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DERIVATIVES
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Introduction

This segment of the class materials looks at some aspects of the recent evolution of the regulation of derivatives (swaps), starting with the financial crisis and looking at the development of transnational standards with respect to swaps and implementation of the transnational standards. This material illustrates the multi-level nature of financial regulation, and the consciousness of legislators and regulators that the swaps markets are transnational. In particular the material addresses the issue of defining who are the US persons to whom the US rules apply. We have thought of this issue before in the context of the Libyan Arab Foreign Bank case, and in the context of F-cubed securities claims.

In addition the developing regulation of swaps illustrates some of the other themes we have noticed this semester. For example, the material set out below relating to the CFTC's and SEC's efforts to develop definitions under Dodd-Frank to establish the regulatory perimeter is a good illustration of complexity both of the activity involved and of the regulations. The developing rules are designed to increase transparency.

Standardization is part of the move from thinking of swap transactions as individual bilateral contracts to instruments that can be traded on an organized market which can be regulated. In the past swaps were thought of as bilateral agreements partly to avoid the impact of regulation. In 1999 ISDA argued that the CFTC should not regulate swaps:

> Privately negotiated swap transactions have become an essential part of risk management for the American economy. Every day, companies, banks and governmental entities face unique financial risks—interest rates, currencies, commodity prices and securities prices. Users of swaps can manage these risks with swaps, which can be custom tailored to meet specific needs, but these users must have the legal certainty that the underlying contracts are enforceable in order to manage risk effectively.

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Each attempt by the CFTC over the years to assert jurisdiction over swaps has created legal uncertainty. Congress should clarify once and for all that swaps are not subject to regulation under the Commodity Exchange Act (the "CEA"). Legal certainty has been aided by previous actions of Congress and the CFTC that recognized the unique nature of swap transactions, but the threat of legal uncertainty remains, as last year's issuance of the CFTC concept release showed. If clarification is not provided by Congress, the continuing threat of uncertainty will make it harder for firms to innovate, increase legal risk by undermining the enforceability of contracts, and potentially place these important hedging transactions out of the reach of many users.

Any legal uncertainty created by CFTC action is an outgrowth of the fact that the CEA is designed to regulate exchange-traded instruments only. The CEA is an inappropriate means for regulating privately negotiated swap transactions because they are fundamentally different from the standardized contracts traded on an exchange. In fact, applying the exchange-trading requirement of the CEA to swaps would render unenforceable thousands of outstanding swap contracts, representing billions of dollars of value to the American economy. The Treasury amendment recognized that financial contracts that are not traded on an exchange are not appropriately regulated as futures under the CEA. Off-exchange financial transactions common at the time the amendment was enacted (government securities and foreign exchange transaction) were excluded from regulation under the CEA. Although swaps were developed later, they are also off exchange financial transactions and should be excluded from regulation under the CEA.

ISDA believes that the best path forward is clear: provide the legal certainty needed for privately negotiated swap transactions and free the regulated exchanges to be more competitive. A clear declaration from Congress that swaps are not subject to regulation under the CEA achieves the first goal; a firm instruction from Congress to the CFTC to lighten the regulatory burden on the exchanges accomplishes the second goal. The result will be a combination of CFTC-regulated exchange activity that can more effectively compete in today's global marketplace and privately negotiated activity that can thrive without recurring episodes of legal uncertainty.

Any policy that increases the cost of swaps or reduces the flexibility and innovation that have been their hallmarks will hurt banks, brokers, corporations and governmental entities that use them to manage risk. Public policy should ensure the availability of a wide range of reliable and affordable risk management tools, both privately negotiated and exchange-traded, for the many users who can benefit from them. The competitiveness of American business, the success of the U.S. economy and the safety and soundness of the financial system will be enhanced if Congress acts to ensure the reliability and affordability of these tools.[2]

Congress subsequently enacted the Commodity Futures Modernization Act of 2000 which excluded many swaps from being considered securities. The CFMA mandated the Federal Reserve Board, the Treasury, the SEC and the CFTC to carry out a study on the subject of whether retail swaps should be regulated. The Report was published in December 2001 and did not recommend regulation of retail swaps:

[2] Statement of the International Swaps and Derivatives Association for the House and Senate Agriculture Committees' Futures, Derivatives, and Public Policy Roundtable Program February 25 and 26, 1999, available at http://www.isda.org/press/pdf/agsum222.pdf.

