LATHAM & WATKINS LLP

# DERIVATIVES MARKET – 2016 YEAR IN REVIEW

## A SUMMARY

## PART I: REGULATORY DEVELOPMENTS & MARKET OUTLOOK

December 7, 2016

**Derivatives Market – 2016 Year in Review: A Summary**

# Part I: Regulatory Developments & Market Outlook

***Latham & Watkins attorneys provide an end-of-year update on the regulatory environment for derivatives, as well as a glimpse of the year ahead.***

As we round the corner and wrap up the year, we note that the derivatives market and regulators, alike, have made significant progress in implementing market reforms since the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the **Dodd-Frank Act**) in 2010. Much of the derivatives regulatory framework is in place and market participants are complying with clearing and trade execution requirements, as well as with business conduct requirements. However, a number of issues remain unresolved, which will need to be addressed going forward. Further, in the spirit of the Dodd-Frank Act and its commitment to the reduction of systemic risk, the US Commodity Futures Trading Commission (the **CFTC**) has continued to address new areas of trading risk resulting from technology and innovation. Additionally, the market has begun complying with the uncleared swap margin rules and will continue to phase in compliance through 2017 and beyond.

While the CFTC has carried a large load in the implementation of market reforms, and has continued to be aggressive in its adoption of its swaps regulatory regime, the US Securities and Exchange Commission (the **SEC**) has also been busy finalizing its own security-based swap rulemakings pursuant to the Dodd-Frank Act.

Across the pond, the European Union has also made significant progress in the implementation of market reforms under the European Market Infrastructure Regulation (**EMIR**), the Markets in Financial Instruments Regulation (**MiFIR**) and the Securities Financing Transactions Regulation (**SFTR**). Most notably, the EU has — among other developments — finalized its margin rules for uncleared over-the-counter (**OTC**) derivative transactions.

We mark the end of 2016 with an important presidential election year. In line with the transition from the Obama administration, SEC and CFTC leadership will change in 2017. There are currently two vacant seats at each of the SEC and the CFTC and, while President Obama has put forth four nominees to fill the vacancies, the Senate has not yet confirmed such commissioner nominations; pending any Senate action to the contrary, the incoming administration will be able to nominate new candidates for the open commissioner positions. Timothy Massad will likely step down as chairman of the CFTC after President-elect Trump is sworn in on January 20, 2017; with two vacant seats at the CFTC, Republicans will likely hold three of the five commissioner positions at the CFTC following the inauguration, with Commissioner Giancarlo — the only current Republican CFTC commissioner — likely serving as acting Chairman until the new President nominates him or someone else to fill the roll full-time. At the SEC, Mary Jo White has announced that she will be stepping down as Chairwoman in 2017.

We have set forth on the following pages a high-level summary of the significant progress made with respect to the finalization and implementation across the US and EU derivatives regulatory regimes and the remaining challenges faced by the industry.

*The information herein was originally presented to clients via a webcast delivered by Latham & Watkins attorneys on December 7, 2016. The replay is available for viewing under the Knowledge Library section of our website, which can be accessed via this link: [https://www.lw.com/webcasts](https://www.lw.com/webcasts).*

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# I. UNCLEARED SWAP MARGIN RULES

In September 2013, the Basel Committee on Banking Supervision (**BCBS**) and the International Organization of Securities Commissions (**IOSCO**), at the direction of the Group of Twenty (**G-20**), published international standards for margin requirements for non-centrally cleared derivatives (the **International Standards**). The International Standards were intended to reduce the opportunity for regulatory arbitrage by creating an international framework for uncleared swaps that regulators could use as a guide to frame their respective margin rules. In October 2015, the **Prudential Regulators** (*i.e.,* the Office of the Comptroller of the Currency (Department of Treasury), the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency) became the first financial regulators worldwide to finalize their margin requirements for uncleared derivative transactions (the **PR Margin Rules**). The PR Margin Rules apply to uncleared swap and uncleared security-based swap transactions entered into by CFTC-registered swap dealers (**SDs**) and major swap participants (**MSPs**) and SEC-registered security-based swap dealers (**SBSDs**) and major security-based swap participants (**MSBSPs**) that are subject to regulatory oversight by the Prudential Regulators.

For further discussion, please refer to our *Client Alert* on the Prudential Regulators' finalized uncleared swap margin rules: **Prudential Regulators Are First to Finalize Uncleared Swap Margin Rules**.

Financial regulatory authorities worldwide have followed suit, with the EU, Canada, Japan, Switzerland and Australia each having finalized (or have regulations that will be finalized soon with respect to) their respective margin requirements for uncleared derivative transactions.

For further discussion, please refer to our publication comparing the US Margin Rules and the EU Margin Rules: **US vs. EU Margin Rules: Comparative Summary as of October 4, 2016**.

## A. Finalized CFTC Uncleared Swap Margin Rules

Shortly after the joint finalization by the Prudential Regulators of the PR Margin Rules in October 2015, the CFTC finalized its own uncleared swap margin requirements on December 16, 2015 (the **CFTC Margin Rules** and, together with the PR Margin Rules, the **US Margin Rules**). Applicable to Swap Entities that are not subject to supervision by the Prudential Regulators (**CFTC Covered Swap Entities**), the CFTC Margin Rules largely track the PR Margin Rules, except with respect to the:

- Exclusion of the Prudential Regulators' discretionary "anti-evasion" provision of the "Margin Affiliate" definition
- Proprietary initial margin (**IM**) model approval process
- Calculation of variation margin (**VM**) and related documentation requirements
- Treatment of certain inter-affiliate trades

Subject to the below phased-in compliance schedule, CFTC Covered Swap Entities entering into uncleared swaps with a person registered with the CFTC as an SD or an MSP (collectively, **Swap Entities**), or with Financial End-Users (as defined in CFTC Rule 23.151) with **Material Swaps Exposure** (*i.e.,* an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange (**FX**) forwards and FX swaps with all counterparties for June, July and August of the previous calendar year that exceeds US$8 billion (calculated only for business days and aggregated with the Financial End-User's "Margin Affiliates")), must collect and post IM and VM on a daily basis. CFTC Covered Swap Entities entering into uncleared swaps with Financial End-Users that do not have Material Swaps Exposure must collect and post daily VM, but will not be required to post or collect IM.

Like the PR Margin Rules, the CFTC Margin Rules will be phased in over four years, a compliance period which began on September 1, 2016 for the highest-volume dealers, as illustrated in the table below:

<table>
<tr><th></th><th>VM Compliance Date</th><th>IM Compliance Date</th></tr>
<tr><td colspan="3">Average Daily Aggregate Notional Amount</td></tr>
<tr><td>Exceeding US$3 Trillion</td><td>September 1, 2016</td><td>September 1, 2016</td></tr>
<tr><td>Exceeding US$2.25 Trillion</td><td rowspan="5">March 1, 2017</td><td>September 1, 2017</td></tr>
<tr><td>Exceeding US$1.5 Trillion</td><td>September 1, 2018</td></tr>
<tr><td>Exceeding US$750 Billion</td><td>September 1, 2019</td></tr>
<tr><td>Exceeding US$8 Billion</td><td>September 1, 2020</td></tr>
<tr><td>US$8 Billion or Less</td><td>N/A</td></tr>
</table>

Pursuant to the Terrorism Risk Insurance Program Reauthorization Act of 2015 (**TRIPRA**), the CFTC Margin Rules contained an interim final rule (the **Interim Final Rule**) exempting from the CFTC Margin Rules certain uncleared swaps entered into with the following Exempted End-Users using such uncleared swaps to hedge or mitigate commercial risk:

- Commercial end-users, including treasury affiliates (that do not otherwise qualify as Financial End-Users) acting as agent
- Financial institutions (*i.e.,* small banks, savings associations, Farm Credit System institutions, credit unions) with total assets of US$10 billion or less and certain financial cooperatives hedging the risks associated with originating loans for their members
- Captive finance companies

The Interim Final Rule — which we would expect to be finalized in substantially similar form — was scheduled to go into effect with the CFTC Margin Rules on April 1, 2016, though the CFTC has not yet formally published the Interim Final Rule in its final form.

For further discussion, please refer to our *Client Alert* on the finalized CFTC uncleared swap margin rules: **CFTC Uncleared Swap Margin Rules to Take Effect in September**.

## B. Cross-Border Application of CFTC Margin Rules

The CFTC finalized regulations addressing the cross-border application of the CFTC Margin Rules in May 2016 (the **CFTC Cross-Border Margin Rules**). The CFTC Cross-Border Margin Rules subject all uncleared swap transactions entered into by US CFTC Covered Swap Entities to the CFTC Margin Rules, as well as certain uncleared swaps entered into by non-US CFTC Covered Swap Entities where the risk flows back to a US entity. Under the CFTC Cross-Border Margin Rules, an uncleared swap entered into by a non-US Swap Entity with a non-US Person counterparty (that is not an affiliate of the non-US Swap Entity) is excluded from the CFTC Margin Rules, provided that (i) neither counterparty's obligations under the uncleared swap are guaranteed by a US Person (where guarantee is defined broadly to capture any arrangement pursuant to which one party to the uncleared swap with a non-US Person counterparty has rights of recourse against a US Person guarantor with respect to the non-US Person counterparty's relevant uncleared swap obligations) and (ii) neither counterparty is (a) an FCS (defined below) nor (b) a US branch of a non-US Swap Entity (the **Exclusion**). A non-US Swap Entity would be a **Foreign Consolidated Subsidiary** (an **FCS**) under the CFTC Cross-Border Margin Rules if its financial statements are included in those of an **ultimate parent entity** (*i.e.,* the parent entity in a consolidated group in which none of the other entities in the consolidated group has a controlling interest, in accordance with US generally accepted accounting principles (**GAAP**)) that is a US Person, regardless of whether such US ultimate parent entity guarantees the non-US Swap Entity's obligations under the relevant uncleared swap transaction.

The CFTC Cross-Border Margin Rules diverge from the cross-border application of the PR Margin Rules in a number of instances. Notably, if a non-US Financial End-User with no US Person guarantee of its relevant uncleared swap obligations is ineligible for the Exclusion due to the identity of its Swap Entity counterparty (or the Swap Entity counterparty's guarantor), substituted compliance may nonetheless be available with respect to such non-US Financial End-User's uncleared swaps with either (i) US Swap Entities or (ii) non-US Swap Entities with a US Person guarantee of their relevant uncleared swap obligations, but only with respect to the Swap Entity's posting of IM to the non-US Financial End-User (*i.e.,* not with respect to the Swap Entity's collection of IM from the non-US Financial End-User or the posting/collection of VM). The effect of this provision is that such a substituted compliance determination would not benefit non-US Financial End-Users without Material Swaps Exposure because such entities would not otherwise be subject to the IM posting/collection requirements under the CFTC Margin Rules.

The CFTC Cross-Border Margin Rules align with the cross-border application of the PR Margin Rules in most respects. Notably, however, differences in the determination of what constitutes a US Person may lead to different outcomes as between the two sets of uncleared swap margin rules.

For further discussion, please refer to our *Client Alert* on the proposed cross-border application of the CFTC uncleared swap margin rules: **CFTC Proposes Cross-Border Application of Margin Requirements for Uncleared Swaps**.

## C. EU Uncleared Derivatives Margin Rules

One of the most important EU regulatory developments of 2016 was the finalization of the margin requirements for uncleared OTC derivative transactions under EMIR (the **EU Margin Rules**). On March 8, 2016, the European Supervisory Authorities (*i.e.,* the European Banking Authority (**EBA**), the European Insurance and Occupational Pensions Authority (**EIOPA**) and the European Securities and Markets Authority (**ESMA**)) (the **ESAs**) published draft regulatory technical standards (**Draft RTS**), which were then endorsed with amendments by the European Commission (the **EC**) on July 28, 2016. However, the ESAs subsequently published an opinion on September 9, 2016, rejecting the EC's proposed amendments to the Draft RTS and proposing a new version of the Draft RTS (the **Final Draft RTS**), which was eventually adopted by the EC on October 4, 2016. The European Council of Ministers (the **European Council**) and the European Parliament then reviewed and endorsed the Final Draft RTS on November 21, 2016, with publication of the finalized EU Margin Rules expected in the coming days. The EU Margin Rules will enter into force 21 days after publication in the Official Journal of the European Union.

