parties to look towards central clearing for stock loans and repos.

# Regulatory Developments in Asia

## OTC Derivatives Reporting and Clearing in Singapore – An Update on the Regulatory Reforms

### Background

Since 2012, in line with its commitment to the G20 and Financial Stability Board ("**FSB**") reform objectives, the Monetary Authority of Singapore (the "**MAS**") has undertaken a comprehensive review of the Securities and Futures Act (the "**SFA**") and related subsidiary regulations to ensure that the domestic laws remain current in light of recent market and international developments. To date, the MAS has focused its reform policy on mitigating systemic risk, strengthening its enforcement regime and enhancing the transparency of over-the-counter ("**OTC**") derivatives activity in Singapore.

### Introduction

In the wake of the global financial crisis, the MAS announced in July 2011 its plans to make several legislative amendments to regulate OTC derivatives in Singapore reflecting its commitment to the G20 and FSB reform objectives to strengthen the international financial regulatory system. As part of its policy reform plan, the MAS proposed to expand the scope of the SFA by:

(a) mandating the central clearing and reporting of OTC derivatives;

(b) extending the current regulatory regimes for market operators, clearing facilities and capital market intermediaries to OTC derivatives; and

(c) introducing a new regulatory regime for trade repositories.[60]

The initial phase of the reform started with The Securities and Futures (Amendment) Act 2012 (the "**SF(A) Act**") which came into effect on 31 October 2013. After the SF(A) Act came into effect, the MAS published further Consultation Papers with regards to proposed legislative amendments that reflected the broad scope of the policy reform and to ensure that the SFA remains current in view of market and international developments.

This article (1) provides a review of the current reporting and clearing obligations under the SFA as amended by the SF(A) Act and (2) considers anticipated changes in relation to the reporting and clearing of OTC derivatives in Singapore.

### The Current State of the Legislative Reform

The SF(A) Act:

(a) introduced a new regulatory regime for trade repositories;

(b) extended the regulatory regime for clearing facilities to OTC derivatives; and

(c) mandated the reporting and clearing of certain OTC derivatives transactions.

In relation to reporting and clearing obligations, the SF(A) Act added a new Part VIA (which sets out the mandatory reporting rules) and a new Part VIB (which regulates the clearing of derivatives contracts).

**Mandatory Reporting**

The mandatory reporting regime for OTC derivatives contracts commenced on 31 October 2013 in Singapore pursuant to the Securities and Futures (Reporting of Derivatives Contracts) Regulations 2013 (No. S 668/2013) ("**SF(RDC)R**") which give effect to the new Part VIA of the SFA.

Pursuant to Part VIA, the mandatory reporting requirement applies to each "specified person" who is a party to a "specified derivatives contract"[61] unless such specified person is exempted.[62] A "specified person"[63] is defined as:

[60] MAS, *Consultation Paper on Proposed Regulation of OTC Derivatives* (Feb 2012).

(a) any bank in Singapore licensed under the Banking Act;

(b) any subsidiary of a bank incorporated in Singapore;

(c) any merchant bank approved as a financial institution under the MAS Act (Cap. 186);

(d) any finance company licensed under the Finance Companies Act (Cap. 108);

(e) any insurer licensed under the Insurance Act (Cap. 142);

(f) any holder of a capital markets services licence;[64]

(g) any approved trustee referred to in section 289;[65] or

(h) any "significant derivatives holder".[66]

The reporting obligations also apply to specified persons acting as agents in a specified derivatives contract.[67]

At present, a "specified derivatives contract" refers to any interest rate derivatives contract, credit derivatives contract or foreign exchange derivatives contract (excluding various spot transactions as specified in regulation 2 under "excluded currency contract"), that is traded or booked in Singapore.[68] It is anticipated that the scope of "specified derivatives contract" may be expanded to include other asset classes such as equity and commodity derivatives contracts in the near future.

**Mandatory Clearing**

The current state of reform in relation to mandatory clearing has not yet been finalised as subsidiary regulations to give effect to the policies under the new Part VIB (*Clearing of Derivatives Contracts*) of the SFA have not yet been issued.