A primary purpose of the CFMA was to create a clear legal foundation and regulatory framework for many types of over-the-counter ("OTC") derivatives transactions entered on a principal to principal basis between "eligible contract participants" ... Parties that do not qualify as ECPs include individuals who do not have total assets in excess of $10 million (or $5 million if they enter swap agreements for risk management) and non-financial entities that do not have total assets in excess of $10 million (or net worth in excess of $1 million if they enter swap agreements in the ordinary conduct of business or for risk management). For purposes of this study, non-ECPs are "retail customers," and swaps offered to them are "retail swaps."

Since its enactment, the CFMA has excluded OTC swap agreements and other specified derivatives transactions between domestic and foreign financial institutions, broker/dealers, insurance companies, commodities firms, and other ECPs from most of the CEA. The CFMA's limitation of this exclusion to ECPs was consistent with the recommendation of the President's Working Group on Financial Markets that OTC swap agreements between institutional counterparties generally should not be subject to the CEA...

Several interviewees noted that there was very little demand for interest-rate swap agreements at present except among institutions and high net worth individuals that already qualify as ECPs. For example, one firm remarked that, to the best of its representatives' recollections, it had never entered into fixed income swaps with an entity that owned or had under management less than $100 million in assets.

Some interviewees said that non-ECPs could potentially use interest-rate swap agreements to obtain the benefit of more favorable interest rates on household or small business expenses, such as mortgage or consumer debt, separately from the underlying loan. These interviewees added, however, that at the present time, it is convenient for non-ECPs to refinance a mortgage or transfer consumer debt, and the ability to enter into an "unbundled" swap agreement would not appear to offer retail customers a cost-effective or convenient alternative...

In summary, all but two of the interviewees reported that there does not appear to be significant demand for retail swaps at present, with one firm specifically stating that there was retail interest in swap agreements with respect to energy products. The interviewees generally noted that retail customers currently have access to a wide range of derivative instruments and other alternatives to swap agreements to meet their financial needs, for example, for purposes of hedging or gaining exposure to particular securities or interest rates. To the extent that non-ECPs might seek to use swap agreements to protect against adverse price movements with respect to household or business expenses (e.g., interest rates, energy prices), several interviewees suggested that in most circumstances it would be cheaper and more convenient for non-ECPs to purchase such protection together with the underlying loan or commodity, rather than in a separate transaction..[3]

The question whether swaps should be regarded as securities was raised in the context of claims by parties who found themselves on the losing side of swap transactions that they should be entitled to avoid the contracts or obtain a remedy. In these cases the party on the losing side might also raise arguments about fiduciary duties, negligent misrepresentations and frauds. An

[3] Joint Report on Retail Swaps (Dec. 2001) *available at* http://www.treasury.gov/resource-center/fin-mkts/Documents/rss-final.pdf

example of such a case is **Procter & Gamble Co. v. Bankers Trust**.[4]

Here is an excerpt from the decision (the court held that the swaps were not securities):

This case involves two interest rate swap agreements. A swap is an agreement between two parties ("counterparties") to exchange cash flows over a period of time. Generally, the purpose of an interest rate swap is to protect a party from interest rate fluctuations. The simplest form of swap, a "plain vanilla" interest-rate swap, involves one counterparty paying a fixed rate of interest, while the other counterparty assumes a floating interest rate based on the amount of the principal of the underlying debt. This is called the "notional" amount of the swap, and this amount does not change hands; only the interest payments are exchanged.