Collateral posted pursuant to the EU Margin Rules will take the form of IM and/or VM. The date on which counterparties will have to comply with the EU Margin Rules will depend on their volume of non-centrally cleared OTC derivatives trades, *a.k.a.,* the **aggregate average notional amount** or **AANA**. AANA calculations should be made on the last business day of March, April and May of the relevant year.

Like the US Margin Rules, compliance with the EU Margin Rules will be phased in over the next four years, as illustrated in the table below, with the highest volume dealers required to comply first:

| | VM Compliance Date | IM Compliance Date |
|---|---|---|
| **Aggregate Average Notional Amount** | | |
| **Exceeding €3 Trillion** | Entry into force + 1 month *(expected end of January 2017)* | Entry into force + 1 month *(expected end of January 2017)* |
| **Exceeding €2.25 Trillion** | Latest of either: (i) March 1, 2017 (ii) Entry into force + 1 month | September 1, 2017 |
| **Exceeding €1.5 Trillion** | | September 1, 2018 |
| **Exceeding €750 Billion** | | September 1, 2019 |
| **Exceeding €8 Billion** | | September 1, 2020 |
| **€8 Billion or Less** | | N/A |

The EU Margin Rules provide in-scope financial counterparties (**FC**) and non-financial counterparties (**NFC**) the ability to benefit from an intra-group exemption if (i) the relevant group has adequate risk management procedures in place (*e.g.,* regular monitoring and timely settlement) and (ii) no current or foreseen practical or legal impediment exists to the prompt transfer of funds or repayment of liabilities between the intra-group counterparties (the **Intra-Group Exemption**). National competent authorities in the EU are in the process of finalizing draft application forms for the Intra-Group Exemption.

The application of the Intra-Group Exemption depends upon the location and classification of the relevant counterparties (*i.e.,* whether they are based within or outside of the EU and whether they are FC or non-financial counterparties above the clearing thresholds (**NFC+**)):

- Transactions entered into by affiliates established in the same EU member state benefit from the Intra-Group Exemption, without further notification or authorization from their national competent authority.

- Transactions entered into by affiliates established in different EU member states benefit from the exemption after a notification or authorization process with the national competent authority in each relevant member state (unless one counterparty is an FC and the other is an NFC+, in which case the approval need only be given by the national competent authority in the FC's member state).

- Transactions between an EU entity and a non-EU affiliate would not qualify as intra-group transactions for the purposes of EMIR (and, therefore, collateral must be exchanged by such affiliate counterparties) unless the EC has published a decision (following a technical assessment by the Directorate-General for Financial Stability, Financial Services and Capital Markets Union) that the regulatory and supervisory framework of the non-EU jurisdiction is equivalent to that of the EU (an **Equivalence Decision**). Absent such an Equivalence Decision, however, the EU Margin Rules have nonetheless recognized and addressed the burden of intra-group IM obligations by implementing a transitional exemption from IM requirements for such EU/non-EU intra-group transactions, pending the EC's publication of Equivalence Decisions.

There is an additional transitional exemption from IM/VM requirements for all other intra-group transactions not qualifying for the Intra-Group Exemption, which is available until the later of (i) six months after the date of entry into force of the EU Margin Rules and (ii) the relevant IM/VM compliance dates discussed above.

## D. Impact on Swaps Documentation

### 1. New ISDA Credit Support Annexes

The International Swaps and Derivatives Association, Inc. (**ISDA**) has published new regulatory credit support annexes (**CSAs**) designed to be capable of addressing different and potentially inconsistent margin rules (*i.e.,* when two or more uncleared swap margin regimes apply to the parties' trades covered by the parties' ISDA Master Agreement and Schedule). Taking the new structure into consideration, parties may have separate CSAs (or Credit Support Deeds for UK security interests) for each specific type of margin being posted and/or collected under the parties' ISDA documentation: (i) regulatory VM; (ii) unregulated IM/VM (*i.e.,* "old" or **Existing CSA**); and (iii) regulatory IM. Parties could potentially have up to four CSAs governing the trades under the parties' ISDA Master Agreement, as illustrated in the table below.

| | CSA Governing VM | CSA Governing IM |
|---|---|---|
| **Types of Trades** | | |
| **Legacy Trades** | Existing CSA | |
| **Trades Subject to Regulatory VM Requirements Only** (*i.e.*, not subject to regulatory IM) | New CSA for Regulatory VM | Either (i) Existing CSA or (ii) New CSA for Regulatory VM |
| **Trades Subject to Both Regulatory VM and IM Requirements** | New CSA for Regulatory VM | **Pre-Compliance Positions:** Either (i) Existing CSA or (ii) New CSA for Unregulated IM |
| | | **Post-Compliance Positions:** New CSA for Regulatory IM |

Please note that parties always have the option to amend their existing CSA to contain regulation-compliant terms, in the interest of operational simplicity.

ISDA has published two new New York law-governed regulatory CSAs — one for VM posted and/or collected pursuant to the US Margin Rules (*i.e.,* the 2016 ISDA Credit Support Annex for Variation Margin), and another for IM posted/collected pursuant to the US Margin Rules (*i.e.,* the 2016 ISDA Phase One Credit Support Annex for Initial Margin).

### 2. ISDA Regulatory Margin Self-Disclosure Letter

To assist counterparties with determining whether and which margin rules apply to their uncleared swap transactions, ISDA has published its Regulatory Margin Self-Disclosure Letter (the **SDL**) which elicits the information necessary to answer this question and which can be exchanged by the parties to an uncleared swap transaction. In its current form, the SDL covers the following margin regimes, with others to be added once their respective rules have been finalized:

- Canada
- European Union
- Japan
- Switzerland
- United States

As with the launch of ISDA Amend for the ISDA August 2012 DF Protocol, ISDA has partnered with Markit to launch ISDA Amend 2.0 so that uncleared swap counterparties can electronically complete and exchange the SDL, with any previously provided responses to the ISDA DF Protocol Questionnaires in ISDA Amend for a party "pre-populating" (where possible) the analogous question in the ISDA Amend 2.0 form for the SDL.

### 3. ISDA 2016 Variation Margin Protocol

On August 16, 2016, ISDA published the ISDA 2016 Variation Margin Protocol (the **VM Protocol**) to allow market participants to comply with global VM regulatory requirements by either (i) putting contractual documentation in place with multiple counterparties to implement the VM requirements or (ii) amending existing collateral agreements to bring them into compliance. As with the SDL, parties are able to electronically complete and exchange VM Protocol Questionnaires in ISDA Amend 2.0. Among a myriad of other elections, counterparties must "match" with each other in

ISDA Amend 2.0 with respect to their method of adherence to the VM Protocol regarding their uncleared swap trading relationship.

| Adherence Method | Pre-Compliance Positions | Post-Compliance Positions |
|---|---|---|
| **Amend** | Covered CSA, incorporating only those amendments to Existing CSA necessary in order to be compliant with applicable VM requirements | |
| **Replicate-and-Amend** | Existing CSA | Replica CSA, incorporating only those amendments to Existing CSA necessary to be compliant with applicable VM requirements |
| **New CSA** | Existing CSA | New CSA, populated with standard terms (and certain optional terms) produced through parties' VM Protocol Questionnaires |

The above table illustrates the effect of the parties' adherence method on their pre- and post-compliance date positions, while the below table lays out the general pros and cons of each adherence method:

| Adherence Method | Pros | Cons |
|---|---|---|
| **Amend** | Operational simplicity (*i.e.,* there will be only one capital call for VM as between the parties) | Maintain benefit of previously negotiated bargain for pre- and post-compliance positions only insofar as Existing CSA complies with applicable VM requirements |
| **Replicate-and-Amend** | Maintain the benefit of previously negotiated bargain for both pre- and post-compliance positions, to the fullest extent permitted by applicable margin rules | Operational complexity (*i.e.,* there will be two capital calls for VM as between the parties) |
| **New CSA** | Maintain the benefit of previously negotiated bargain for pre-compliance positions | More operational complexity than "Amend" method; lose the benefit of previously negotiated bargain for post-compliance positions |

# II. CFTC CROSS-BORDER UPDATES

## A. CFTC Cross-Border Guidance and Related Proposal

### 1. CFTC Cross-Border Proposal

On October 11, 2016, the CFTC approved a proposed rulemaking and interpretations (the **Cross-Border Proposal**) addressing the cross-border application of certain swap provisions of the Commodity Exchange Act, as amended (the **CEA**), that would replace aspects of its existing policy statement and cross-border interpretative guidance issued on July 26, 2013 (the **2013 Cross-Border Guidance**).

- **US Person Definition.** If finalized, the Cross-Border Proposal would make the following changes to the **US Person** definition previously contained in the 2013 Cross-Border Guidance:
  - The proposed definition would no longer include a commodity pool, pooled account, investment fund, or other collective investment vehicle that is majority-owned by one or more US Persons.
  - The proposed definition would include legal entities where one or more US Person owner(s) bear unlimited responsibility for the obligations and liabilities of the legal entity (*i.e.,* the unlimited US responsibility prong), which represents a modified version of a similar concept from the 2013 Cross-Border Guidance, but eliminates the majority ownership criteria.

- The proposed definition would remove the catch-all lead-in language for non-enumerated persons such that definition of US Persons would be limited to persons enumerated in the specific prongs of the definition.

- The proposed definition would exclude international financial institutions and multilateral development banks from the definition of US Person.

Below please find a redline comparing the US Person definition under the 2013 Cross-Border Guidance, against the US Person definition put forth by the CFTC in the Cross-Border Proposal:

~~In summary, for purposes of the application of CEA section 2(i), the Commission will interpret the term~~Under the Proposed Rule, a "U.S. person" ~~generally to include, but not be limited to~~would be defined as follows:~~[1]~~

(i) Any natural person who is a resident of the United States;

(ii) Any estate of a decedent who was a resident of the United States at the time of death;

(iii) Any corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund or any form of ~~enterprise~~entity similar to any of the foregoing (other than an entity described in ~~prongs~~paragraph (iv) or (v)~~, below~~) (~~a~~ "legal entity"), in each case that is organized or incorporated under the laws of ~~a state or other jurisdiction in~~ the United States or ~~having~~that has its principal place of business in the United States, including any branch of the legal entity;[1]

(iv) Any pension plan for the employees, officers or principals of a legal entity described in ~~prong~~paragraph (iii), unless the pension plan is primarily for foreign employees of such entity;

(v) Any trust governed by the laws of a state or other jurisdiction in the United States, if a court within the United States is able to exercise primary supervision over the administration of the trust;

~~(vi) Any commodity pool, pooled account, investment fund, or other collective investment vehicle that is not described in prong (iii) and that is majority-owned by one or more persons described in prong (i), (ii), (iii), (iv), or (v), except any commodity pool, pooled account, investment fund, or other collective investment vehicle that is publicly offered only to non-U.S. persons and not offered to U.S. persons;~~

(~~vii~~vi) Any legal entity (other than a limited liability company, limited liability partnership or similar entity where all of the owners of the entity have limited liability) that is ~~directly or indirectly majority~~ owned by one or more persons described in ~~prong~~paragraphs (i)~~, (ii), (iii), (iv), or~~ through (v) ~~and in which such person bears~~who bear(s) unlimited responsibility for the obligations and liabilities of the legal entity, including any branch of the legal entity; and

(~~viii~~vii) Any individual account or joint account (discretionary or not) where the beneficial owner (or one of the beneficial owners in the case of a joint account) is a person described in ~~prong~~paragraphs (i)~~, (ii), (iii), (iv), (v),~~ through (vi)~~, or (vii)~~.[2]

~~Under this interpretation, the term "U.S. person" generally means that a foreign branch of a U.S. person would be covered by virtue of the fact that it is a part, or an extension, of a U.S. person.~~

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1 The Commission ~~believes~~notes that ~~Commission regulation 140.99, which provides for persons to request that the staff of the Commission provide written advice or guidance, would be an appropriate mechanism for a person to seek guidance as to whether it is a U.S. person for purposes of applying the Commission swaps regulations promulgated under Title VII~~the reference in proposed 17 CFR 1.3(aaaaa)(5)(iii) and (vi) (indicating that legal entities would include "any branch of the legal entity") is intended to make clear that the definition includes both foreign and U.S. branches of an entity. The Commission further notes that a branch does not have a legal identity apart from its principal entity. The proposed language is not intended to introduce any additional criteria for determining an entity's U.S. person status.