Part VIB of the SFA sets out the requirements of the clearing obligations of specified persons. A "specified person" who is a party to a specified derivatives contract shall cause the specified derivatives contract to be cleared through an approved clearing house or a recognised clearing house.[69] The MAS has not yet finalised which type of derivatives contracts shall come within the scope of "specified derivatives contract" for the purposes of Part VIB of the SFA.

At present, a "specified person" under Part VIB (*Clearing of Derivatives Contracts*) of the SFA differs from a specified person under Part VIA (*Reporting of Derivatives Contracts*) of the SFA. Under Part VIB of the SFA, a "specified person" includes all the specified persons under Part VIA of the SFA except for subsidiaries of banks incorporated in Singapore and significant derivatives holders.[70] As with the definition under section 124 of the SFA, the composition of "specified persons" under Part VIB of the SFA is subject to change as the MAS

---

61 Section 125(1) of the SFA.

62 Section 129A of the SFA. The Fourth Schedule of the SF(RDC)R provides that such exempted persons include the Government, any statutory board, any central bank, any central government, any non-commercial agency of a central government and any of the listed multilateral agencies, organisations or entities in the Fourth Schedule. The Securities and Futures (Reporting of Derivatives Contracts) (Exemption) Regulations 2014 ("**SF(RDC)(E)R**") also provides for additional persons to be exempted from section 125.

63 Section 124 of the SFA.

64 Pursuant to the SF(RDC)(E)R, a holder of a capital markets services licence in fund management or real estate investment trust management (collectively, the "**Asset Managers**") with managed assets of less than S$8 billion, is exempted from having to comply with the reporting obligations under section 125 of the SFA.

65 Pursuant to the SF(RDC)(E)R, approved trustees in respect of collective investment schemes managed by Asset Managers who qualify for the relief or other fund management companies are not subject to reporting obligations under section 125 of the SFA.

66 See regulation 6 of the SF(RDC)R. A specified person is a "significant derivatives holder" if he is not a specified person that falls within paragraphs (a) to (g) of the definition of "specified person" in section 124 of the SFA, is resident in Singapore and is a party to a specified derivatives contract booked or traded in Singapore which aggregate gross notional amount exceeds S$8 billion (current reporting threshold amount).

67 Section 125(2) of the SFA.

68 Regulation 5 of the SF(RDC)R.

69 Section 129C(1) of the SFA.

70 Section 129B of the SFA.

has authority to prescribe additional specified persons or amend the relevant specified persons by subsidiary regulations.

## Further Reform Expected

### Mandatory Reporting

On 18 January 2016, the MAS published a Consultation Paper on Proposed Amendments to the Securities and Futures (Reporting of Derivatives Contracts) Regulations to complete the implementation of the OTC derivatives reporting regime in Singapore. In this Consultation Paper, the MAS proposed to make further amendments to the SF(RDC)R to:

(a) implement the reporting of commodity and equity derivative contracts (in addition to interest rate, credit and the relevant foreign exchange derivatives contracts) to licensed trade repositories or licensed foreign trade repositories;

(b) include additional data fields for collateral, booking location and trading desk location for all specified derivatives contracts;

(c) include reporting obligations for active non-bank financial institutions ("**NBFIs**") in OTC derivatives;

(d) exempt all approved trustees and licensed trust companies from reporting obligations;

(e) exclude the reporting of derivatives contracts transacted with retail investors; and

(f) require NBFIs to keep proper records of OTC derivatives activities and to submit the required information to the MAS on a periodic basis.

These amendments are expected to be phased in between 1 July 2016 and 1 November 2018.

*Commodity Derivatives Contracts*

In relation to commodity derivatives contracts, the MAS proposed that all forwards, swaps and options related to commodities or commodity indices, or contracts with cash flows determined by reference to one or more commodities be subject to the reporting obligations under the SFA. However, physically-settled commodity derivatives contracts entered into for commercial purposes and certain commodity sale and purchase agreements (which contain some form of optionality) entered into for commercial purposes and intended for physical settlement, may be excluded.