In more complex interest rate swaps, such as those involved in this case, the floating rate may derive its value from any number of different securities, rates or indexes. In each instance, however, the counterparty with the floating rate obligation enters into a transaction whose precise value is unknown and is based upon activities in the market over which the counterparty has no control. How the swap plays out depends on how market factors change...

Those swaps transactions are governed by written documents executed by BT and P&G. BT and P&G entered into an Interest Rate and Currency Exchange Agreement on January 20, 1993. This standardized form, drafted by the International Swap Dealers Association, Inc. ("ISDA"), together with a customized Schedule and written Confirmations for each swap, create the rights and duties of parties to derivative transactions. By their terms, the ISDA Master Agreement, the Schedule, and all Confirmations form a single agreement between the parties...

P&G unwound both ..swaps before their spread set dates, as interest rates in both the United States and Germany took a significant turn upward, thus putting P&G in a negative position vis-a-vis its counterparty BT. BT now claims that it is owed over $ 200 million on the two swaps, while P&G claims the swaps were fraudulently induced and fraudulently executed, and seeks a declaratory verdict that it owes nothing...

.P&G and BT were in a business relationship. They were counterparties. Even though, as I point out hereafter, BT had superior knowledge in the swaps transactions, that does not convert their business relationship into one in which fiduciary duties are imposed...

This does not mean, however, that there are no duties and obligations in their swaps transactions. Plaintiff alleges that in the negotiation of the two swaps and in their execution, defendants failed to disclose vital information and made material misrepresentations to it. For these reasons plaintiff has refused to make any payments required by the swaps transactions to defendants. Plaintiff requests that a jury verdict should declare that it owes nothing to defendants....

I turn to the statute law of New York. The Uniform Commercial Code, as part of New York statute law, particularly Section 1-203, states: "Every contract or duty written in this Act imposes an obligation of good faith in its performance or enforcement." New York has also adopted the principles in the Restatement (Second) Contracts, § 205, that every contract imposes upon each party a duty of good faith and fair dealing in its performance and enforcement....

New York case law establishes an implied contractual duty to disclose in business negotiations. Such a

[4] 925 F. Supp. 1270 (SD Ohio 1996).

duty may arise where 1) a party has superior knowledge of certain information; 2) that information is not readily available to the other party; and 3) the first party knows that the second party is acting on the basis of mistaken knowledge...
Thus, I conclude that defendants had a duty to disclose material information to plaintiff both before the parties entered into the swap transactions and in their performance, and also a duty to deal fairly and in good faith during the performance of the swap transactions....

In the UK, regulators entered into agreements with major banks with respect to the mis-selling of interest-rate hedging products to customers, including small and medium businesses which did not understand the implications of the transactions they were entering into.[5] In Italy banks have been convicted of fraud with respect of sales of swaps to Milan.[6]

The Derivatives Market and the Financial Crisis

Earlier this semester we discussed the 2008 bailout of AIG, which resulted from AIG's involvement in the credit default swaps (CDS) market.[7] CDS transactions are just one part of the derivatives market[8] in which participants enter into speculative and hedging transactions. Before the financial crisis many swaps were essentially unregulated as they were seen as bilateral negotiated contracts dissimilar to the sort of standardized contracts which were subject to trading. Banks needed to have regulatory capital with respect to their involvement in swaps transactions, but the swaps market was not regulated. In the lead up to the financial crisis financial regulators did focus on the risks associated with credit derivatives. In 2005 the Joint Forum[9] published a report on credit risk transfer,[10] and this was followed by a 2008 report which studied

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5 FSA, Interest Rate Hedging Products: Information about our Work and Findings at http://www.fca.org.uk/static/fca/documents/fsa-interest-rate-hedging-products.pdf. See also e.g. http://bully-banks.co.uk/ .

6 Giovanni Legorano, Four Banks Convicted in Italy Swaps Case (Dec. 19, 2012) at http://online.wsj.com/article/SB10001424127887324731304578189661422420232.html.