2 See proposed 17 CFR 1.3(aaaaa)(5). See also proposed 17 CFR 1.3(aaaaa)(2) (defining "non-U.S. person" as any person that is not a "U.S. person"); 17 CFR 23.160(a)(10) (defining "U.S. person" for purposes of the Cross-Border Margin Rule). The Commission notes that an affiliate or a subsidiary of a U.S. person that is organized or incorporated in a non-U.S. jurisdiction would not be deemed a U.S. person solely by virtue of its affiliation with a U.S. person. As used herein, the term "U.S. counterparty" refers to a swap counterparty that is a "U.S. person" under the Proposed Rule.

- **Non-US Persons with US Nexus.** The Cross-Border Proposal would modify the categories of persons that are not US Persons, but which the CFTC has nonetheless determined should be subject to the CFTC's swap regulations as a result of concerns with risk transferring back to the United States. Specifically, the Cross-Border Proposal would replace the categories for "Guaranteed Affiliates" and "Conduit Affiliates" with categories for FCS and **US Guaranteed Entities**, where **guarantee** has the same meaning as under the CFTC Cross-Border Margin Rules. The introduction of the FCS concept would have the result of capturing certain non-US Persons which are consolidated on the US ultimate parent entity's financials, but which were not previously captured under the 2013 Cross-Border Guidance due to their not being Conduit Affiliates.

- **Proposed Interpretation Regarding Transactions Arranged, Negotiated or Executed by US Personnel.** In November 2013, the CFTC's Division of Swap Dealer and Intermediary Oversight (the **DSIO**) issued a staff advisory providing that a non-US Swap Entity that regularly uses personnel or agents located in the U.S. (**US Personnel**) to arrange, negotiate, or execute a swap with a non-US Person would generally be required to comply with "transaction-level" requirements applicable to Swap Entities, regardless of the location of their counterparty. The Cross-Border Proposal reiterates the CFTC's belief that to extent that a person uses US Personnel (whether its own personnel or personnel of an agent) to arrange, negotiate or execute its swap dealing transactions, the CFTC believes that such person is conducting a substantial aspect of its swap dealing activity within the United States and therefore falls within the scope of the Dodd-Frank Act. The Cross-Border Proposal would clarify, however, that the terms **arrange** and **negotiate** to refer to market-facing activity normally associated with sales and trading, as opposed to internal, back-office activities, such as ministerial or clerical tasks, performed by personnel not involved in the actual sale or trading of the relevant swap. Accordingly, the terms <u>would not</u> encompass activities such as swap processing, preparation of the underlying swap documentation (including negotiation of a master agreement and related documentation), or the mere provision of research information to sales and trading personnel located outside the U.S.

- **Swap Dealer *De Minimis* Threshold Calculations.** Under the Cross-Border Proposal, the requirements for calculating the SD *de minimis* threshold remain largely the same.

  - A US Person would include all of its swap dealing transactions.

  - A non-US Person would include all swap dealing transactions with respect to which it is a "US Guaranteed Entity."

  - An FCS would include all of its swap dealing transactions.

  - A non-US Person that is neither an FCS nor a US Guaranteed Entity would include all of its swap dealing transactions with counterparties that are US Persons, US Guaranteed Entities or FCS, unless the swap is executed anonymously on a registered designated contract market (**DCM**), swap execution facility (**SEF**) or foreign board of trade (**FBOT**) and cleared.

  - All potential swap dealers, whether US or non-US Persons, would aggregate their swap dealing transactions with those of persons controlling, controlled by, or under common control with the potential SD to the extent that those affiliates are themselves required to include those swaps in their own *de minimis* thresholds, unless the affiliated person is a registered SD.

The below table compares the CFTC's proposed cross-border application of the swap dealer *de minimis* registration threshold calculations in the Cross-Border Proposal, to the approach taken in the 2013 Cross-Border Guidance.

| | | | Counterparty | | | |
|---|---|---|---|---|---|---|
| | | | US Person | Non-US Person | | |
| | | | | US Guaranteed Entity[1] / FCS | | Other Non-US Person |
| | | | | ~~Guaranteed Affiliate~~ | ~~Conduit Affiliate~~ | |
| Potential SD/MSP | US Person | | Include | Include | ~~Include~~ | Include |
| | Non-US Person | US Guaranteed ~~or Conduit Affiliate~~ Entity[1]/FCS | Include | Include | ~~Include~~ | Include |
| | | Other Non-US Person | Include[2] | Include[2] | ~~Exclude~~ | Exclude |

1 A non-US Person that is a US Guaranteed Entity with respect to a swap would include the swap in its *de minimis* calculation if its swap counterparty has rights of recourse against a US Person with respect to its obligations under the swap.

2 ~~Exclude swaps with: (i) Guaranteed Affiliates that are SDs; (ii) Guaranteed Affiliates that are not SDs but which are affiliated with an SD and where the Guaranteed Affiliate itself engages in *de minimis* swap dealing activity; (iii) Guaranteed Affiliates that are guaranteed by a non-financial entity; and (iv) swaps~~An Other Non-US Person would include all swaps connected with its dealing activity with counterparties that are US persons, US Guaranteed Entities or FCS unless the swap is executed anonymously on a registered SEF, DCM or FBOT and cleared.

Additionally, a potential SD, whether a US or non-US Person, would aggregate all swaps connected with its dealing activity with those of persons controlling, controlled by or under common control with such potential SD to the extent that these affiliated persons are themselves required to include those swaps in their own *de minimis* thresholds, unless the affiliated person is a registered SD.

- **External Business Conduct Standards.** Under the Cross-Border Proposal, external business conduct standards (the **CFTC EBC Rules**) would apply as follows:
  - US Swap Entities would comply with applicable CFTC EBC Rules, without substituted compliance, except with respect to transactions conducted through a foreign branch of the US Swap Entity (a **Foreign Branch**).
  - Non-US Swap Entities and Foreign Branches would comply with applicable CFTC EBC Rules, without substituted compliance, if the counterparty is a US Person (other than a Foreign Branch).
  - Non-US Swap Entities and Foreign Branches would not be subject to the CFTC EBC Rules for their swaps with non-US Persons and Foreign Branches. However, Foreign Branches and non-US Swap Entities that use US Personnel to arrange, negotiate or execute such transactions would be required to comply with CFTC Rules 23.410 (*Prohibition on Fraud, Manipulation and other Abusive Practices*) and 23.433 (*Fair Dealing*), without substituted compliance.

The below table compares the CFTC's approach to the cross-border application of the CFTC EBC Rules in the Cross-Border Proposal, to the cross-border application of the CFTC EBC Rules under the 2013 Cross-Border Guidance.

| | | | **Counterparty** | | | |
|---|---|---|---|---|---|---|
| | | | **US Person** | | **Non-US Person** | |
| | | | **Not a Foreign Branch of an SD/MSP** | **Foreign Branch of an SD/MSP** | ~~**Guaranteed Affiliate or Conduit Affiliate**~~ | ~~**Not a Guaranteed Affiliate or Conduit Affiliate**~~ |
| **Potential SD/MSP** | **US Person** | **Not a Foreign Branch** | Apply | Apply | ~~Apply~~ | Apply |
| | | ~~**Soliciting and Negotiating Through a Foreign Subsidiary or Affiliate**~~ | ~~Apply~~ | ~~Do Not Apply~~ | ~~Do Not Apply~~ | ~~Do Not Apply~~ |
| | | **Foreign Branch** | Apply | Do Not Apply* | ~~Do Not Apply~~ | Do Not Apply* |
| | **Non-US Person** | | Apply ~~Do Not Apply under certain circumstances~~[1] | Do Not Apply* | ~~Do Not Apply~~ | Do Not Apply* |

* An SD that uses US Personnel to arrange, negotiate, or execute a swap transaction (or a swap that is offered but not entered into) would nevertheless be subject to CFTC Rules 23.410 (*Prohibition on Fraud, Manipulation, and other Abusive Practices*) and 23.433 (*Fair Dealing*).

~~1 Transaction-Level Requirements do not apply where the swap is executed anonymously on a registered DCM or SEF and cleared by a registered DCO, or on a registered FBOT and cleared.~~

The CFTC has requested comment on the Cross-Border Proposal until December 19, 2016, and has indicated that it intends to finalize this rule during the first half of 2017.

### 2. Final Response to Remand Order in *SIFMA v. CFTC*

On August 16, 2016, the CFTC published in the Federal Register its final response (the **Final Response**) to the US District Court for the District of Columbia's remand order (the **Order**) in *Securities Industry and Financial Markets Association, et al. v. CFTC*. The Order remanded eight swaps-related rulemakings to the CFTC to resolve what the court found to be inadequacies in the CFTC's cost-benefit analysis with respect to those rules.

The CFTC had initially published a response to the Order in March 2015 (the **Initial Response**) where it took two preliminary actions:

- First, the CFTC supplemented the discussion of the costs and benefits in the preamble of the remanded rules for further consideration, stating that the CFTC is clarifying that it considered the costs and benefits of each rule on the understanding that the swaps market operates internationally and noting that where the CFTC did not specifically refer to matters of location, its discussion of costs and benefits referred to the effects of its rules on all business activity subject to its regulations.

- Second, the CFTC solicited comments on certain questions to further inform its consideration of costs and benefits of the remanded rules.

The Final Response summarizes the various comments that it received in response to its request in the Initial Response for comment. Ultimately, however, the CFTC concluded that the record does not establish a need to make any changes in the substantive requirements of the remanded rules.

### 3. Extension of No-Action Relief for Non-US Swap Entities

As described above, the CFTC's DSIO previously issued an advisory regarding the application of the CFTC's transaction-level requirements for Swap Entities with respect to swaps between a non-US Swap Entity and a non-US person, if the swap is arranged, negotiated, or executed by US Personnel of the non-US Swap Entity in the U.S. Thereafter, the CFTC staff issued time-limited no-action relief for non-US Swap Entities from compliance with transaction-level requirements, when entering into swaps with non-US Persons that are neither "Guaranteed Affiliates" nor "Conduit Affiliates" (each as defined in the 2013 Cross-Border Guidance) of a US Person using US Personnel to arrange, negotiate or execute such swaps. That relief has since been extended numerous times and, on August 4, 2016 the CFTC staff extended the relief once more, until the earlier of (i) September 30, 2017 or (ii) any CFTC action with respect to the issues discussed therein.

### B. CFTC Rule 3.10(c)(3) Update

CFTC Rule 3.10(c)(3) provides an exemption from registration for firms that would otherwise qualify as an introducing broker (**IB**), commodity trading advisor (**CTA**) or commodity pool operator (**CPO**) where the person seeking the exemption (i) is located outside of the U.S. and (ii) only acts on behalf of persons located outside the U.S. (the **3.10(c)(3) Exemption**). However, as currently written, CFTC Rule 3.10(c)(3) limits the scope of the exemption to transactions submitted for clearing through a futures commission merchant (**FCM**) registered with the CFTC. This additional condition regarding clearing has resulted in uncertainty among market participants as to whether the 3.10(c)(3) Exemption would be available with respect to uncleared swaps.

On February 12, 2016, DSIO clarified that CFTC Rule 3.10(c)(3) was not intended to impose an independent clearing requirement on transactions involving foreign entities and granted no-action relief from CFTC registration requirements to foreign persons engaged in the activities of an IB, CTA or CPO only on behalf of persons located outside the U.S., without regard to whether the transaction is cleared through an FCM. On August 5, 2016, the CFTC also published in the Federal Register proposed amendments to CFTC Rule 3.10(c)(3) to eliminate the condition on clearing.

