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New Opportunities and Challenges for Global CCPs

ANNETTE L. NAZARETH AND JEFFREY T. DINWOODIE

Annette L. Nazareth is a partner and Jeffrey T. Dinwoodie is an associate in Davis Polk & Wardwell's Financial Institutions Group. They can be reached at annette.nazareth@davispolk.com and jeffrey.dinwoodie@davispolk.com, respectively.

In the United States, the Dodd-Frank Act and Commodity Futures Trading Commission ("**CFTC**") rules require a broad range of U.S. and non-U.S. market participants to clear certain swap transactions through either a CFTC-registered derivatives clearing organization ("**DCO**") or a clearinghouse that has been exempted from DCO registration. As a result, the CFTC's registration and regulation of DCOs has emerged as a critical global regulatory issue.

There has been surprisingly little focus, however, on the CFTC's ability to exempt comparably regulated foreign clearinghouses from the DCO registration requirements, despite the significant implications that the exercise of this authority may have for global clearinghouses and market participants alike. This article is intended to help fill this gap. It begins by providing basic background information about the CFTC's mandatory clearing requirements and the DCO regulatory landscape. The second half of the article explores the CFTC's DCO exemptive authority, including discussions of the CFTC's prior recognition of foreign clearinghouses and several of the key policy considerations associated with the potential exercise of this exemptive authority.

Mandatory Clearing of Swaps

The Dodd-Frank Act amended the Commodity Exchange Act (the "**CEA**") to make it unlawful for any person to engage in a swap unless that person submits such swap for clearing to either a CFTC-registered DCO or a DCO that is exempt from registration, if the swap is required to be cleared.[1] The CEA charges the CFTC with the responsibility for determining if a swap is required to be cleared (any such swap, a "**Designated Swap**"), through one of two means: (1) pursuant to a CFTC-initiated review; or (2) pursuant to a submission

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from a DCO of a swap, or any group, category, type or class of swaps that the DCO plans to accept for clearing.[2]

In November 2012, the CFTC designated for mandatory clearing the first cohort of swaps, which includes the following types of credit default swaps and interest rate swaps:

- **CDS**. The CFTC designated for mandatory clearing specified tenors of recent series of the untranched CDX North American Investment Grade and High Yield indices and the untranched iTraxx Europe, iTraxx Europe Crossover and iTraxx Europe HiVol indices.
- **IRS**. The CFTC designated for mandatory clearing specified tenors of fixed-to-floating, floating-to-floating, forward rate agreement and overnight indexed swaps denominated in U.S. dollars, euros, British pounds and (other than for overnight indexed swaps) Japanese yen.[3]

The CFTC has not yet proposed clearing requirements for other swaps in the interest rate or CDS asset classes or for other swap asset classes, such as energy swaps, commodity swaps and non-deliverable forwards—but may do so in the future.

The requirement to clear Designated Swaps was phased in according to the types of market participants that are counterparties to a swap, and it is currently effective for all Designated Swaps between covered market participants. In its final interpretive guidance concerning the cross-border application of its swap regulations (the "**Cross-Border Guidance**"), the CFTC took an expansive position with respect to the application of the new swaps requirements, including mandatory clearing.[4] Unless an exemption applies, all U.S. market participants are subject to the CEA Clearing Requirements for their Designated Swaps, regardless of counterparty. Non-U.S. swap market participants are also subject to the clearing requirement for many of their swaps, depending on factors such as whether they are considered guaranteed or conduit affiliates of U.S. persons and the status of their counterparties.[5]

DCO Registration Requirements

The CEA makes it unlawful for a clearinghouse to "perform the functions of a DCO" with respect to swaps and certain other instruments, unless the clearinghouse is registered with the CFTC.[6] Subject to certain exclusions, a "DCO" is defined in the CEA to mean a clearinghouse, clearing association, or similar entity that: (1) enables each party to an agreement, contract or transaction to substitute, through novation or otherwise, the credit of the clearinghouse for the credit of the parties; (2) arranges or provides, on a multilateral basis, for the settlement or netting of obligations resulting from any such agreement, contract or transaction; or (3) otherwise provides clearing services or arrangements that mutualize or transfer the credit risk arising from such transactions.[7]

The CFTC has interpreted these provisions to mean that any clearinghouse that clears swaps directly for U.S. person clearing members or indirectly for U.S. customers of U.S. *or* non-U.S. clearing members must register with the CFTC as a DCO or obtain an exemption. Importantly, this requirement applies regardless of whether a particular cleared swap is a Designated Swap. Therefore, to determine whether it must register with the CFTC or obtain an exemption, a clearinghouse must continually evaluate the U.S. person status of its clearing members and their customers. This registration requirement is expansive and can be challenging to monitor and apply, particularly given the breadth and complexity of the CFTC's U.S. person definition. For example, non-U.S. branches of U.S. banks are considered U.S. persons. In addition, a complex analysis is often required to ascertain the U.S. person status of certain types of funds.