*Equity Derivatives Contracts*

In relation to equity derivatives contracts, the MAS has proposed to subject securities-based derivatives (such as equity derivatives contracts) to reporting requirements but exclude exchange-traded equity derivatives contracts in line with the current approach to exclude exchange-traded products. For the purposes of the reporting regulations, the MAS also proposed that "equity derivatives contracts" be defined as: (i) rights, options or derivatives related to stocks or shares issued or proposed to be issued by a corporation or body unincorporated, (ii) contracts related to equities or equity indices, or (iii) derivatives of a unit in a business trust. It is not clear whether this definition would capture other certificates or structured notes linked to securities.

*NBFIs with OTC derivatives activity (based on annual aggregate notional amounts) exceeding S$5 billion*

After a survey was conducted, the MAS considered that the aggregate gross notional amount of OTC derivatives transactions offered a better measure of the potential systemic risk posed by financial institutions to the market as compared with the amount of managed assets. As a result, the MAS proposed that NBFIs (including subsidiaries of banks incorporated in Singapore, insurers and holders of CMS licenses) whose annual aggregate notional amount of OTC derivatives activity exceeds a threshold of S$5 billion be subjected to the reporting requirements.

However even if an NBFI may be exempted from reporting, it should still continue to ensure proper record keeping of its OTC derivatives activities as the MAS may periodically require a NBFI to submit requested information in relation to such NBFI's derivatives trading activity.

*Exemptions and Exclusions*

As approved trustees ("**ATs**") and licensed trust companies ("**LTCs**") largely perform administrative roles and do not make investment decisions, the MAS has proposed to exempt both ATs and LTCs from the reporting requirements irrespective of the value of managed assets held.

After its review, the MAS considered that derivatives contracts transacted with retail investors are unlike to pose significant risk to the overall financial system as the exposure of all such transactions are relatively low. Accordingly, the MAS has proposed to exclude derivatives transactions where counterparties are retail investors (i.e. non-accredited or non-institutional investors) from being subject to the reporting obligations under the SFA.

**Mandatory Clearing**

On 1 July 2015, the MAS published a Consultation Paper on Draft Regulations for Mandatory Clearing of Derivatives Contracts and invited interested parties to provide comments on the proposed draft regulations.

The proposed draft Securities and Futures (Clearing of Derivatives Contracts) Regulations ("**SF(CDC)R**") sets out the initial implementation details of Part VIB of the SFA including the type of OTC derivatives contracts to be cleared, the circumstances under which clearing is mandatory, persons who are subject to or exempt from clearing obligations and other implementation details. The SF(CDC)R was initially anticipated to be issued by the end of 2015.[71]

In determining the scope of the "specified derivatives contracts" to be cleared, a key consideration for the MAS is the level of systemic risk that any particular class of contract poses to the financial system.[72] Other relevant considerations that the MAS may have regard to include the characteristics and level of standardisation of the contractual terms and operational processes of that class of derivatives contracts and the depth and liquidity of the market for that class of derivatives contracts.[73]

*Interest Rate Swaps*

Given that approximately 50% of derivatives transactions booked in Singapore are interest rate derivatives contracts with 90% of interest rate derivatives contracts being standardised interest rate swaps ("**IRS**"), the MAS has proposed to commence mandatory clearing with interest rate derivatives contracts. It is anticipated that at a minimum, Singapore Dollar fixed-to-floating swaps based on the Swap Offer Rate and US Dollar fixed-to-floating swaps based on the London Interbank Offered Rate will be subject to clearing obligations from commencement. The MAS is still considering whether IRS denominated in Euro, Pound Sterling and Japanese Yen should also be subjected to the same clearing obligations from commencement as these transactions comprise a significant portion of trades booked in Singapore.

