

# Key Questions Raised by the CFTC's Plans for Non-US CCPs

July 2, 2014

A version of this article was first published in *Risk Magazine* on June 24, 2014.

As swaps clearing rules take effect around the world, recognition of foreign clearinghouses by domestic regulators is becoming increasingly important—and so are the international standards for clearinghouses, the Principles for financial market infrastructures (the “**PFMIs**”) developed by CPSS-IOSCO.

The PFMIs are set to play a significant role in a forthcoming CFTC proposal that would allow foreign clearinghouses to clear swaps for U.S. market participants without having to register as a derivatives clearing organization (“**DCO**”) with the Commodity Futures Trading Commission (the “**CFTC**”). But while the PFMIs are fairly well-understood by the market, their potential application in the context of the proposed exempt DCO regime raises some important questions—about how prescriptive the CFTC’s approach will be, and how much flexibility the agency will give to clearinghouses established in jurisdictions that are not fully compliant with the principles.

While some insight can be found in the role played by the PFMIs in current CFTC regulation, there are still several unknowns associated with the planned exempt DCO rule. Foreign regulators already appear to have expressed concern about a separate condition that would prevent an exempt clearinghouse from offering its swaps clearing services to U.S. customers. In addition, with the CFTC’s new Chairman and two new Commissioners recently sworn in, the agency’s approach and priorities could change. As a result, significant uncertainty surrounds a rulemaking that has significant global implications.

## **The CFTC’s Exemptive Authority**

Any clearinghouse that clears swaps directly for U.S. clearing members or indirectly for the U.S. customers of U.S. and non-U.S. clearing members must register with the CFTC as a DCO or obtain an exemption. This DCO registration requirement applies regardless of whether a particular cleared swap is subject to a mandatory clearing requirement. The CFTC has statutory authority to exempt swaps clearinghouses from DCO registration if the CFTC determines that the clearinghouse is subject to “comparable, comprehensive supervision and regulation” by either the regulatory authorities in the clearinghouse’s home country or the Securities and Exchange Commission. The CFTC has not yet exempted any swaps clearinghouses from registration or proposed a way for a clearinghouse to apply for an exemption.

That is expected to change shortly. At a public meeting on May 21, Phyllis Dietz, the Deputy Director of the CFTC’s Division of Clearing and Risk, said that the current draft of the proposed DCO rulemaking provides that in order for a clearinghouse to be eligible for an exemption, it must, among other things, observe the PFMIs and be organized and in good standing in a jurisdiction where the regulator applies legal requirements consistent with the PFMIs. In addition, a clearinghouse would need to submit to the CFTC a PFMI disclosure framework and an annual certification confirming it complies with the PFMIs. Other eligibility requirements and conditions would also apply. Before this proposal can be issued for public comment, it will need to be approved by the agency’s Commissioners.

## **Prior Use of the PFMIs in the CFTC’s Clearinghouse Regulatory Program**

If the CFTC ultimately proposes an exemptive rule that is consistent with the recommendations of the CFTC staff (the “**Staff**”), it would not be the first time the CFTC or the Staff have used the PFMIs as a

central feature of a regulatory program—there may be some clues here as to how the agency will apply the PFMIs as part of the exempt DCO regime.

### **Clearinghouse No-Action Letters**

The Staff recently issued a number of limited, conditional no-action letters that temporarily relieve certain non-U.S. clearinghouses from the DCO registration requirements. These no-action letters have enabled the clearinghouses to clear swaps for certain U.S. market participants in the absence of DCO registration. While several of the no-action letters were issued to clearinghouses that applied for DCO registration and thus allowed the clearinghouse to clear during the Staff's review of its application, more recently the Staff also provided no-action relief to clearinghouses that have not applied for DCO registration, but expressed an interest in applying for an exemption. To ensure there was a reasonable likelihood that these clearinghouses would meet the requirements of the anticipated proposed rulemaking, these clearinghouses addressed how they are subject to extensive home country regulation and supervision, including standards consistent with the PFMIs.