Swaps clearinghouses that do not clear for U.S. persons and thus are not legally required to register or obtain an exemption may nonetheless, for business purposes, consider registering or seeking an exemption in order to clear for market participants that must clear their Designated Swaps through a CFTC-registered DCO or an exempt clearinghouse. If a clearinghouse is not registered or exempt, then swap market participants subject to the clearing requirement will by necessity seek

to clear their Designated Swaps through other clearinghouses.

The DCO registration process is rigorous. The CFTC requires a clearinghouse applicant to provide voluminous information through CFTC Form DCO, describing its ability to comply with all applicable regulatory obligations, many of which are described below. Given the wide-ranging requirements that a clearinghouse must satisfy and the extensive information required for a complete Form DCO application, the DCO registration process typically lasts over a year. The CFTC staff has recently provided temporary, limited no-action relief to four non-U.S. clearinghouses that applied for DCO registration. The no-action relief allowed the clearinghouses to clear for certain U.S. market participants during the pendency of their applications.[8] In addition, as discussed below, the CFTC staff also recently provided temporary, limited no-action relief to the Australian Securities Exchange ("**ASX**"), a non-U.S. clearinghouse that had not applied for DCO registration, but which expressed a strong interest in applying for an exemption from registration and evidenced that it is subject to extensive home country regulation and supervision.[9]

Registration and Substantive Regulation of DCOs

Eighteen statutory "DCO Core Principles" establish the minimum foundational requirements that a DCO must satisfy.[10] The DCO Core Principles impose, among other things: requirements concerning a clearinghouse's financial, operational and managerial resources (including a "cover one" requirement, as further codified in the Part 39 Rules and noted below); clearing member admission and eligibility standards; requirements relating to the efficient, fair and safe management of clearing member defaults and insolvencies; standards regarding a clearinghouse's monitoring and enforcement of its own rules; standards concerning the holding and investment of the funds and assets of members and participants; and clearinghouse governance standards. To become registered and maintain registration status, a DCO must also satisfy all applicable CFTC regulatory requirements, including, among other things, the CFTC's:

- *Part 39 Rules*. The CFTC's Part 39 Rules impose prescriptive requirements that a DCO must meet to satisfy the DCO Core Principles. For example, a DCO must establish admission and continuing participation requirements for clearing members that permit fair and open access.[11] In addition, a DCO may not set a minimum capital requirement of more than $50 million for any person seeking to become a clearing member.[12] A DCO must also maintain sufficient financial resources to meet its financial obligations to its clearing members, notwithstanding a default by the clearing member creating the largest financial exposure for the DCO in extreme but plausible market conditions—i.e., a "cover one" requirement.[13] The Part 39 Rules also require a DCO to, among other things: appoint a chief risk officer with specified responsibilities;[14] comply with extensive obligations concerning the reporting of margin, position and other information to the CFTC at various designated intervals;[15] and establish business continuity and disaster recovery plans that meet certain standards.[16]
- *Customer Clearing Requirements*. The CFTC requires that a DCO offer, and have the operational capability to support, customer clearing services.[17] This means that a clearinghouse that provides only "dealer-to-dealer" clearing services or does not allow futures commission merchants ("**FCMs**") to join as members and clear for U.S. customers will not be eligible to register as a DCO.
- *Part 22 Rules*. A DCO must comply with many of the CFTC's Part 22 Rules, which address the protection of cleared swaps customer collateral and are commonly referred to as the legal segregation, operational commingling ("**LSOC**") model. Among other things, the Part 22 Rules require a DCO to treat and deal with collateral received to margin customer swap positions as belonging to the customer and not any other person, including the FCM clearing broker that deposited such

collateral on behalf of the customer.[18] In addition, the legal situs of the accounts on the DCO's books and records with respect to the cleared swaps customers of FCMs must be in the United States.