### C. CFTC-EU Common Approach Regarding Dually-Registered Clearinghouses

On February 10, 2016, the CFTC and the EC announced a common approach regarding requirements for entities that serve as central counterparties (**CCPs**) to facilitate the EC's ability to grant an equivalence decision with respect to CFTC requirements for US CCPs, so that US CCPs could continue to provide services in the EU while complying with CFTC requirements (the **Common Approach**). The Common Approach included both:

- A commitment by the EC to adopt an equivalence decision that would allow EU regulators to recognize US CCPs
- A commitment by the CFTC to propose a determination of comparability with respect to EU requirements, which would permit EU CCPs to provide services to US clearing members and clients while complying with certain corresponding EU requirements

The Common Approach was premised on the condition that CFTC-registered derivatives clearing organizations (**DCOs**) seeking recognition in the EU maintain internal rules and procedures that ensure compliance with certain EU requirements, most notably including the requirement that, for clearing members' proprietary positions in exchange-traded derivatives, collection of IM be sufficient to take into account a two-day liquidation period, rather than a one-day liquidation period as currently required by CFTC rules. Following the announcement of the Common Approach, the EC adopted an equivalency decision with respect to US CCPs and the CFTC, on March 16 2016, approved (i) a substituted compliance framework for dually-registered CCPs located in the EU, together with (ii) a comparability determination with respect to certain EU rules.

## III. CLEARING AND TRADE EXECUTION UPDATES

### A. Additional Interest Rate Swaps Subject to Mandatory Clearing

On September 28, 2016, the CFTC expanded the mandatory clearing requirement (the **CFTC Clearing Mandate**) for interest rate swaps to include certain fixed-to-floating interest rate swaps, basis swaps, forward rate agreements and overnight index swaps denominated in currencies that were not covered by the initial CFTC Clearing Mandate adopted in 2013. Specifically, the following interest rate swaps are now subject to mandatory clearing:

- Fixed-to-floating interest rate swaps denominated in Australian Dollar (**AUD**), Canadian Dollar (**CAD**), Hong Kong Dollar, Mexican Peso, Norwegian Krone (**NOK**), Polish Zloty (**PLN**), Singapore Dollar, Swedish Krona (**SEK**) and Swiss Franc

- Basis swaps denominated in AUD

- Forward rate agreements (**FRAs**) denominated in NOK, PLN and SEK

- Overnight index swaps (**OIS**) denominated in AUD and CAD, as well as US Dollar-, Euro- and Sterling-denominated OIS with termination dates up to three years.

While AUD-denominated FRAs were included in the CFTC's initial proposal, the CFTC decided not to include such instruments in the final rulemaking. The CFTC has provided phased-in compliance with respect to these additional instruments based on when analogous clearing requirements have taken or will take effect in non-US jurisdictions, subject to a maximum two-year phase-in schedule.

## B. Amendments to Cleared Swap Data Reporting Requirements

On June 14, 2016, the CFTC approved a final rule that amends its existing swaps reporting regulations in order to provide clarity to swap counterparties, SEFs, DCMs, DCOs and SDRs regarding their reporting obligations for cleared swap transactions. Specifically, the amendment removes uncertainty as to which cleared swap counterparty is responsible for reporting creation and continuation data for each of the various components of the cleared swap transaction, including to further clarify as to whose obligation it is to report the extinguishment of a cleared swap upon its acceptance for clearing by a DCO.

## C. CFTC Guidance and No-Action Relief

### 1. DCO Recovery and Wind-Down Plans

CFTC Rules require DCOs to maintain viable plans for each of the following:

- Recovery or orderly wind-down necessitated by uncovered credit losses or liquidity shortfalls

- Recovery or orderly wind-down necessitated by general business risk, operational risk, or any other risk that threatens the DCO as a going concern (each, as applicable, a **Recovery Plan** or **Wind-Down Plan**)

According to the CFTC's Division of Clearing and Risk, it has (i) discussed — in its preliminary review of Recovery Plans and Wind-Down Plans — a number of issues pertaining to recovery tools a DCO may seek to use and (ii) received requests from DCOs for guidance regarding the types of information and analysis that should be included in the Recovery Plans and Wind-Down Plans. Accordingly, on July 21, 2016, the CFTC issued guidance to DCOs to further the development of Recovery Plans and Wind-Down Plans. The guidance is very detailed, but, in general, sets forth questions that DCOs should consider in both:

- Evaluating whether particular tools for recovery and orderly wind-down should be included in their Recovery Plans and Wind-Down Plans

- Designing proposed rule changes to support the inclusion of particular tools in such Recovery Plans and Wind-Down Plans

### 2. Extended Relief for Exchange Operational and Clerical Errors

Under existing CFTC staff guidance, SEFs are required to have rules providing that trades that are submitted for clearing but are rejected are void *ab initio* (the **Swap Rejection Rule Requirement**). However, after imposing the Swap Rejection Rule Requirement on SEFs, certain market participants expressed concern that some swaps are rejected by DCOs because of a SEF's operational or clerical errors that are readily correctable. Accordingly, the CFTC responded on April 22, 2015 by providing time-limited no-action relief from the Swap Rejection Rule Requirement, subject to certain terms and conditions, and, on June 10, 2016, the CFTC further extended its no-action relief until the earlier of (i) June 15, 2017 or (ii) the effective date of a revised CFTC rulemaking that establishes permanent relief.

### 3. Extended Relief for Certain SEF Trade Confirmation Requirements

The CFTC's SEF rules require that a SEF "provide each counterparty to a transaction that is entered into on or pursuant to the rules of the [SEF] with a written record of all of the terms of the transaction which shall legally supersede any previous agreement and serve as a confirmation of the transaction." The CFTC initially indicated that SEFs could satisfy this written confirmation requirement by incorporating by reference the terms set forth in the master trading agreements previously negotiated by the counterparties to a transaction (the **Governing Bilateral Agreements**), provided that such Governing Bilateral Agreements had been submitted to the SEF ahead of execution. Given the significant undertaking for a SEF to collect such Governing Bilateral Agreements from each of its participants, the CFTC's Division of Market Oversight issued a no-action letter on August 18, 2014, which provided relief for SEFs from certain confirmation and recordkeeping requirements applicable to SEFs, so that SEFs would not be required to obtain copies of the Governing Bilateral Agreements between the counterparties to an uncleared swap transaction. On March 14, 2016, the CFTC further extended this relief until March 31, 2017, so that the CFTC can work toward a more permanent solution.

# IV. COMMODITY TRADING UPDATES

## A. Finalized Amendments to Trade Option Exemption

On March 16, 2016, the CFTC approved a final rulemaking that removes reporting and recordkeeping requirements for trade option counterparties that are neither SDs nor MSPs. **Trade options** are commodity options that, if exercised, would result in the sale of a non-financial commodity for immediate (*i.e.,* spot) or deferred (*i.e.,* forward) shipment or delivery. An instrument must meet the following conditions to qualify as a trade option:

- The offeror of such commodity option:
  - Is either (i) an eligible contract participant (**ECP**) or (ii) a producer, processor or commercial user of, or merchant handling the commodity that is the subject of, the commodity option or the products or by-products thereof (a **commercial party**)
  - Is offering or entering into such commodity option for purposes related to its business as such
- The offeree of such commodity option:
  - Is a commercial party
  - Is offered or entering into the commodity option solely for purposes related to its business as such
- Such commodity option is intended to be physically settled so that, if exercised, the option would result in the sale of an "exempt commodity" (*e.g.,* energy commodities) for immediate or deferred shipment or delivery

Like physically-delivered non-financial forward contracts, trade options are exempt from most — though not all — of the CFTC's regulatory requirements which are otherwise applicable to swaps (the **Trade Option Exemption**). Recently, the CFTC further eliminated certain reporting and recordkeeping requirements for trade options. On March 21, 2016, the CFTC finalized a rule that amended the Trade Option Exemption by eliminating the Form TO annual notice reporting requirement for otherwise unreported trade options. Additionally, non-Swap Entity trade option counterparties are not subject to regulatory reporting requirements under Part 45 of the CFTC's regulations (**Part 45**) in connection with their trade options. Significantly, the CFTC also declined to adopt a requirement that had previously been proposed which would have required commercial parties to provide notice to the CFTC of its trade options activities if such activities have a value of more than US$1 billion in any calendar year. With respect to recordkeeping, the CFTC eliminated the swaps-related recordkeeping requirements for commercial parties in connection with their trade option activities, although trade option counterparties must nonetheless continue to maintain records concerning their trade option activities in the ordinary course of business and make such records available to the CFTC upon request.

Note that trade options remain subject to large trader reporting requirements, as well as the CEA's antifraud and anti-manipulation provisions under the CEA and related CFTC regulations promulgated thereunder, despite the fact that neither party is registered with the CFTC as a Swap Entity.

Market participants entering into trade options should review their documentation to ensure they are properly notifying their commodity option counterparties of their qualification for the Trade Option Exemption. For example, the North American Energy Standards Board, Inc. (**NAESB**) has recently updated its form Base Contract for Sale and Purchase of Natural Gas to include a "Party CFTC Classification" question, in response to which counterparties may indicate to each other whether they each qualify for the Trade Option Exemption. Parties should review the Trade Option Exemption requirements to aid them in responding to this question on NAESB and other derivatives documentation.

For further discussion, please refer to our *Client Alert* on the extension of the Form TO filing deadline by the CFTC in February 2016 shortly before its adoption of the final amendments to the trade option exemption: **CFTC Extends Trade Option Reporting Deadline to April 1, 2016**

## B. Position Limits Status Update

On December 5, 2016, the CFTC voted unanimously to re-propose regulations implementing limits on speculative futures and swaps (the **Position Limits Re-Proposal**) and to adopt a final rule on aggregation of positions (the **Final Aggregation Rules**). The Position Limits Re-Proposal incorporates concepts from a supplemental rulemaking that was published earlier in 2016, which, among other things, provided for an alternative process for DCMs to recognize certain positions in commodity derivative contracts as non-enumerated *bona fide* hedges or enumerated anticipatory *bona fide* hedges, as well as to exempt from federal position limits certain spread positions, in each case subject to CFTC review. The Position Limits Re-Proposal also introduces a series of new estimates of deliverable supply for purposes of determining whether the position limit levels have been exceeded. Further, the Position Limits Re-Proposal only extends to 25 referenced futures contracts (and their "economically equivalent" futures, options and swaps), whereas the CFTC's initial proposal applied to 28 referenced futures contracts; three agricultural contracts were excluded from the Position Limits Re-Proposal. The Final Aggregation Rules largely follow the CFTC's initial proposal on aggregation and supplemental proposal on disaggregation of positions of owned entities in expanded circumstances.

## C. CFTC/SEC Proposed Guidance Regarding Certain Natural Gas and Power Contracts

On April 4, 2016, the CFTC and the SEC jointly proposed guidance providing that certain capacity contracts in electric power markets and certain natural gas contracts (*i.e.,* peaking supply contracts) should not be considered "swaps" under the CEA because they are examples of "customary commercial arrangements" as described in the agencies' final "swap" definition adopting release. Specifically, the CFTC and the SEC described the following contracts as being excluded from the "swap" definition under its proposed guidance:

- **Capacity Contracts** in electric power markets used in situations where state public utility commission (**PUC**) regulatory requirements require load serving entities (**LSEs**) and load serving electric utilities in the state to purchase "capacity" (*i.e.,* "resource adequacy") from suppliers to secure grid management and on-demand deliverability of power to consumers

- **Peaking Supply Contracts**, meaning contracts that enable an electric utility (with or without a minimum gas delivery requirement) to purchase natural gas from another natural gas provider on those days when its local natural gas distribution companies (**LDCs**) curtail its natural gas transportation service

## D. CFTC Large Trader Reporting Rules

The CFTC's ownership and control reporting rules (the **OCR Rules**) were approved by the CFTC in 2013 to enhance the CFTC's large trader reporting program by (i) collecting additional ownership and control information and (ii) requiring that such information be reported electronically. Since the adoption of its OCR Rules, the CFTC has issued various no-action letters and guidance documents to facilitate compliance with these new requirements.