7 International Finance 3: Cross Border Financial Regulation, at pp. 4-7.

8 Derivatives are instruments whose value derives from the value of an underlying asset (for example a loan or a commodity such as coffee), index (for example interest rates or exchange rates) or phenomenon (such as weather conditions). Futures, options and swaps are derivatives.

9 *See* http://www.bis.org/bcbs/jointforum.htm ("The Joint Forum was established in 1996 under the aegis of the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS) to deal with issues common to the banking, securities and insurance sectors, including the regulation of financial conglomerates. The Joint Forum is comprised of an equal number of senior bank, insurance and securities supervisors representing each supervisory constituency.")

10 The Joint Forum, Credit Risk Transfer, (March 2005) *available at* http://www.bis.org/publ/joint13.pdf.

developments in the credit risk transfer market between 2005 and 2007.[11] Although a significant part of the impetus for the 2005 report was the development of the CDS market, the 2008 report highlights securitization, especially with respect to asset-backed securities and leveraged loans.

With respect to CDS the **2008 Joint Forum Report on Credit Risk Transfer** stated:

At the time of the 2005 report, there was widespread concern about market infrastructure for CDS trading. There were two concerns:
1. dealers had excessive backlogs of unconfirmed CDS trades, and
2. secondary trading of CDS positions was being undertaken by assignments without the consent of the remaining party.

The prevalence of manual settlement mechanisms contributed to both problems. During 2005, regulators worked closely with major credit derivative dealers to quantify the extent of operational backlogs. Targets were then agreed on the scale of reductions in credit derivative confirmations outstanding for longer than 30 days and the timeframe within which backlogs would be reduced. Dealers also committed to reduce the use of manual trade processing in favour of more automated systems. These targets were largely met, and quarterly public disclosures of industry average data are made on a range of metrics against which industry is benchmarking itself. More detailed disclosures are made to supervisors monthly.

However, the situation deteriorated beginning in July 2007 as CDS trading volumes increased to 250 percent above average. This demonstrates that there are still significant challenges in achieving an acceptable "steady-state" for average CDS settlement timeframes. Regulators have held discussions with firms to set new targets and initiatives for reducing the credit derivative settlement timeframe, and progress is reported monthly. The industry has increased the percentage of trades which are executed and settled electronically in order to avoid the more cumbersome settlement processes associated with manual systems. Deals executed and settled electronically constituted 45 percent of all credit derivative trading volumes in September 2005, but grew to 90 percent by September 2007. A number of hedge funds now "give up" all their CRT trades for settlement to their prime broker, which allows the hedge funds to benefit from the extensive systems investments made by their prime broker. Such funds have seen their average time for complete settlement fall from over 40 days to 1 day.

Issues associated with delays in the prompt notification of assignments have been significantly reduced since ISDA introduced its Novation Protocol in November 2005. This enhances the communication process between parties to novated trades and ensures the remaining party is informed on a timely basis that the transferor wishes to transfer an existing trade to a new counterparty.

Settlement risk is a market infrastructure concern that has grown since the 2005 report. The growth in CDS trading means that the value of outstanding CDS is now usually much greater than the underlying reference debt. This poses a risk when settlement takes place after a credit event. The typical settlement mechanism in a standard CDS contract is physical settlement. An investor who had bought credit protection must obtain eligible bonds referenced by the CDS, if the investor did not already own eligible bonds, and then deliver the bonds to the protection seller in exchange for par. Because CDS contracts