- *Swap Data Reporting Rules*. The CFTC's Part 45 swap data reporting rules require DCOs to report certain cleared swap transaction data to swap data repositories.[19]

In addition, any DCO that has been designated by the U.S. Financial Stability Oversight Council as systemically important and for which the CFTC acts as the Supervisory Agency (a "**SIDCO**") must also comply with Subpart C of the CFTC Part 39 Rules (the "**Subpart C Provisions**"), in addition to all otherwise applicable CFTC requirements. The Subpart C Provisions close the gaps between the otherwise applicable DCO requirements and the Principles for Financial Market Infrastructures (the "**PFMIs**") developed by the Bank for International Settlements' Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions. The Subpart C Provisions impose, among other things, a "cover two" requirement, which will require a DCO to maintain financial resources sufficient to enable it to meet its financial obligations to its clearing members notwithstanding a default by the two clearing members creating the largest combined financial exposure for the clearinghouse in extreme but plausible market conditions.[20] Any DCO that does not qualify as a SIDCO may voluntarily opt-in to the heightened regulatory standards imposed by the Subpart C Provisions. A non-SIDCO DCO's incentive for electing to become subject to the Subpart C Provisions would be to attain "Qualified CCP" status for purposes of the Basel CCP Capital requirements.[21]

All DCOs are also subject to extensive ongoing regulatory obligations after registering with the CFTC. For example, a DCO must continue to satisfy the DCO Core Principles and all applicable CFTC rules and requirements and follow specified procedures to accept new products for clearing or to amend its rules.

The CFTC's Exemptive Authority

Recognizing that many foreign clearinghouses are subject to extensive home country regulation and supervision, Congress gave the CFTC the authority to exempt clearinghouses from the DCO registration requirements if the CFTC determines that the clearinghouse is subject to "comparable, comprehensive supervision and regulation" by either the regulatory authorities in the clearinghouse's home country or the SEC.[22]

It is currently unknown whether the CFTC will develop a process through which clearinghouses can apply for an exemption and, if so, when. In its Cross-Border Guidance, the CFTC emphasized that this exemptive authority is entirely discretionary, and it is not *required* to exempt any clearinghouse, even if a clearinghouse is found to be subject to comparable, comprehensive supervision and regulation by another regulator.

Importantly, however, in February 2014, the CFTC staff issued temporary, limited no-action relief that permits ASX, which is not registered as a DCO, to clear certain proprietary Australian and New Zealand dollar-denominated interest rate swaps of U.S. clearing members. The relief was premised on ASX's plans to apply for an exemption from DCO registration and in view of the extensive regulation and supervision of ASX by Australian authorities. The staff noted, among other things, that the Australian government has confirmed that ASX is prudentially supervised in a jurisdiction where the PFMIs are applied. ASX's no-action relief is significant because it implies that the CFTC staff contemplates that a regulatory framework for exempting a clearinghouse from registration as a DCO may be developed in the near future.

Indeed, several compelling policy reasons exist that would support the exemption of adequately regulated clearinghouses, including the following:

- *More swaps would be cleared*. Due to concerns about the costs and burdens associated with registering and maintaining DCO status, several foreign clearinghouses currently limit their clearing services to non-U.S. persons, despite U.S. market participants' interest in clearing through these venues. As a result, numerous swap transactions that would

otherwise be cleared through these clearinghouses remain uncleared.

- *More competition and choices.* By creating an exemptive pathway, the CFTC would help promote competition among clearinghouses and increase the number of clearing venues available to swap market participants.
- *CFTC resources would be preserved.* The CFTC devotes significant staff resources to the processing of DCO applications and the ongoing monitoring and regulation of DCOs. By deferring to a foreign clearinghouse's home country regulatory and supervisory authorities, the CFTC would help preserve scarce agency resources.
- *Added liquidity.* Non-U.S. clearinghouses that cannot clear swaps for U.S. persons because of regulatory constraints are deprived of a significant source of liquidity that would be beneficial for clearinghouse risk management purposes.
- *Unnecessary clearinghouse costs would be reduced.* Foreign clearinghouses that apply for DCO status must devote hundreds of hours and vast resources preparing application materials and responding to CFTC staff comments and questions. After registering, a DCO must then devote significant resources to comply with the panoply of CFTC regulatory requirements. By developing an exemptive pathway, the CFTC would free non-U.S. clearinghouses that are subject to comprehensive home country regulation and supervision from high regulatory costs and unnecessary burdens that yield few, if any, regulatory benefits.

Prior Recognition of Foreign Clearinghouses

The CFTC has provided limited recognition to non-U.S. clearinghouses that are subject to extensive home country regulation. If the CFTC decides to act on its DCO exemptive authority, it may look to the conditions that it attached to its prior recognition of foreign clearinghouses.