In 2016, the CFTC provided market participants no-action relief with respect to certain aspects of the OCR Rules. For example, in April 2016, the CFTC staff extended previously issued no-action relief relating to the compliance date for the various reporting requirements under the OCR Rules and allowing reporting entities, subject to certain terms and conditions, to mask certain information that market participants which would be prohibited from disclosure under applicable foreign privacy laws. The CFTC's Division of Market Oversight also issued guidance in April 2016 to respond to questions from market participants regarding the meaning of the terms "owner" and "controller" for purposes of the OCR Rules.

To aid in the market's compliance with the OCR Rules, the Futures Industry Association (**FIA**) has developed the FIA Tech Portal to provide a central repository that counterparties can use to collect and store the required information. Swap Entities have begun asking their commodities counterparties to onboard with FIA Tech so that the information provided by counterparties therein could be used in the event that such counterparties become subject to the large trader reporting rules with respect to its physical commodity transactions.

## E. CFTC Recordkeeping Requirements for Commodity Interest and Related Cash or Forward Transactions

CFTC Rule 1.35(a) is a recordkeeping rule that applies to FCMs, retail foreign exchange dealers (**RFEDs**), IBs and members of a DCM or SEF, including DCM or SEF members that are not registered or required to register with the CFTC (**Unregistered Members**). The rule requires these market participants to keep records of their business of dealing in commodity interest transactions and related cash or forward transactions (**Transaction Records**). Subject to certain exceptions, CFTC Rule 1.35(a) had previously required that:

- These market participants maintain records of written communications that lead to the execution of a commodity interest transaction and related cash or forward transactions (**Written Pre-Trade Communications**)

- A subset of these market participants keep records of oral communications that lead to the execution of a commodity interest transaction (**Oral Pre-Trade Communications**)

On December 18, 2015, the CFTC approved a final rule requiring Unregistered Members to maintain Transaction Records, thus removing the requirement to maintain either (i) Written Pre-Trade Communications or (ii) Transaction Records transmitted via text messages. Additionally, (x) Unregistered Members are not required to maintain their records in any particular form and manner and (y) CTAs that are members of a DCM or of a SEF are excluded from the requirement to record and maintain Oral Pre-Trade Communications.

# V. OTHER CFTC SWAPS REGULATORY UPDATES

## A. Proposed Regulation Automated Trading

On November 4, 2016, the CFTC published a supplemental proposal for Regulation Automated Trading (**Proposed Regulation AT**) , which would impose risk controls, transparency measures and other requirements on (i) certain market participants (*i.e.,* **AT Persons**) using algorithmic trading systems (**ATS**), (ii) clearing member FCMs, with respect to their AT Person customers, and (iii) US DCMs executing AT Person orders. Proposed Regulation AT would also require certain proprietary traders to register with the CFTC as **floor traders** if such traders (x) are engaged in algorithmic trading through direct electronic access (**DEA**) to a DCM and (y) are not otherwise registered with the CFTC in any capacity. Proposed Regulation AT represents an effort by the CFTC to streamline certain regulatory requirements originally proposed by the CFTC in November 2015.

Proposed Regulation AT would:

- Apply across all commodity interest trading on or subject to the rules of a DCM, where either (i) computer algorithms or systems determine whether to initiate, modify or cancel an order or (ii) computers make other determinations (*e.g.,* which product to trade and order timing, quantity and volume) with respect to any commodity interest trade on or subject to the rules of a DCM (**Algorithmic Trading**)

- Define AT Persons to include any person registered or required to be registered with the CFTC as an FCM, floor broker, Swap Entity, CPO, CTA, IB or floor trader that engages in Algorithmic Trading on or subject to the rules of a DCM

Proposed Regulation AT would explicitly exclude from the definition of Algorithmic Trading, orders (or modifications thereto or cancellations thereof) for which every parameter is manually entered into a front-end system by a person, with no further discretion by any computer system or algorithm. Most notably, the CFTC's original proposal would have required AT Persons to, among other things:

- Maintain a repository of its source code used for algorithmic trading (**AT Source Code**), which must include (among other things) an audit trail of material changes to AT Source Code that would allow the AT Person to determine (i) who made the material change, (ii) when such material change was made and (iii) the rationale for such material change

- Manage AT Source Code access, persistence, copies of production code and changes to production code

- Make such repository available for inspection by the CFTC and/or the US Department of Justice (the **DOJ**)

This last requirement was by far the most controversial requirement in the original proposal. The CFTC responded to industry concerns raised during the initial comment period by hosting a public roundtable on June 10, 2016, and subsequently reopening the comment period before publishing its supplemental proposal.

Proposed Regulation AT amends the CFTC's original proposal as follows:

- **Risk Control Framework.** Proposed Regulation AT would replace the originally proposed three-level risk control structure (*i.e.,* risk controls imposed at AT Persons, FCMs and DCMs), with a two-level structure (*i.e.,* risk controls imposed on the DCM and either the AT Person or its FCM).

- **CFTC Registration.** Proposed Regulation AT would incorporate a volume-based test for floor trader registration; this volume threshold would also apply in determining whether a CFTC registrant is an AT Person subject to Regulation AT.

- **AT Source Code.** Under Proposed Regulation AT, AT Source Code and related records would be subject to preservation pursuant to rules separate from the CFTC's general recordkeeping requirements. Further, the CFTC would have access to the following items via a subpoena or "special call" approved by the CFTC:

  - AT Source Code

  - Records tracking changes to an AT Person's AT Source Code

  - Log files recording the activity of an AT Person's ATS

- **Reporting to DCMs.** Proposed Regulation AT would: (i) replace the originally proposed annual compliance report, with an annual certification requirement consisting of the AT Person or FCM, as applicable, attesting that it complies with Regulation AT; and (ii) replace the originally proposed requirement that DCMs review AT Person and FCM annual compliance reports, with an obligation for DCMs to establish a program for periodic review of AT Person or FCM compliance with Regulation AT, as applicable.

- **Third-Party Algorithmic Trading Systems.** Proposed Regulation AT would provide AT Persons using third-party ATS with options to facilitate regulatory compliance, including the ability to satisfy Regulation AT's development and testing requirements with a combination of third-party certifications and the AT Person's own due diligence efforts.

The CFTC has requested comment on Proposed Regulation AT until January 24, 2017.

## B. Finalized CFTC Cybersecurity Rules for Trading Platforms and Data Repositories

On September 8, 2016, the CFTC finalized amendments to its rules on system safeguards testing requirements applicable to DCOs, DCMs, SEFs and swap data repositories (**SDRs**) (the **Amended System Safeguards Rules**), which amend the CFTC's previously finalized system safeguards testing rules as follows:

- Generally clarifying existing requirements related to cybersecurity testing and system safeguards, including the provision of definitions (based on industry standards) for certain key terms not previously defined in existing CFTC regulations

- Imposing new minimum frequency requirements for testing and requires the engagement of independent contractors (**ICs**) for certain testing and assessments and, where permitted, clarifying which employees may conduct the required testing, where permitted

- Adding enterprise risk management and governance to the (now seven) enumerated categories of system safeguards-related risk analysis and oversight

- Clarifying the scope of testing and internal reporting, review and remediation required under CFTC regulations

Please note that, because the CFTC's previously finalized system safeguards testing rules referenced generally accepted industry standards, the CFTC is of the view that its amendments generally do not impose additional obligations on DCOs, DCMs, SEFs and SDRs.

The CFTC has distinguished among "Covered" and "Non-Covered" DCMs for purposes of determining whether a DCM is subject to the new minimum frequency and testing requirements under the Amended System Safeguards Rules, defining a **Covered DCM** to capture a DCM whose annual total trading volume in 2015 or any subsequent calendar year constitutes five percent or more of the combined trading volume of all CFTC-regulated DCMs for the year in question. A DCM qualifying as a Covered DCM under the Amended System Safeguards Rules may only become a Non-Covered DCM once such DCM has remained below the five percent threshold for three consecutive calendar years. All registered DCMs are now subject to a related volume reporting requirement in connection with the Amended System Safeguards Rules, effective October 19, 2016.

## C. Swap Dealer *De Minimis* Exception

The definition of "swap dealer" sets forth a *de minimis* exception to swap dealer registration, which provides that a person shall not be deemed to be a swap dealer unless its swap dealing activity exceeds an aggregate gross notional amount threshold of US$3 billion (measured over the prior 12-month period), subject to a phase-in period during which the gross notional amount threshold is set at US$8 billion. Absent further action by the CFTC, the phase-in period would have terminated on December 31, 2017, at which time the swap dealer *de minimis* threshold would have automatically decreased to US$3 billion.

On August 15, 2016, the CFTC staff issued its Swap Dealer *De Minimis* Exception Final Staff Report (**Swap Dealer Report**), which analyzed available swap data in conjunction with relevant policy considerations to assess alternative *de minimis* threshold levels and other potential changes to the swap dealer *de minimis* registration exception. However, the CFTC noted in the Swap Dealer Report that the data available was insufficient for purposes of assessing whether, and to what extent, specific changes to the *de minimis* threshold levels would increase or decrease the coverage of swaps regulated by CFTC rules applicable to swap dealers. In particular, the CFTC noted in the Swap Dealer Report that reliable swaps notional amount data was unavailable in the non-financial commodity, equity and FX asset classes. In light of the Swap Dealer Report and the CFTC staff's findings, the CFTC opted to extend the swap dealer *de minimis* threshold phase-in period for one year by approving an order on October 13, 2016 establishing December 31, 2018 as the swap dealer registration *de minimis* threshold phase-in termination date. The CFTC noted in the order, however, that it may take further action regarding the *de minimis* threshold prior to the phase-in termination date, by rule amendment, order or other appropriate action.

## D. Amended Portfolio Reconciliation Rules

Under CFTC Rule 23.500, Swap Entities must exchange the swap data with their counterparties for the purpose of portfolio reconciliation (the **Portfolio Reconciliation Rule**). In an effort to minimize the burden on Swap Entities while fulfilling the CFTC's regulatory mandate under the Dodd-Frank Act, the CFTC finalized an amendment to the Portfolio Reconciliation Rule on May 2, 2016, scaling back the scope of the exchanged swap data to require that Swap Entities only exchange the "material terms" of their swaps for portfolio reconciliation purposes. The CFTC's final rule also amended the definition of **material terms** in the Portfolio Reconciliation Rules to mean the minimum primary economic terms of a swap, as defined in Appendix 1 to Part 45.

## E. CFTC Reporting Updates

### 1. CCO Reporting

- **Proposed Amendments to FCM, SD and MSP CCO Annual Reporting Deadline.** On November 10, 2016, the CFTC finalized an amendment to CFTC Rule 3.3(f)(2) requiring Swap Entities and FCMs to electronically file their CCO Annual Reports within 30 days after their submission of, as applicable, its Form 1-FR-FCM, Financial and Operational Combined Single Report or financial condition report. Under the previous version of CFTC Rule 3.3(f)(2), chief compliance officers (**CCOs**) for Swap Entities and FCMs furnished their CCO Annual Reports to the CFTC not more than 60 days following the end of such Swap Entity or FCM's fiscal year. However, the DSIO published a no-action letter (**CFTC Letter No. 15-15**) in March 2015 providing time-limited no-action relief from compliance with the timing requirements under CFTC Rule 3.3, allowing FCMs and Swap Entities up to 90 days to deliver their CCO Annual Reports. The CFTC's recent rulemaking codified and superseded the no-action relief previously provided under CFTC Letter No. 15-15.

  Further, the CFTC had previously issued comparability determinations deeming a Swap Entity located in Canada, the EU, Hong Kong, Japan or Switzerland to be in compliance with CFTC Rule 3.3(e) regarding the preparation of the Swap Entity's comparable annual reporting information (**Comparable CCO Annual Report**), but did not provide a comparability determination with respect to CFTC Rule 3.3(f)(2) regarding the timing of furnishing such report to the CFTC. The CFTC's rulemaking in November regarding the CCO Annual Report filing deadline allows for the furnishing of a Comparable CCO Annual Report up to 15 days after the date on which the Comparable CCO Annual Report must be completed (as specified in the regulations of the relevant Swap Entity's home jurisdiction).