[11] The Joint Forum, Credit Risk Transfer: Developments from 2005 to 2007, (Jul. 2008) *available at* http://www.bis.org/publ/joint21.pdf

must be settled in a short period of time following a credit event, physical settlement could lead to an artificial scarcity that bids up the price of the referenced bonds. Also, bottlenecks in the settlement process could result as many transfers of bonds must occur in a short period of time.
A key development has been the emergence of credit event auctions. These auctions give investors the option of cash-settling their CDS and LCDS trades, after a credit event has been triggered, at a price that is set in a market-wide auction. This removes the need for all investors who have bought credit protection to obtain the actual eligible bonds in a short period of time.
However, each auction is an ad hoc process that must be quickly agreed to following a default. Settlement risk will still be high until the auction settlement mechanism is incorporated into standard CDS documentation and is tested in actual defaults, including some in less benign market environments. The cash settlement auction has not been quickly embraced by non-dealer CDS counterparties, per haps because they worry that the process favours dealers over non-dealers.
Another element of settlement risk concerns the lack of experience with credit events for CDS referencing new CRT asset classes. The documentation for CDS trades referencing corporate obligors has been tested many times and settlements have, in recent years, gone smoothly. Until new CRT asset classes go through similar tests, there will be uncertainty about how smoothly settlements will run. In particular, CDS on ABS and CDS referencing monoline financial guarantors have not been tested as thoroughly as CDS on corporate obligors.

In September 2009, in Pittsburgh, the G-20 agreed that:

> All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Noncentrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse.

Just over a year later, in October 2010, the FSB published the **Financial Stability Board Report on Implementing OTC Derivative Market Reforms.**[12] The report, an excerpt from which is set out below, stated that there should be more standardization of derivatives, that transactions in standardized derivatives should be carried out on exchanges or electronic trading platforms and centrally cleared and that there should be greater transparency with respect to derivatives trading:

...The recent financial crisis exposed weaknesses in the structure of the over-the-counter (OTC) derivatives markets that had contributed to the build-up of systemic risk. While markets in certain OTC derivatives asset classes continued to function well throughout the crisis, the crisis demonstrated the potential for contagion arising from the interconnectedness of OTC derivatives market participants and the limited transparency of counterparty relationships. OTC derivatives benefit financial markets and the

[12] Available at http://www.financialstabilityboard.org/publications/r_101025.pdf.

wider economy by improving the pricing of risk, adding to liquidity, and helping market participants manage their respective risks.

However, it is important to address the weaknesses in these markets which exacerbated the financial crisis. To this end, building on the commitments set out in the Pittsburgh statement, the G-20 Leaders committed at the subsequent Toronto Summit to accelerate the implementation of strong measures to improve transparency and regulatory oversight of OTC derivatives in an internationally consistent and non-discriminatory way.

This report includes 21 recommendations summarised below, which address practical issues that authorities may encounter in implementing the G-20 Leaders' commitments concerning standardisation, central clearing, exchange or electronic platform trading, and reporting of OTC derivatives transactions to trade repositories:

-Standardisation: The proportion of the market that is standardised should be substantially increased in order to further the G-20's goals of increased central clearing and trading on organised platforms, and hence mitigate systemic risk and improve market transparency. The report sets out recommendations for authorities to work with market participants to increase standardisation, including through introducing incentives and, where appropriate, regulation.

- Central clearing: To implement the G-20 commitment effectively, it is necessary to specify the factors that should be taken into account when determining whether a derivative contract is standardised and therefore suitable for clearing. The recommendations do this, as well as address mandatory clearing requirements; robust risk management requirements for the remaining non-centrally cleared markets; and supervision, oversight and regulation of central counterparties (CCPs) themselves.

- Exchange or electronic platform trading: Further work is being set in train in the coming months to identify what actions may be needed to fully achieve the G-20 commitment that all standardised products be traded on exchanges or electronic trading platforms, where appropriate.

- Reporting to trade repositories: Authorities must have a global view of the OTC derivatives markets, through full and timely access to the data needed to carry out their respective mandates. The recommendations help achieve this objective, including that trade repository data must be comprehensive, uniform and reliable and, if from more than one source, provided in a form that facilitates aggregation on a global scale.