*Banks With OTC Derivatives Exposures exceeding S$20 billion*

To address the largest counterparty credit risks in the OTC derivatives markets, the MAS proposed to subject only banks with exposures in OTC derivatives contracts that exceed the threshold of S$20 billion (gross notional outstanding of contracts booked in Singapore in the last four quarters) to the clearing obligations. Therefore, it is anticipated that at commencement, a "specified person" for the purposes of the mandatory clearing obligations will only be limited to banks that exceed the relevant threshold with exemptions applying to public bodies such as central banks, governments and international multilateral organisations (e.g. Bank for International Settlements, the International Monetary Fund and the World Bank). The MAS has also proposed that intra-group transactions be exempted from the scope of clearing obligations as such transactions do not transfer risks in or out of a corporate group. These issues have been posed to the public for comment.

---

71 MAS, *Consultation Paper on Draft Regulations for Mandatory Clearing of Derivatives Contracts* (1 July 2015), p 8.

72 Section 129G(2) sets out the various factors that the MAS may have regard to in determining whether to prescribe that a particular class of derivatives contracts be subject to clearing.

73 Section 129G(2) of the SFA.

## Other Developments

### Casting the Net Wider to Address "Too Big to Fail" - The ISDA 2015 Universal Resolution Stay Protocol

*21 major global banks signed the ISDA 2015 Universal Resolution Stay Protocol at launch. Pursuant to the ISDA 2015 Universal Resolution Stay Protocol, these banks have agreed to suspend their termination rights in relation to their derivatives contracts facing a failing "systematically important financial institution".*

#### Introduction

As part of the ongoing push for global financial stability, on 12 November 2015, the International Swaps and Derivatives Association ("**ISDA**") published the ISDA 2015 Universal Resolution Stay Protocol ("**2015 Stay Protocol**"), a re-launch (and replacement) of the ISDA 2014 Resolution Stay Protocol ("**2014 Stay Protocol**"). The 2015 Stay Protocol extends the coverage of contracts to securities financing transactions ("**SFTs**") and expands the scope of the 2014 Stay Protocol to accommodate special resolution regimes ("**SRR**") developed in additional jurisdictions. It is otherwise substantially similar to the 2014 Stay Protocol in terms of the operative provisions. The aim of the 2015 Stay Protocol is to ensure that cross-border derivatives and SFTs are captured by the relevant statutory stays in the event a systemically important financial institution ("**SIFI**") enters insolvency proceedings and to give regulators sufficient time to facilitate an orderly resolution and limit any market contagion effects.

#### Development of the 2015 Stay Protocol

Since the collapse of Lehman Brothers, regulators have been concerned with market contagion effects should another major bank fail. It is clear from the 2008 financial crisis that regulators had limited tools with which to deal with failing financial institutions, particularly when large derivatives positions are on the books. Traditional insolvency proceedings and bailouts have proven to be costly (with the costs largely being passed on to taxpayers) and do not afford regulators much control in managing global financial stability. In response to public criticism, financial regulators have worked to develop a new regulatory framework to deal with the resolution of SIFIs and which is aimed at improving economic stability and mitigating systemic risk. As a result, various SRR such as the Orderly Liquidation Authority ("**OLA**") and the Bank Recovery and Resolution Directive ("**BRRD**") were progressively implemented in the US and European Union respectively.

The OLA and BRRD, among other things, temporarily stay the non-defaulting party's exercise of its early termination rights in an insolvency situation to give the relevant authority sufficient time to stabilise the failing SIFI. However, the OLA and BRRD are national statutory regimes and it is uncertain whether they could be enforced extraterritorially to apply to cross-border trades, particularly where the governing law of the contract at issue is different from that which authorised the resolution proceedings. Therefore until the relevant jurisdictions provide for recognition and enforcement of foreign SRR, financial regulators generally agree that a contractual approach to address such enforceability issues is necessary.