In February this year, the Staff provided no-action relief to ASX Clear (Futures) Pty Limited ("ASX"). The relief was largely premised on an affirmation from Australian regulators that ASX is subject to domestic rules that are consistent with the PFMIs. The satisfaction of the PFMIs also played a prominent role in the Staff's May 2014 issuance of relief to OTC Clearing Hong Kong Limited ("OTC Clear") and its U.S. clearing members and the Staff's June 2014 issuance of relief to Korea Exchange, Inc. ("KRX"). For example, the no-action letter issued to OTC Clear noted, among other things, that to gain recognition by Hong Kong's Securities and Futures Commission, OTC Clear was required to demonstrate its ability to observe the PFMIs to the satisfaction of the Securities and Futures Commission of Hong Kong. The Staff was careful to make clear its issuance of relief to ASX, OTC Clear and KRX should not be interpreted to mean that the CFTC will necessarily exempt either clearinghouse from registration.

### **Subpart C of the CFTC's Part 39 Requirements**

At the end of 2013, the CFTC sought to close a number of gaps between its existing DCO requirements and the PFMIs. One reason for this is the Basel Committee on Banking Supervision's bank capital regime, which creates financial incentives for banks to clear their financial derivatives through so-called qualifying central counterparties ("QCCPs")—generally defined as clearinghouses that are subject to rules consistent with the PFMIs. Since these incentives could cause banks to migrate their business to QCCPs, a DCO's inability to gain QCCP status would put it at a huge competitive disadvantage.

The result—Subpart C of the agency's Part 39 requirements—is significant because it required the CFTC to take a forensic approach to assessing the degree to which the statutorily-imposed DCO Core Principles and CFTC regulations are consistent with the PFMIs and to write new rules where it identified gaps. The exempt DCO framework, as currently outlined, will now require the CFTC to make similar judgments about other jurisdictions.

### **Other Rulemakings**

The CFTC's inter-affiliate clearing exemption provides a rule-based exemption from the mandatory clearing requirements for certain swaps between qualifying affiliates (each such affiliate, an "**Eligible Affiliate Counterparty**"). The exemption is subject to several conditions, including one relating to an Eligible Affiliate Counterparty's "designated swaps" (i.e., swaps required to be cleared) with unaffiliated counterparties (each such swap, an "**Outward Facing Designated Swap**"). To meet this particular condition, an Eligible Affiliate Counterparty must either satisfy an exception or exemption from clearing for each of its Outward Facing Designated Swaps or clear each of its Outward Facing Designated Swaps at: (1) a CFTC-registered DCO or (2) a clearinghouse that is subject to supervision by appropriate government authorities in the clearinghouse's home country and has been assessed to be in compliance with the PFMIs.

The CFTC's foreign boards of trade ("FBOT") registration rules establish a registration regime and procedures for FBOTs that wish to provide their identified members or other participants based in the U.S. with direct access to their electronic trading and order matching systems. Under the rule, in order to be registered with the CFTC, an FBOT must, among other things, clear through either: (1) a CFTC-registered DCO or (2) a clearinghouse that observes the PFMI, is subject to comprehensive supervision and regulation comparable to that provided by the CFTC to DCOs and is in good regulatory standing in its home country.

## Open Questions

For foreign clearinghouses and regulators, some interesting questions are raised by the potential use of the PFMI as the foundation for the exempt DCO rulemaking.

- **Evaluating Satisfaction of the PFMI.** *How prescriptive will the CFTC be in evaluating satisfaction of the PFMI?*

The PFMI generally do not prescribe particular tools or arrangements and instead permit different means to achieve most of the standards. The PFMI state that assessment of an entity's conformance should generally focus on a set of key considerations laid out in the report for each individual principle. As such, the PFMI recognize that different jurisdictions, by necessity, will implement the PFMI using different approaches, taking into account their unique legal and regulatory frameworks.

It remains to be seen whether, in the context of evaluating an application for an exemption, the CFTC would second-guess other jurisdictions' approaches to implementing the PFMI or a clearinghouse's stated observance of the PFMI.