- *Inter-affiliate Clearing Exemption.* The CFTC's inter-affiliate clearing exemption, which was adopted in April 2013, provides a rule-based exemption from the clearing of Designated Swaps between certain qualifying affiliates (each such affiliate, an "**Eligible Affiliate Counterparty**").[23] The exemption is subject to several conditions, including one relating to an Eligible Affiliate Counterparty's Designated Swaps with unaffiliated counterparties (each such swap, an "**Outward Facing Designated Swap**"). To meet this particular condition, an Eligible Affiliate Counterparty must either satisfy an exception or exemption from clearing for each of its Outward Facing Designated Swaps or clear each of its Outward Facing Designated Swaps at: (1) a CFTC-registered DCO, or (2) a clearinghouse that is subject to supervision by appropriate government authorities in the clearing organization's home country and has been assessed to be in compliance with the PFMIs.[24]
- *FBOT Registration Requirements.* The CFTC's foreign boards of trade ("**FBOT**") registration rules, which were adopted in November 2010, establish a registration requirement and procedures for FBOTs that wish to provide their identified members or other participants based in the U.S. with direct access to their electronic trading and order matching systems.[25] Previously, FBOT requests to provide direct access to their electronic trading and order matching systems were addressed through the CFTC staff no-action process. Under the rule, in order to be registered with the CFTC, an FBOT must, among other things, clear through either: (1) a CFTC-registered DCO, or (2) a clearinghouse that, among other things: (a) observes the PFMIs; (b) is in good regulatory standing in its home country; (c) is subject to comprehensive supervision and regulation comparable to that provided by the CFTC to DCOs; (d) is subject to oversight by regulatory authorities that are signatories to satisfactory information sharing agreements; (e) agrees to provide directly to the CFTC, upon

the CFTC's request, any information that is deemed necessary to evaluate the continued eligibility of the clearing organization and its members and participants; (f) maintains disciplinary procedures that empower it to prosecute disciplinary actions for suspected rule violations and impose sanctions for such violations; and (g) satisfies certain annual CFTC filing requirements regarding its home country standing.[26]

Open Questions

If the CFTC seeks to exercise its DCO exemptive authority, it will need to consider several key issues, including:

- **Defining "comparable, comprehensive supervision and regulation."** *What approach will the CFTC take in evaluating the home country supervision and regulation of a foreign clearinghouse?*

  In the context of making a substituted compliance determination that allows non-U.S. swap dealers or foreign branches of U.S. swap dealers to comply with local requirements rather than the corresponding CFTC swap dealer requirements, the CFTC must find that the relevant foreign jurisdiction applies requirements that are "comparable with and as comprehensive as the corollary [CFTC requirements]." In this context, the CFTC has explained that the basis for any such comparability findings is as follows:

  "In evaluating whether a particular category of foreign regulatory requirement(s) is comparable and comprehensive to the applicable [CFTC] requirement(s) . . . the Commission will take into consideration all relevant factors, including but not limited to, the comprehensiveness of those requirement(s), the scope and objectives of the relevant regulatory requirement(s), the comprehensiveness of the foreign regulator's supervisory compliance program, as well as the home jurisdiction's authority to support and enforce its oversight of the registrant. In this context, comparable does not necessarily mean identical. Rather, the Commission would evaluate whether the home jurisdiction's regulatory requirement is comparable to and as comprehensive as the corresponding U.S. regulatory requirement(s)."

- **Conditions.** *What conditions will the CFTC attach to an exemption?*

  In its Cross-Border Guidance, the CFTC noted that if it elects to exercise its discretionary exemptive authority, the conditions that a foreign clearinghouse may be required to meet to qualify as an exempt DCO could include the CFTC having entered into an appropriate supervisory arrangement with the foreign regulators and the clearinghouse having submitted an assessment that it is in compliance with the PFMIs. However, as noted, in the context of the FBOT registration rules, the CFTC imposed a number of additional conditions to the recognition of a foreign clearinghouse.

- **Clearing for U.S. Customers.** *Will exempt DCOs be allowed to clear for U.S. customers? If so, will they be required to comply with the CFTC's Part 22 Rules?*

  Certain aspects of the CFTC's Part 22 LSOC requirements have proven extremely challenging for non-U.S. DCO applicants to satisfy, due to inconsistencies between U.S. and foreign legal constructs concerning the protection of customer collateral and related bankruptcy issues. The CFTC could conceivably prohibit exempt DCOs from clearing for U.S. customers. A prohibition of this sort would be ironic, however, since the CFTC requires foreign clearinghouses to offer U.S. customer clearing services as a condition of DCO registration, even where there is no market demand for the foreign clearinghouse to provide such services.