This report aims to set ambitious targets for fully implementing the G-20 commitments, while minimising the potential for regulatory arbitrage. It sets appropriate deadlines to meet the G-20's end-2012 commitments, and specifies bodies to take the recommendations forward. Given the global nature of the OTC derivatives markets, continued international coordination in dealing with ongoing implementation of the G-20 commitments is critical. Work should be taken forward by the relevant standard setters and authorities to achieve international consistency. Furthermore, given the continuous innovation in the OTC derivatives markets, this report identifies areas where monitoring will need to continue and exploration of additional measures is recommended...

Increasing standardisation

Standardisation is a key condition for central clearing and trading on exchanges or electronic trading platforms, and also helps to facilitate greater market transparency. To promote the G-20's vision for greater use of these safer channels, authorities must ensure that appropriate incentives for market participants to use standardised products are in place. In particular, authorities should counter incentives that market participants may have to use nonstandardised products solely to avoid central clearing and trading requirements. We recommend the following:

1. Authorities should work with market participants to increase standardisation of OTC derivatives

products' contractual terms. In setting priorities for increased standardisation of contractual terms, authorities should consider the systemic relevance of particular types of OTC derivatives products, including by assessing factors such as volumes and exposures.

2. Authorities should work with market participants to increase the proportion of the OTC derivatives markets that uses standardised operational processes and straightthrough- processing. Greater use of standardised, automated processes will promote the use of standardised products.

3. To achieve increased standardisation of contractual terms and greater use of standardised operational processes as set out in the above recommendations 1 and 2, the OTC Derivatives Supervisors Group (expanded to include relevant market regulators) (ODSG) should continue to secure ambitious commitments from the major OTC derivatives market participants. These commitments should include publishing a roadmap by 31 March 2011 with demanding implementation milestones for achieving greater standardisation and, as an interim measure until mandatory clearing requirements are fully implemented, increasing volumes of centrally cleared transactions. The roadmap should set forth baseline metrics and forward-looking targets against which market participants will be measured.

4. Authorities should develop incentives and, where appropriate, regulation, to increase the use of standardised products and standardised processes. Authorities should examine new market activity on a regular basis to monitor the extent to which market participants may be trading non-standardised contracts solely for the purpose of avoiding central clearing and trading requirements and take steps to address such behaviour.

Moving to central clearing

To help mitigate systemic risk in the OTC derivatives markets, the G-20 Leaders agreed that all standardised derivatives contracts should be cleared through central counterparties by end- 2012 at the latest. They also agreed that non-centrally cleared contracts should be subject to higher capital requirements. In combination with setting mandatory clearing requirements and raising capital requirements for non-centrally cleared contracts to reflect their risks, including systemic risks, the use of central clearing should be expanded through industry commitments to increasing standardisation and volumes of centrally cleared transactions (as addressed by recommendations 1 through 4 above). Increased standardisation of contractual terms and operational processes should lead to greater liquidity and greater availability of reliable pricing data for such products, and thus a greater likelihood that a CCP can effectively risk manage them. For products that remain non-centrally cleared, authorities should set strengthened bilateral counterparty risk management requirements. Specifically, we recommend the following:

5. In determining whether an OTC derivative product is "standardised" and therefore suitable for central clearing, authorities should take into account (i) the degree of standardisation of a product's contractual terms and operational processes; (ii) the depth and liquidity of the market for the product in question; and (iii) the availability of fair, reliable and generally accepted pricing sources. In determining whether a mandatory clearing requirement should apply, authorities should consider whether the risk characteristics of the product can be measured, financially modelled, and managed by a CCP that has appropriate expertise.

6. Authorities should determine which products should be subject to a mandatory clearing obligation; however, they should not require a particular CCP to clear any product that it cannot risk-manage effectively, and should not mandate central clearing in circumstances that are not consistent with the G-20 objectives. When authorities determine that an OTC derivative product is standardised and suitable for clearing, but no CCP is willing to clear that product, the authorities should investigate the reason for this. Subsequent to an investigation, if authorities determine there is insufficient justification for the lack

of clearing, the authorities should take appropriate measures to promote central clearing. Such action could include creating incentives to encourage innovation by CCPs in a timely yet prudent manner or considering measures to limit or restrict trading in OTC derivatives products that are suitable for clearing but not centrally cleared.