This was the impetus for the development of the 2014 Stay Protocol by ISDA and a working group composed of dealer and buy-side member firms in consultation with the regulatory authorities from Germany, France, Japan, Switzerland, the UK and the US ("**Home Authorities**"). A key aim of the 2014 Stay Protocol was to provide a contractual approach to cross-border recognition until comprehensive statutory regimes are developed and adopted.[74] On the launch date, 18 of the world's largest dealers in OTC derivatives adhered to the 2014 Stay Protocol. As of 2 November 2015 when the 2014 Stay Protocol was closed, that number had increased to 189 dealers in OTC derivatives.[75]

In 2015, the Home Authorities requested ISDA to, among other things, expand the scope of the 2014 Stay Protocol to include: (1) certain master agreements that govern SFTs and (2) provisions pursuant to which annexes could be added to clarify that SRRs enacted in the member jurisdictions of the Financial Stability

---

74 ISDA, 'ISDA 2014 Resolution Stay Protocol' <http://www2.isda.org/functional-areas/protocol-management/faq/20> accessed 7 June 2016.

75 ISDA, 'Adhering Parties' <http://www2.isda.org/functional-areas/protocol-management/protocol-adherence/20> accessed 7 June 2016.

Board ("**FSB**") would be covered by the protocol.[76] In response, ISDA developed the 2015 Stay Protocol which replaces the 2014 Stay Protocol in its entirety for those entities that had already adhered to it, provided that both parties to a Protocol Covered Agreement are Adhering Parties (both terms as defined below). If either of the parties that adhered to the 2014 Stay Protocol does not adhere to the 2015 Stay Protocol, the 2014 Stay Protocol will continue to have operative effect. On the launch date, 21 major global banks adhered to the 2015 Stay Protocol.

## How does the 2015 Stay Protocol work?

The operative provisions of the 2015 Stay Protocol are substantially similar to those of the 2014 Stay Protocol with the exception of the expanded scope as mentioned above. Adherence is on a voluntary basis and parties adhere to the protocol in its entirety. Entities that have adhered to the 2015 Stay Protocol are listed on ISDA's website.

### Protocol Covered Agreement

An entity that adheres to the 2015 Stay Protocol (each such entity an "**Adhering Party**") is deemed to have incorporated the 2015 Stay Protocol into the relevant Protocol Covered Agreement (defined below) as well as the transactions to which the agreement relates, unless the agreement already addresses the substance of the 2015 Stay Protocol or the parties expressly provide that the terms of the 2015 Stay Protocol will not apply. The 2015 Stay Protocol will not amend future Protocol Covered Agreements unless the parties agree bilaterally to make them subject to the terms of the 2015 Stay Protocol. Suggested wording for this purpose is included in Section 9 (*Specific Questions on the Amendment Language)* set out in the frequently asked questions relating to the 2015 Stay Protocol published by ISDA (the "**2015 FAQs**").

As it currently stands, the agreements covered under the 2015 Stay Protocol include ISDA Master Agreements (and its related Credit Support Documents) and certain master agreements published by the SFT Trade Associations (i.e. the Global Master Repurchase Agreement, the Global Master Securities Lending Agreement, the Master Equity and Fixed Interest Stock Lending Agreement, the Master Gilt Edged Stock Lending Agreement, the Master Repurchase Agreement, the Master Securities Loan Agreement and the Overseas Securities Lender's Agreement) entered into between Adhering Parties and related credit enhancements entered into between Adhering Parties or provided by one Adhering Party to another (each a "**Protocol Covered Agreement**").[77]

Although the 2015 Stay Protocol largely deals with uncleared transactions, if a cleared transaction is documented under a Protocol Covered Agreement, then those transactions will fall within the scope of the 2015 Stay Protocol. However if the 2015 Stay Protocol violates the rules of an applicable clearinghouse, it will not apply to the relevant Protocol Covered Agreement.

There are two ways in which the 2015 Stay Protocol amends a Protocol Covered Agreement and its related transactions – via the "Opt-in" mechanism pursuant to Section 1 and the application to ordinary US insolvency proceedings pursuant to Section 2.