- **Staff Advisory on CCO Reporting Line Requirements.** On July 25, 2016, the DSIO issued a staff advisory regarding CCO reporting line requirements for Swap Entities and FCMs under CFTC Rule 3.3 (the **CCO Reporting Advisory**). The CCO Reporting Advisory (i) clarified the required elements for CCO Annual Reports under CFTC Rule 3.3 and (ii) addressed additional supervisory relationships that a CCO may have with senior management, in addition to those with the firm's board or the senior officer.

### 2. Extended Reporting Relief Based on Foreign Privacy Law Considerations

The CFTC issued a no-action letter on June 28, 2013 (i) permitting swap data reporting counterparties to mask legal entity identifiers (**LEIs**), other enumerated identifiers and other identifying terms and (ii) permitting large trader reporting entities to mask identifying information in certain enumerated jurisdictions as a result of foreign privacy laws barring the reporting of such information under Parts 20, 45 and/or 46 (**CFTC Letter No. 13-41**). On January 15, 2016, the CFTC's Division of Market Oversight extended the relief originally provided in CFTC Letter No. 13-41, subject to certain conditions, until the earlier of either (x) the reporting party no longer holding the requisite reasonable belief regarding the privacy law consequences of reporting or (y) March 1, 2017 (**CFTC Letter No. 16-03**). CFTC Letter No. 16-03 differs from CFTC Letter No. 13-41 and the extension of such relief in previous letters by:

- Not requiring an opinion of outside counsel (or any other particular basis) to form a reasonable belief that foreign privacy laws bar certain reporting under Parts 20, 45 and/or 46 of the CFTC's regulations
- Requiring a formal response from the relevant foreign regulator(s) that reporting such information pursuant to Parts 20, 45 and/or 46 would violate the law of the non-US jurisdiction
- Permitting relief based on the privacy laws of additional jurisdictions upon receipt of the foreign regulator's letter confirming that its laws bar certain reporting under Parts 20, 45 and/or 46
- Stating that the Division of Market Oversight will consider triggers for the relief in addition to a swap counterparty's regulatory status, if it receives sufficient detail on what (in addition to the nature of the counterparty) triggers foreign privacy law bars on reporting under Parts 20, 45 and/or 46

CFTC Letter No. 16-03 permits reporting parties that had previously met the conditions of CFTC Letter No. 13-41 (or who meet those conditions in the future) to fulfill their reporting obligations under Parts 20, 45 and/or 46 while acknowledging privacy, secrecy and blocking laws in certain non-US jurisdictions.

# VI. SEC SECURITY-BASED SWAPS REGULATORY UPDATES

## A. Security-Based Swap Rulemaking Status Update

Compliance with many of the SEC's finalized security-based swaps regulations is contingent on the occurrence of the **SBS Entity Registration Compliance Date**, which will be the latest of the following:

- Six months following publication in the Federal Register of the SEC's final rules establishing capital, margin and segregation requirements for SBSDs and MSBSPs (collectively, **SBS Entities**)

- Compliance date of the SEC's final rules establishing recordkeeping and reporting requirements for SBS Entities

- Compliance date of the SEC's final business conduct rules

- Compliance date of final rules establishing a process for an SBS Entity to apply to the SEC to permit a statutorily disqualified associated person (**AP**) to effect or be involved in effecting security-based swaps on behalf of the SBS Entity

Of these, the SEC has thus far only adopted its external business conduct standards for SBS Entities (the **SEC EBC Rules**) (discussed below). The compliance date for the SEC EBC Rules will be the SBS Entity Registration Compliance Date. The remainder of the above-listed rulemakings have been proposed, but have not yet been finalized by the SEC.

## B. SEC Amendments to Security-Based Swap Data Rules

### 1. Regulation SBSR Amendments

On July 13, 2016, the SEC finalized amendments (the **Regulation SBSR Amendments**) to its previously adopted rules with respect to the regulatory reporting and public dissemination of security-based swap transaction data (**Regulation SBSR**). As adopted in February 2015, Regulation SBSR applied to security-based swaps entered into or guaranteed by SBS Entities and/or US Persons, as well as security-based swaps accepted for clearing by US clearing agencies, and contained (i) an obligation for counterparties to report security-based swap data to security-based swap data repositories (**SBSDRs**) and (ii) an obligation for SBSDRs to publicly disseminate certain information with respect to such security-based swaps. The reporting obligation for counterparties under Regulation SBSR is determined based on the identities of each "side" to the security-based swap transaction (*i.e.,* a US Person guarantor of a non-US Person's security-based swap obligations may trigger the reporting obligation for that "side").

- **Platform-Executed and Cleared Security-Based Swaps.** The Regulation SBSR Amendments scope in cleared security-based swaps and platform-executed security-based swaps that will be submitted for clearing, including by establishing the following reporting hierarchy under Regulation SBSR and finalizing certain conforming amendments:

  - For platform-executed security-based swaps that will be submitted for clearing, the Regulation SBSDR reporting obligation falls on the platform (*i.e.,* a national securities exchange or security-based swap execution facility (**SBSEF**))

  - For cleared security-based swaps, the Regulation SBSR reporting obligation falls on the registered clearing agency

- **Cross-Border Application.** The SEC's initial adoption of Regulation SBSR did not capture security-based swaps that are either (i) entered into by two non-SBS Entities that are non-US Persons or (ii) cleared through a US clearing agency. The Regulation SBSR Amendments expanded the scope of Regulation SBSR to pick up the following cross-border transactions:

  - Security-based swaps executed on a platform having its principal place of business in the U.S.

  - Security-based swaps effected by or through a registered broker-dealer (including a registered SBSEF)

  - Security-based swap transactions that are both:

    - Connected with a non-US Person's security-based swap dealing activity

    - Arranged, negotiated or executed by (i) personnel of such non-US Person located in a US branch or office or (ii) personnel of such non-US Person's agent located in a US branch or office (collectively, **US Personnel**)

    Assignment of the reporting obligation under Regulation SBSR for such security-based swap dealing transactions will be determined as follows:

    - If both sides include either a US Person or a non-US Person using US Personnel to arrange, negotiate or execute the security-based swap, then parties shall select the reporting side

    - If one side includes only non-US Persons not using US Personnel to arrange, negotiate or execute the security- based swap, and the other side includes either a US Person or a non-US Person using US Personnel to arrange, negotiate or execute the security-based swap, then the latter shall be the reporting side

  The SEC began accepting applications for substituted compliance determinations with respect to Regulation SBSR on October 11, 2016.

- **Delayed Phased-in Compliance Schedule.** The Regulation SBSR Amendments included a delayed phased-in compliance schedule for Regulation SBSR, which is contingent on (i) the registration of SBSDRs and (ii) the finalization and/or effectiveness of various other SEC security-based swap rulemakings.

  - **Compliance Date 1.** Market participants must comply with the SBSDR reporting requirement with respect to their security-based swaps beginning on the first Monday following the later of:

    - Six months after the date on which the first SBSDR that can accept transaction reports in an asset class registers with the SEC

    - One month following the SBS Entity Registration Compliance Date (which, as noted above, is itself contingent on the finalization and effectiveness of various SEC security-based swap rulemakings)

  - **Compliance Date 2.** SBSDRs must comply with Regulation SBSR's public dissemination requirements beginning on the first Monday that is three months following Compliance Date 1.

- **Compliance Date 3.** Security-based swap counterparties must report historical security-based swap data to an SBSDR in accordance with Regulation SBSR by the first Monday that is two months following Compliance Date 2.

Given the current status of the SEC's security-based swap rulemaking endeavors, market participants would not be subject to the first phase of Regulation SBSR (*i.e.,* Compliance Date 1) until at least mid-to-late 2017. We would note in particular the following with respect to Compliance Date 1 under the finalized amendments:

- Compliance Date 1 is contingent on an SBSDR registration trigger, rather than upon the commencement of operations by an SBSDR
- There may be different Compliance Dates 1 — resulting in separate phased-in compliance schedules — for different asset classes (*e.g.,* different compliance schedules for credit, as opposed to equity, products)
- The compliance schedule as finalized does not provide for any delay pending an SEC substituted compliance determination with respect to Regulation SBSR
- The compliance schedule as adopted likewise does not provide for any delay pending the adoption by the SEC of its SBSEF rules
- Market participants must comply with Regulation SBSR's UIC requirements (*e.g.,* branch ID, trading desk ID, trader ID, transaction ID, product ID) beginning on Compliance Date 1

The adopting release for the Regulation SBSR Amendments also included SEC guidance regarding the application of Regulation SBSR to prime brokerage transactions and to the allocation of cleared security-based swaps.

For further discussion, please refer to our *Client Alert* on Regulation SBSR: **Regulation SBSR: The Compliance Guide to Reporting Security-Based Swaps**.

### 2. Amended SBSDR Data Access Rules

On August 29, 2016, the SEC adopted amendments to a rule that would require SBSDRs to make security-based swap data available to certain designated regulators and other authorities in the U.S. and abroad, allowing them to share information and more effectively oversee the security-based swap market. The finalized amendments included, among others:

- Requirement of an arrangement between the SEC and the recipient of the security-based swap data to address the confidentiality of the security-based swap data provided to the recipient
- Identification of the Prudential Regulators, the Federal Reserve banks and the Office of Financial Research as eligible recipients of security-based swap data
- Listing of factors the SEC may consider in determining whether to permit other entities to access security-based swap data

### 3. Delayed Compliance for SBSDR Rules

On September 29, 2016, the SEC published an order delaying compliance with Rules 13n-1 to 13n-12, as currently amended, with respect to SBSDR registration, duties and core principles (**SBSDR Rules**) until April 1, 2017. While the SBSDR Rules adopting release originally provided for a compliance date of March 18, 2016, the SEC had twice previously extended the SBSDR Rules compliance date, most recently to October 5, 2016, to allow the SEC additional time to review and consider issues related to the SBSDR registration applications it had received thus far. The most recent extension of the SBSDR Rules compliance date to April 1, 2017 is meant to allow the SEC to review the SBSDR registration applications that it has received and to consider issues related to those applications.

## C. Finalized External Business Conduct Standards

On April 15, 2016, the SEC finalized the SEC EBC Rules, which impose business conduct requirements on SBS Entities (including heightened protections in security-based swap transactions with Special Entities) and address the cross-border application thereof.

### 1. SBS Entity Requirements

The SEC EBC Rules require that SBS Entities, among other requirements:

- Verify whether their security-based swap counterparties are ECPs and/or a "special entity" (**Special Entity**)
- Disclose to their counterparties material information about their security-based swap, including (i) material risks, (ii) characteristics, (iii) incentives and (iv) conflicts of interest
- Provide their counterparties with information regarding (i) the daily mark of their security-based swaps, as well as (ii) the ability to require that the security-based swap be cleared
- Communicate with their security-based swap counterparties in a fair and balanced manner, based on principles of good faith and fair dealing
- Establish a supervisory and compliance infrastructure
- Designate a CCO that is required to fulfill certain enumerated duties and prepare an annual compliance report

### 2. SBSD Requirements

In addition to the SBS Entity requirements described above, the SEC EBC Rules require that SBSDs:

- Determine the suitability of any recommendations made by such SBSD to its counterparties regarding security-based swaps
- Establish, maintain and enforce policies and procedures reasonably designed to obtain and retain a record of the essential facts concerning each of the SBSD's known security-based swap counterparties that are necessary to conduct business with such counterparties

### 3. Special Entity Counterparties

- **SBS Entity Requirements.** The SEC EBC Rules require that SBS Entities with Special Entity counterparties reasonably believe that such Special Entity has a qualified independent representative that either (i) is an Employee Retirement Income Security Act of 1974 (**ERISA**) fiduciary (if the Special Entity is an ERISA plan) or (ii) meets the following requirements:
  - Has sufficient knowledge to evaluate the security-based swap transaction and risks
  - Is not subject to statutory disqualification

  - Is independent of the SBS Entity

  - Undertakes a duty to act in the Special Entity's best interests

  - Makes appropriate and timely disclosures to the Special Entity of material information concerning the security-based swap

  - Evaluates, consistent with any guidelines provided by the Special Entity, the fair pricing and appropriateness of the security-based swap

  - Is subject to "pay-to-play" regulations

  The SEC EBC Rules permit SBS Entities to reasonably rely on representations to satisfy their various due diligence obligations. Further, the SEC EBC Rules generally do not apply if a counterparty's identity is not known at a reasonably sufficient time prior to execution of the security-based swap transaction so as to permit the SBS Entity to comply with its obligations under the SEC EBC Rules.