- **Deregistration of Foreign DCOs.** *Will foreign registered DCOs be permitted to apply to become exempt DCOs and deregister from DCO status upon the receipt of an exemption?*

  Non-U.S. registered DCOs are sure to have a keen interest in comparing the costs and

benefits of maintaining DCO registration status against the conditions associated with exemptive status. If the CFTC allows non-U.S. registered DCOs to deregister and seek exempt status and at the same time prohibits exempt DCOs from clearing for U.S. customers, then U.S. customers would have fewer clearinghouses through which to clear.

- **Potential Delays for Supervisory Arrangements.** *Will negotiations with foreign regulators cause delays?*

  It is very likely that the CFTC will require that there be satisfactory supervisory arrangements in place with each applicable foreign regulator or supervisor to establish how the regulators will cooperate, share information and consult with each other with respect to clearinghouse regulation. These arrangements may include establishing expectations for ongoing communications, memorializing understandings related to on-site CFTC visits and addressing confidentiality issues related to non-public information. As a result, their negotiations could take months or even years to complete.

Conclusion

Given the critical role of clearinghouses in the new swaps trading environment, the CFTC's regulation and recognition of DCOs is more important than ever. Global clearinghouses and market participants will benefit by continuing to closely monitor this evolving regulatory area.

END NOTES

1. *See* CEA Section 2(h)(1). The Dodd-Frank Act also amended the Securities Exchange Act of 1934 to make it unlawful for any person to engage in a security-based swap unless that person submits such security-based swap for clearing to either an SEC-registered clearing agency or a clearing agency that is exempt from registration, if the security-based swap is required to be cleared. *See* Exchange Act Section 3C. To date, however, the SEC has not finalized or proposed any mandatory clearing determinations for security-based swaps.
2. *See* CEA Section 2(h)(2).
3. *See* Clearing Requirement Determination Under Section 2(h) of the CEA, 77 FR 74284 (Dec. 13, 2012).
4. *See* Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations, 78 FR 45292 (July 26, 2013).
5. The Cross-Border Guidance allows certain market participants to comply with local law for certain requirements, including clearing, to the extent that the CFTC has made a "substituted compliance" determination with respect to a foreign jurisdiction's comparable regulatory requirements. In December 2013, the CFTC finalized several substituted compliance determinations, although none applied to the clearing requirement. *See, e.g.*, Comparability Determination for Australia: Certain Entity-Level Requirements, 78 FR 78864 (Dec. 27, 2013).
6. *See* CEA Section 5b(a).
7. *See* CEA Section 1a(15).
8. *See, e.g.*, CFTC Letter No. 13-73 (Dec. 19, 2013) (extending time-limited no-action relief to JSCC from CEA Section 5b(a) and certain market participants from CEA Section 2(h)(1) and certain CFTC regulations).
9. *See* CFTC Letter No. 14-07 (Feb. 6, 2014).
10. *See* CEA Section 5b(c)(2).
11. *See* CFTC Rule 39.12(a)(1).
12. *See* CFTC Rule 39.12(a)(2)(iii).
13. *See* CFTC Rule 39.11 (a)(1). The cover one requirement is also codified in the DCO Core Principles. *See* CEA Section 5b(c)(2)(B).
14. *See* CFTC Rule 39.13(c).
15. *See* CFTC Rule 39.19.
16. *See* CFTC Rule 39.18(e).
17. *See* CFTC Rule 39.12(b)(4) (providing that a DCO "shall not require that one of the original executing parties be a clearing member in order for a product to be eligible for clearing").
18. *See* CFTC Rule 22.3(a).
19. *See* CFTC Rules 45.3 and 45.4.
20. *See* CFTC Rule 39.29(a).
21. The Basel CCP Capital requirements provide incentives for banks to clear swaps through "QCCPs"—CCPs that are prudentially supervised in a jurisdiction where the regulator applies regulations that are consistent with the PFMIs.
22. *See* CEA Section 5b(h).
23. *See* Clearing Exemption for Swaps Between Certain Affiliated Entities, 78 FR 21750 (Apr. 11, 2013).
24. *See* CFTC Rule 50.52(b)(4)(i)(E).
25. *See* Registration of Foreign Boards of Trade, 76 FR 80674 (Dec. 23, 2011).
26. *See* CFTC Rules 48.7 and 48.8.