### "Opt-in" mechanism

Under Section 1, for each relevant Protocol Covered Agreement, Adhering Parties opt in to the SRR applicable to their counterparty and each of its related entities as well as the resolution regimes in the Home Authority jurisdictions ("**Identified Regimes**") even if it is not required to do so by law or regulation. This means the Adhering Party will only be permitted to exercise its termination rights under the Protocol Covered Agreement to the extent that the applicable SRR permits. Accordingly in this regard, Section 1 ensures the parity of treatment between Adhering Parties and those parties transacting under agreements governed by the laws of the jurisdiction of the applicable SRR.[78] Note that the 2015 Stay Protocol extends to direct default rights as well as cross-default rights where such rights are stayed or overridden under the applicable SRR.

If the relevant resolution action is successful under the applicable SRR, then Adhering Parties are not permitted to terminate the relevant derivatives transactions to the same extent as a counterparty that is subject to such applicable SRR. If the relevant resolution action is not successful under the applicable SRR,

---

76 Ibid.

77 ISDA 2015 Universal Resolution Stay Protocol paragraph 4 definition of "Covered Agreement".

78 ISDA, ISDA 2015 Universal Resolution Stay Protocol FAQ <http://www2.isda.org/functional-areas/protocol-management/faq/22> accessed 7 June 2016.

then an Adhering Party can exercise its termination and cross-default rights to the same extent as a counterparty that is subject to such applicable SRR.

For example, if a UK bank which is subject to the BRRD enters into resolution, any derivative trades that its US subsidiary has with a US counterparty (assuming such trades are governed by New York law) may potentially be terminated by the US counterparty if a New York court does not recognise the application of the BRRD. However if the parties had adhered to the 2015 Stay Protocol, then the US counterparty would have opted in to the UK implementation of the BRRD and would be bound by its terms. In this case, the US counterparty would not be permitted to terminate those derivatives trades where it faces the US subsidiary of the UK bank.

In addition to the Identified Regimes, Adhering Parties will also opt in to the SRR of FSB jurisdictions and any jurisdiction in which a current or future global systemically important bank is headquartered ("**G-SIB Jurisdiction**") if these SRRs satisfy the relevant credit protection safeguards.[79] The expansion to include G-SIB Jurisdictions is one of the key changes made to the 2015 Stay Protocol. Ultimately, the SRR that is applicable to a party is the one that is applicable to its direct counterparty or the SRR applicable to each of its related entities (which includes any Credit Support Providers or Specified Entities as such terms are defined in the relevant ISDA Master Agreements).

If an SRR is amended and negatively affects the enforceability of certain creditors' default rights, an Adhering Party may choose to opt out of future resolutions under that SRR.[80]

The Section 1 provisions came into effect between initial Adhering Parties on 1 January 2016.

It is anticipated that ISDA may, over time, publish additional "Country Annexes" to the 2015 Stay Protocol to include SRRs in the additional FSB jurisdictions and G-SIB jurisdictions. An Adhering Party to a Country Annex does not get to choose which Country Annex it wishes to adhere to, rather it adheres to all the Country Annexes that have been published as of the date of its adherence.[81] Where Adhering Parties adhere to a Country Annex that was published after their initial adherence to the 2015 Stay Protocol ("**Annex Implementation Date**"), all Protocol Covered Agreements entered into prior to the Annex Implementation Date will be subject to the 2015 Stay Protocol.

**US ordinary insolvency proceedings**

Section 2 introduces similar stays and overrides under ordinary US insolvency regimes where none exist, such as the Bankruptcy Code and the Federal Deposit Insurance Act. In this section, each Adhering Party contractually agrees to override certain default rights under the relevant Protocol Covered Agreement if an affiliate of its bank counterparty becomes subject to ordinary US insolvency proceedings.