- **SBSD Requirements.** The SEC EBC Rules require that SBSDs that "act as an advisor" to a Special Entity:

  - Make a reasonable determination that any security-based swap or any trading strategy involving security-based swaps recommended by such SBSD is in the best interests of the Special Entity

  - Make reasonable efforts to obtain information that such SBSD considers necessary to make a reasonable determination that such recommendation is in such Special Entity's best interests

  The SEC EBC Rules require SBSDs to comply with rules designed to prevent "pay-to-play" in transactions with municipal entities. Note that the SEC EBC Rules provide a "safe harbor" under which the parties could agree that the SBSD is not "acting as an advisor" to the Special Entity counterparty.

### 4. Cross-Border Application

The SEC EBC Rules define the cross-border application of the transaction-level business conduct requirements to SBS Entities:

- US SBS Entities must comply with transaction-level business conduct requirements with respect to all of their security-based swap transactions, except for certain security-based swaps conducted through such US SBS Entity's foreign branch.

- Non-US SBS Entities must comply with transaction-level business conduct requirements with respect to:

  - Any security-based swap transaction with a US Person (except for a security-based swap conducted through the foreign branch of a US Person)

  - Any security-based swap that the Non-US SBS Entity arranges, negotiates or executes using US Personnel, even if the counterparty is a non-US Person

The SEC EBC Rules provide for the possibility of substituted compliance, allowing the SEC to conditionally provide that non-US SBS Entities may satisfy the SEC EBC Rules by complying with foreign requirements that the SEC has determined to be comparable.

As discussed above, while the SEC EBC Rules went into effect on June 14, 2016, the compliance date for the SEC EBC Rules will be the SBS Entity Registration Compliance Date.

## D. Security-Based Swap Trade Acknowledgement and Verification

On June 8, 2016, the SEC finalized rules establishing timely and accurate trade acknowledgement and verification requirements for SBS Entities that enter into security-based swap transactions (**SBS Trade Acknowledgement Rules**). Under the SBS Trade Acknowledgement Rules, an SBS Entity must:

- Provide a trade acknowledgement electronically to its security-based swap counterparties promptly, but in no case later than the end of the first business day following the day of execution of the relevant security-based swap
- Promptly verify or dispute with its security-based swap counterparties the terms of such trade acknowledgement
- Have written policies and procedures in place that are reasonably designed to obtain verification of the terms outlined in any trade acknowledgement provided by such SBS Entity

The SBS Trade Acknowledgement Rules exempt certain security-based swap transactions that are either (i) processed through a registered clearing agency or (ii) executed on an SBSEF or national securities exchange.

## E. Permitted Retail FX Transactions for Broker-Dealers

SEC Rule 15b12-1, which was adopted by the SEC as a time-limited rule in July 2013, permitted a registered broker-dealer (**BD**) to engage in agreements, contracts or transactions in foreign currency that are contracts of sale of a commodity for future delivery (or an option on such a contract), including foreign currency options, that are offered to or entered into with non-ECP counterparties (but excluding options executed or traded on a national securities exchange registered pursuant to Section 6(a) of the Securities Exchange Act of 1934 (**Exchange Act**)) (**Retail Forex Transactions**). Pursuant to its terms, SEC Rule 15b12-1 expired on July 31, 2016 — as such, BDs registered pursuant to Section 15(b) of the Exchange Act (including an entity that is registered as both a BD and an FCM) are now prohibited from offering or entering into Retail Forex Transactions pursuant to Section 2(c)(2)(E) of the CEA.

## F. Cross-Border Application of SBSD *De Minimis* Threshold Calculation

On February 10, 2016, the SEC finalized rules requiring non-US Persons that use US Personnel to arrange, negotiate or execute a security-based swap transaction in connection with its security-based swap dealing activity, to include such security-based swap transaction in its calculations to determine whether such non-US Person is required to register with the SEC as an SBSD (**Cross-Border SBSD Rule**). The SEC clarified in the adopting release that the Cross-Border SBSD Rule:

- Is limited to market-facing activity of a non-US Person's (or its agent's) sales or trading personnel
- Does not capture US Personnel performing internal functions (*e.g.,* trade processing or other back-office activities) or preparing underlying documentation (*e.g.,* negotiation of a master agreement or related documentation, performing ministerial or clerical tasks) in connection with a non-US Person's security-based swap dealing transactions
- Does not require a non-US Person to separately consider the location of its non-US Person counterparties (or their agents') location in making its own *de minimis* threshold calculation

Moreover, the Cross-Border SBSD Rule will require that non-US Persons count their exchange- or SBSEF-traded and cleared dealing security-based swap transactions (regardless of whether such security-based swaps are executed anonymously) if such security-based swaps were arranged, negotiated or executed on the non-US Person's behalf by US Personnel. While the Cross-Border SBSD Rule went into effect on April 19, 2016, the compliance date for the Cross-Border SBSD Rule will be the later of (i) February 21, 2017 and (ii) the SBS Entity Registration Compliance Date.

### G. Proposed Regulation of Derivatives Used by Registered Investment Companies and Business Development Companies

On December 11, 2015, the SEC proposed a new Rule 18f-4 (**Proposed Rule 18f-4**) under the Investment Company Act of 1940 (**ICA**) to limit the use of derivatives and other leveraged transactions by mutual funds, exchange-traded funds, closed-end funds and business development companies (**BDCs**) (collectively, **Funds**). Private funds that are excluded from regulation under Section 3(c)(1) or 3(c)(7) of the ICA would not be subject to the proposed rule. If adopted, Proposed Rule 18f-4 would require reporting and disclosure of certain information regarding a Fund's derivatives activities, and would only permit a Fund to enter into "derivatives transactions" if the Fund satisfies each of the following conditions:

- Complies with one of two alternative portfolio limitations designed to impose a limit on the amount of leverage the Fund may obtain through derivatives and other senior securities transactions
- Manages the risks associated with the Fund's derivatives transactions by maintaining a certain amount of assets (defined in Proposed Rule 18f-4 as **qualifying coverage assets**) designed to enable the Fund to meet its obligations under its derivatives transactions
- In certain circumstances, establishes a formalized derivatives risk management program

Proposed Rule 18f-4 would also require Funds that engage in "financial commitment transactions" — including reverse repurchase agreements, short sale borrowings or any firm or standby commitment agreement — to maintain qualifying coverage assets equal in value to the Fund's full obligations under such transactions.

For further discussion, please refer to our *Client Alert* on the SEC's proposed rules on the use of derivatives by registered investment companies and business development companies: **SEC Proposes Rules on the Use of Derivatives by Funds**.

## VII. OTHER EU DERIVATIVES REGULATORY UPDATES

### A. Review of EMIR's Implementation

Although there remains much to do with respect to implementing the currently effective version of EMIR and despite the fact that the EU Margin Rules were finalized nearly three months after the BCBS-IOSCO September 1, 2016 deadline, the EC nonetheless launched a public consultation in May 2015 on the implementation of EMIR thus far (the **EMIR Consultation**). In so doing, the EC is fulfilling its mandate (which is hardwired in the text of EMIR) to review the impact of the regulation three years after its adoption. One of the noteworthy items included in the review is the mandate to assess — in coordination with ESMA — the systemic importance of non-financial firms' OTC derivatives and the impact of EMIR on such non-financial firms' use of OTC derivatives.

Stakeholders responded to the EMIR Consultation, with ESMA notably contributing a report to the assessment, which included two controversial recommendations:

- Removal of the hedging exemption from the test for determining whether an NFC was above the clearing thresholds (and therefore subject to more burdensome EMIR clearing and margining obligations), which would mean that a corporate group would have to calculate the volume of all its derivatives — whether hedging and non-hedging — and comparing such volume against a higher threshold

- Reclassification of quasi-financials (*i.e.,* alternative investment funds (**AIFs**) that are not managed by alternative investment fund managers (**AIFMs**) authorized or registered in accordance with the Alternative Investment Fund Managers Directive (**AIFMD**) and certain securitization vehicles) — which are currently categorized as NFC below the clearing thresholds (**NFC-**) — as either FC or NFC+, which would subject such quasi-financials to the burdensome EMIR clearing and margining obligations, with associated impacts on their liquidity

While the EC was initially expected to issue a final report on the EMIR Consultation at the beginning of 2016, the timing of such publication is unclear, though currently expected to be published at the end of 2016 or the beginning of 2017. The EC's report is expected to recommend amendments to EMIR, although the scope of such amendments likewise remains unclear. What is certain, however, is that any change to key items — such as the scope of the EMIR counterparty categories and the addition of hedging transactions to threshold calculations — would be subject to lobbying by interested stakeholders, followed by intense debate in the European Parliament and European Council.

## B. Clearing and Trade Execution Under EMIR

### 1. EMIR Clearing Obligation

An important development during 2016 was ESMA's public consultation, which was published in July 2016, seeking stakeholders' views on a proposal to extend the phase-in period of the clearing obligation by two years for the following market participants (collectively, **Category 3 Entities**):

- FC with limited volume of activity (*i.e.,* firms that have less than €8 billion outstanding in OTC derivatives contracts)
- AIFs which are NFC

If finalized, the original clearing compliance date for these Category 3 Entities (which was originally set for June 21, 2017) would be postponed until June 21, 2019.

In June 2016, ESMA imposed mandatory clearing requirements on clearing members of certain clearinghouses with respect to certain products (**Category 1 Entities**); ESMA plans on rolling out the mandatory clearing requirements to other counterparty categories in phases, starting on December 21, 2016 for FC and NFC+ AIFs which (i) are not Category 1 Entities and (ii) hold an aggregate gross notional amount of non-centrally cleared OTC derivatives contracts above a given threshold by reference to a prescribed time period (**Category 2 Entities**).

ISDA recently estimated that these entities would face annual fees of between €100,000 and €280,000 to clear their positions following the introduction of Basel III leverage requirements; this proposed delayed compliance for Category 3 Entities would thus reduce the cost of EMIR compliance for smaller financial and non-financial end-users. However, it remains to be seen whether Category 3 Entities would actually take advantage of this delayed compliance schedule in practice, as counterparties are being offered better pricing if they clear and certain FCs have refused new lines of credit without a commitment to clear certain products.

In its response to the ESMA consultation, the European Association of Corporate Treasurers argued that such extension of the phase-in period should also include all NFC+ (**Category 4 Entities**), which is the final counterparty category subject to the clearing mandate, beginning on December 21, 2018.

On November 14, 2016, ESMA published its final report on the clearing obligation for FCs with limited trading volume. Although many stakeholders emphasized that delaying the clearing obligation by two years for Category 3 Entities would mean that the deadline for these entities would fall after the deadline for Category 4 Entities, pointing out that Category 4 Entities comprise NFC+ having less experience and operational capacity with OTC derivatives and central clearing, ESMA disagreed and took the view that the level of sophistication of NFC+ entities is actually higher than that of many small FCs. ESMA therefore considered it appropriate that Category 4 Entities would be required to start clearing a few months prior the Category 3 Entities. The final ESMA report states that the original compliance date of June 21, 2017 for Category 3 Entities will be postponed until June 21, 2019, whereas the December 21, 2018 compliance date for Category 4 Entities remains the same.

### 2. MiFID Derivatives Trading Obligation

MiFIR outlines the process for determining which derivatives should be traded on organized "trading venues" and includes certain non-intra-group derivatives contracts which are (i) cleared through a CCP and (ii) deemed sufficiently liquid.