- **Flexibility for Jurisdictions Still Implementing the PFMI.** *Will the CFTC offer any flexibility to clearinghouses organized in jurisdictions that have not yet fully implemented the PFMI?*

Certain jurisdictions need additional time to finalize legislation and regulatory changes before they have fully implemented all of the principles and responsibilities in the PFMI report—including the principles that apply to financial market infrastructures and the responsibilities for regulators. It is possible that a clearinghouse based in such a jurisdiction could develop, apply and enforce its own rules, requirements and policies and procedures that would fill in the majority of the gaps between the PFMI and the jurisdictional-level requirements in its home country.

While this approach may not technically fulfill the responsibilities placed on regulators in the PFMI report, the clearinghouse could, nonetheless, potentially be regarded as *functionally* satisfying the PFMI, particularly during the period before its jurisdiction has completed all necessary legislative and regulatory changes. That said, the Staff has thus far expressed the view that unless the legislation and regulation mandate the PFMI requirements, the CFTC will not regard the jurisdiction as satisfying the PFMI.

- **Other Conditions.** *Would other conditions that the CFTC may attach to an exemption be problematic?*

The Staff has said it intends to recommend that exempt DCOs be prohibited from clearing for U.S. customers. Certain aspects of the CFTC's Part 22 requirements regarding the protection of client collateral have proven challenging for non-U.S. clearinghouses to satisfy, so a potential prohibition of this type would not be surprising.

That said, this aspect of the exemptive rulemaking may be controversial among other regulators—some regulators in Europe have apparently already expressed opposition, and it is unknown whether the European Commission (the "EC") would regard the Staff's contemplated approach as an "effective equivalent system" for the recognition of non-U.S. clearinghouses. This

is a key determination that needs to be made for the EC to adopt a positive equivalence decision for a U.S. clearinghouse seeking recognition under the European Market Infrastructure Regulation.

- **New Chairman and Commissioners.** *What role will the confirmations of Timothy Massad, Christopher Giancarlo and Sharon Bowen have on the potential rulemaking?*

The confirmations in June of Timothy Massad, Christopher Giancarlo and Sharon Bowen as the new CFTC Chairman and Commissioners, respectively, create additional uncertainty concerning the substance and timing of the rulemaking. It is unknown what their respective views are concerning a DCO exemptive regime, and whether they have other regulatory priorities they may seek to advance ahead of this potential rulemaking.

## Conclusion

The PFMIs provide regulators with a benchmark for the cross-border recognition of clearinghouses, but if it becomes the basis for the proposed exempt DCO rulemaking, much will depend on how the CFTC interprets the principles and assesses their satisfaction. Up until now, the agency has been willing to rely on the representations of foreign clearinghouses and their regulators, but this was purely for the purpose of issuing no-action letters; the process will undoubtedly become more complex when an exemption is at stake.

---

If you have any questions regarding the matters covered in this publication, please contact either of the lawyers listed below or your regular Davis Polk contact.

<b>Annette L. Nazareth</b>	<b>202 962 7075</b>	<a href="mailto:annette.nazareth@davispolk.com">annette.nazareth@davispolk.com</a>
<b>Jeffrey T. Dinwoodie</b>	<b>202 962 7132</b>	<a href="mailto:jeffrey.dinwoodie@davispolk.com">jeffrey.dinwoodie@davispolk.com</a>

---

© 2014 Davis Polk & Wardwell LLP | 450 Lexington Avenue | New York, NY 10017

Notice: This publication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. If you have received this email in error, please notify the sender immediately and destroy the original message, any attachments thereto and all copies. Refer to the firm's [privacy policy](#) located at [davispolk.com](http://davispolk.com) for important information on this policy. Please consider adding Davis Polk to your Safe Senders list or adding [dpwmail@davispolk.com](mailto:dpwmail@davispolk.com) to your address book.

Unsubscribe: If you would rather not receive these publications, please respond to this email and indicate that you would like to be removed from our distribution list.