Default rights that arise because the affiliate that is subject to insolvency proceedings is a Specified Entity are treated differently to the default rights that arise because the affiliate is a Credit Support Provider (as defined in the relevant ISDA Master Agreement). Where a Credit Support Provider enters insolvency proceedings, Section 2 imposes conditions designed to preserve the value and effectiveness of the credit support as much as possible notwithstanding the insolvency of the Credit Support Provider.[82] However, where a Specified Entity becomes subject to insolvency proceedings, the default rights of the non-defaulting counterparty are overridden in their entirety.[83]

Notably, when a direct counterparty enters into ordinary insolvency proceedings, non-defaulting Adhering Parties still retain their rights to terminate. This is also the case if the direct counterparty fails to satisfy a payment or delivery obligation.

Unlike with the Section 1 provisions which do not require the implementation of regulations, Section 2 provisions will only become effective between Adhering Parties who are counterparties when the related US regulations become effective and compliance is required. Further, the Section 2 provisions will only apply to a Protocol Covered Agreement if the relevant Adhering Party is subject to such US regulations.

79 Attachment to the ISDA 2015 Universal Resolution Stay Protocol Clause 1(a)(iii).

80 Attachment to the ISDA 2015 Universal Resolution Stay Protocol Clause 4(b)(i).

81 ISDA 2015 Universal Resolution Stay Protocol Clause 1(f).

82 See Attachment to the ISDA 2015 Universal Resolution Stay Protocol Clause 2(b).

83 Attachment to the ISDA 2015 Universal Resolution Stay Protocol Clauses 2(a) and (e).

## Outstanding Issues

Although it is generally accepted that the 2015 Stay Protocol could offer support to an orderly resolution of a SIFI by suspending the exercise of early termination rights upon the SIFI entering resolution proceedings, the protocol has yet to be tested in an environment similar to that of 2007-8 and therefore it remains to be seen whether the 2015 Stay Protocol could work as anticipated in practice.

Some of the main criticisms of the 2015 Stay Protocol reflect the lack of balance between the individual entity's interest and that of the financial regulator in pursuit of financial stability.

### Fragmented adherence

At present, not all market participants are Adhering Parties to the 2015 Stay Protocol. This creates an inequitable situation where one counterparty facing a distressed SIFI is an Adhering Party and therefore subject to the stays imposed by the relevant SRR and another counterparty facing the same SIFI is not an Adhering Party and is therefore in a position to exercise its termination rights. Such fragmented participation distorts the level playing field of market participants and is likely to lead to increased costs of participation. Until the protocol for buy-side participants is available and there is widespread adoption of such protocol, it is difficult to see how effective the stay protocol measure will be in the long run.

ISDA is currently developing the ISDA Resolution Stay Jurisdictional Modular Protocol ("**Jurisdictional Modular Protocol**"). It seeks to achieve the same policy goals as the 2015 Stay Protocol in relation to the orderly resolution of systemically important financial institutions. It is expected that the buy-side entities generally will not adhere to the 2015 Stay Protocol, but will adhere to the Jurisdictional Modular Protocol to be published by ISDA in the near future.

### Excluded entities

There is no expectation for sovereigns or clearing houses to adhere to the 2015 Stay Protocol, although they are technically permitted to do so in relation to transactions documented under Protocol Covered Agreements.

### Investment or asset managers

Special considerations arise in relation to investment and asset managers. These are dealt with in greater detail in Section 7 (*Special Considerations for Investment/Asset Managers*) of the 2015 FAQs. Importantly, if the relevant investment/asset manager does not have authority from all clients or is not able to disclose the underlying client's identity (whether by name or by a unique identifier), the investment/asset manager will not be able to enter into the 2015 Stay Protocol for those clients and bilateral amendment agreements will need to be entered into with each relevant counterparty to incorporate the amendments made by the 2015 Stay Protocol.

White & Case LLP
1155 Avenue of the Americas
New York, New York 10036-2787
United States

**T** +1 212 819 8200

White & Case LLP
5 Old Broad Street
London EC2N 1DW
United Kingdom

**T** +44 20 7532 1000

White & Case Pte. Ltd.
8 Marina View #27-01
Asia Square Tower 1
018960
Singapore

**T** +65 6225 6000