The trading obligation under MiFIR is closely linked to the clearing obligation under EMIR. Once a class of derivatives needs to be centrally cleared under EMIR, ESMA must determine whether these derivatives (or a subset of them) should be traded **on-venue** (*i.e.,* on a regulated market (**RM**), multilateral trading facility (**MTF**), organized trading facility (**OTF**) or an equivalent third-country trading venue). MiFIR contemplates utilizing two tests to determine whether the trading obligation applies:

- The **venue test** (*i.e.,* a class of derivatives must be admitted to trading or traded on at least one admissible trading venue)
- The **liquidity test** (*i.e.,* whether a derivative is "sufficiently liquid" and whether there is sufficient third-party buying and selling interest)

In September 2016, ESMA published a discussion paper regarding the trading obligation, seeking stakeholders' feedback on various options put forth by ESMA on how to calibrate the obligation. The discussion paper included options on how to determine the trading obligation by applying both tests, including an initial liquidity assessment on the basis of trading data covering the period between July 1, 2015 and December 31, 2015. The consultation was open for stakeholder comment until November 21, 2016. ESMA will use the feedback received to continue working on implementing MiFIR's trading obligation and, if deemed appropriate, draft regulatory technical standards specifying which derivatives should be subject to the trading obligation.

## C. Securities Financing Transactions Regulation

Effective January 12, 2016, the purpose of SFTR is to enhance transparency in the securities financing transaction (**SFT**) market (*i.e.,* repurchase transactions, securities or commodities lending and securities or commodities borrowing, buy-sell back transactions or sell-buy back transactions and margin lending transactions) and in the reuse of financial instruments provided by counterparties as collateral and, as such: (i) requires all SFTs to be reported to trade repositories; (ii) places additional disclosure requirements on investment managers; and (iii) introduces prior risk disclosures and written consent requirements before assets are reused. **Reuse** means the use by a receiving counterparty — in its own name and on its own account, or on the account of another counterparty — of financial instruments received under a title transfer or security collateral arrangement. SFTR applies to:

- SFT counterparties or counterparties engaging in reuse, that are either:
  - Established in the EU

- Established in third countries, if (i) the SFT is concluded or the reuse is effected in the course of the operations of an EU branch of such counterparty or (ii) the reuse concerns financial instruments provided under a security or title transfer collateral arrangement by an EU counterparty or EU branch

- AIFMs and management companies of undertakings for collective investments in transferable securities (**UCITS**)

### 1. SFT Reporting and Safeguarding

SFT counterparties must report the details of any concluded, modified or terminated SFT to a trade repository, no later than one business day following such conclusion, modification or termination of the transaction. Where a trade repository is not available, these details must be reported to ESMA. Counterparties must keep a record of any concluded, modified or terminated SFT, for at least five years following the termination of the transaction (*i.e.,* mirroring the EMIR/MiFIR derivatives recordkeeping requirements). These recordkeeping requirements have applied to SFT counterparties since January 12, 2015 and, as such, counterparties must ensure that they have appropriate procedures in place to comply with their SFTR obligations.

Reportable data includes the SFT counterparty identities, principal amount, currency, type, quality and value of collateral, details relating to reuse of collateral, repurchase rate, lending fee, haircut, value date and maturity date.

Both SFT counterparties have an obligation to report the details of an SFT, except that an FC shall be responsible for reporting on behalf of both SFT counterparties if such FC concludes an SFT with an NFC which does not exceed at least two of the following thresholds on its balance sheet:

- Balance Sheet Total: €20,000,000

- Net Turnover: 40,000,000

- Average Number of Employees during the Financial Year: 250.

Where a UCITS or an AIF is a counterparty to the SFT, the UCITS management company or the AIFM, as applicable, shall be responsible for reporting on behalf of such UCITS or AIF counterparty. SFT counterparties may also delegate reporting obligations under SFTR.

The details required to be reported are to be documented in regulatory technical standards which ESMA and the European System of Central Banks (**ESCB**) are drafting, and which draft is expected to be submitted i to the EC in the first quarter of 2017.

Following their entry into force, the SFTR reporting requirements will impose obligations on SFT counterparties as follows:

| Market Participant | Compliance Date |
|---|---|
| Investment Firms and Credit Institutions | Entry into force + 12 months |
| CCPs and Central Securities Depositories | Entry into force + 15 months |
| UCITS, AIFs, Insurers and Pension Funds | Entry into force + 18 months |
| NFCs | Entry into force + 21 months |

**2. Transparency Requirements**

UCITS management companies, UCITS investment companies and AIFMs must disclose their use of SFTs and total return swaps (**TRS**), as follows:

- For UCITS management companies and investment companies, in their semi-annual and annual reports
- For AIFMs, in their annual reports

The information to be disclosed includes (i) the amount of securities and commodities on loan, as a proportion of the total lendable assets, and (ii) the amount of assets engaged in each type of SFTs and TRS, expressed as an absolute amount and as a proportion of the collective investment undertaking's assets under management.

The UCITS prospectus and the AIF investor disclosure must (i) specify the types of SFT/TRS which UCITS management and investment companies and AIFMs, respectively, are authorized to use and (ii) include a clear statement that those transactions and instruments are used by the UCITS or AIF, as applicable.

These requirements come into force on July 13, 2017 for UCITS/AIFs that were already constituted as of January 12, 2016; however, UCITS and AIFs authorized on or after January 12, 2016 cannot benefit from the transitional period and must therefore begin compliance with these requirements on January 13, 2017.

**3. Restrictions on Reuse**

The following restrictions on reuse went into force on July 13, 2016:

- A counterparty may only reuse financial instruments received as collateral if it both:
  - Discloses to the providing counterparty the risks and consequences that may be involved in either (i) granting a right of use of collateral provided under a security collateral arrangement or (ii) concluding a title transfer collateral arrangement
  - Obtains prior express consent from the providing counterparty that includes a right of reuse or the express consent to provide collateral under a title transfer collateral arrangement
- (i) Any exercise by SFT counterparties of their right to reuse must be undertaken in accordance with the terms specified in the collateral arrangements and (ii) the financial instruments received must be transferred from the account of the providing counterparty

**4. Non-Compliance**

EU member states must empower competent regulatory authorities to apply sanctions to members of the management body and any other individuals responsible for any infringements of the above requirements, which include (i) a cease-and-desist order, (ii) a public statement of censure, withdrawal or suspension of authorization, (iii) a temporary ban against any person discharging managerial responsibilities and (iv) a fine of up to three times the amount of the profits gained or losses avoided because of the infringement.

**5. ESMA Consultation**

On September 30, 2016, ESMA published a public consultation paper relating to the draft regulatory standards and draft implementing standards implementing SFTR. The draft technical standards aim to address (i) the procedure and criteria for registration as a trade repository, (ii) the reporting logic and structural aspects and content of reports, (iii) requirements relating to transparency of data, data collection, aggregation and comparison and (iv) access levels for different competent authorities. In order to ensure a level playing field for market participants, ESMA's consultation paper also proposed amendments to technical standards implementing requirements relating to trade repositories under EMIR.

The public consultation closed on November 30, 2016 and it is expected that the final draft technical standards will be submitted to the EC for endorsement by the end of the first or second quarter of 2017. We would expect final implementing measures to go into effect in 2018.

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**Latham & Watkins Derivatives Practice**

*Latham & Watkins lawyers advise clients with respect to the full range of over-the-counter (OTC) and exchange-traded derivative products. Latham's derivatives practitioners have experience with swap, option and structured note transactions involving established products, such as interest rates, currencies, commodities, securities and credit. In addition, the firm provides counsel with respect to emerging products and structures, such as those relating to weather, longevity and property derivatives. Latham's lawyers have extensive experience with the full life cycle of relevant products, from new product development and assessment, to transaction execution and documentation, and ongoing legal risk management, including defaults, regulatory-inquiry response, and customer complaints and litigation.*

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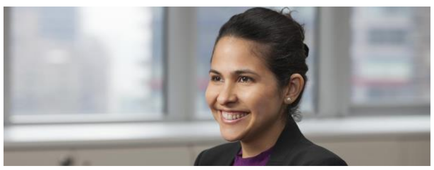

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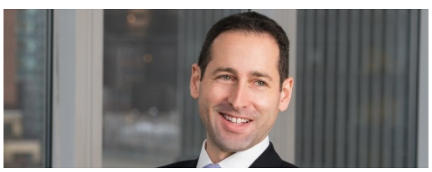

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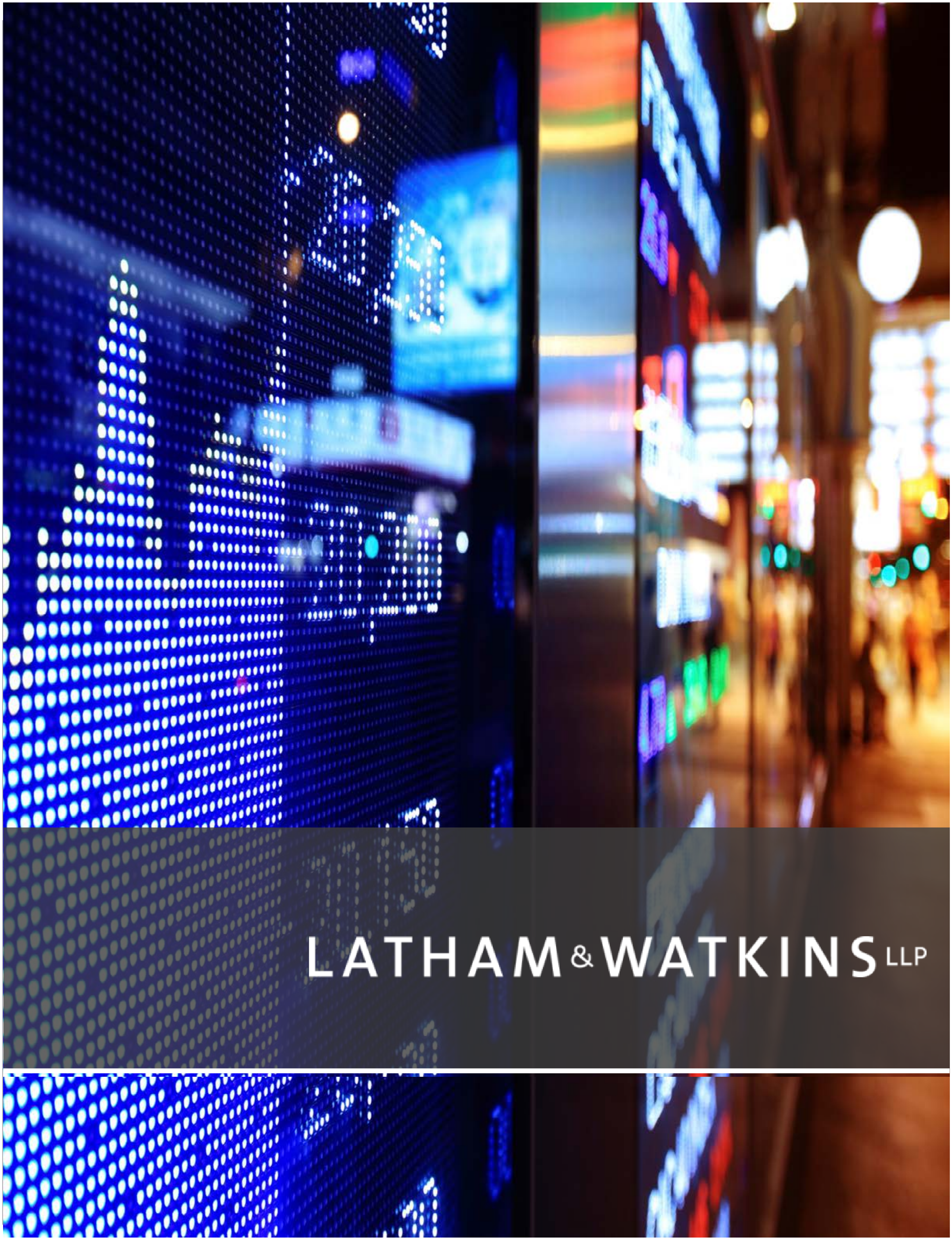
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