7. For market participants to satisfy mandatory clearing requirements, access to CCPs (both direct and indirect, through client arrangements with direct participants) must be based on objective criteria that do not unfairly discriminate. Authorities should create a safe and sound environment for indirect access to clearing, and make any necessary proposals to change the legal framework and rules under which CCPs and market participants operate to achieve this. Authorities should monitor and, if detected, address unjustified impediments to indirect access. Authorities should require that CCPs and direct participants have effective arrangements in place that provide for the segregation and portability of customer positions and assets. In this context, authorities need to address the impact of insolvency laws and conflicts between insolvency laws that may arise in cross-border contexts.

8. Authorities should appropriately tailor any exemptions to mandatory clearing, and should not grant exemptions where doing so could create systemic risk. Authorities should actively monitor the use of any exemptions and review their appropriateness on a regular basis.

9. To help ensure a global regulatory level playing field and increase the safety of the financial system, CCPs that clear OTC derivatives should be subject to robust and consistently applied supervision and oversight on the basis of regulatory standards, that, at a minimum, meet evolving international standards developed jointly by CPSS and IOSCO.

10. Supervisors should apply prudential requirements that appropriately reflect the risks, including systemic risks, of non-centrally cleared OTC derivatives products, such as the reforms proposed by BCBS relating to higher capital requirements. In parallel, authorities should apply similar capital incentives to other financial institutions that trade OTC derivatives and are subject to capital regimes (such as broker-dealers and insurance companies). Authorities should consider whether measures other than capital incentives may be needed to encourage central clearing by market participants that are not subject to capital regimes (such as commercial entities or investors).

11. Recognising that some portion of the OTC derivatives markets, including nonstandardised derivatives, will remain non-centrally cleared, authorities must ensure that market participants have robust and resilient procedures in place to measure, monitor and mitigate counterparty credit and operational risks associated with noncentrally cleared contracts. Authorities should set and apply strong bilateral risk management standards, including collateralisation, and require market participants to benchmark themselves against defined best practices. In this regard, the ODSG should continue to secure ambitious commitments from the major dealers for extensions of trade compression, dispute resolution, and portfolio reconciliation. Authorities should actively monitor the non-centrally cleared portion of the market to determine if additional or strengthened measures may be necessary.

12. To minimise the potential for regulatory arbitrage, IOSCO, working with other authorities as appropriate, should coordinate the application of central clearing requirements on a product and participant level, and any exemptions from them. Promoting trading on exchanges or electronic trading platforms

The G-20 Leaders agreed that all standardised derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate. It may be appropriate to require trading of standardised derivatives on exchanges or electronic platforms where the market is sufficiently developed to make such trading practicable and where such trading furthers the objectives set forth by the G-20 Leaders and provides benefits incremental to those provided by standardisation, central clearing and reporting of transactions to trade repositories. Also, increasing public price and volume transparency for all derivatives transactions, including non-standardised OTC transactions, should be explored. We recommend the following:

13. IOSCO, with involvement of other appropriate authorities, should conduct an analysis by 31 January 2011 of: (i) the characteristics of the various exchanges and electronic platforms that could be used for derivatives trading; (ii) the characteristics of a market that make exchange or electronic platform trading practicable; (iii) the benefits and costs of increasing exchange or electronic platform trading, including identification of benefits that are incremental to those provided by increasing standardisation, moving to central clearing and reporting to trade repositories; and (iv) the regulatory actions that may be advisable to shift trading to exchanges or electronic trading platforms.

14. Authorities should explore the benefits and costs of requiring public price and volume transparency of all trades, including for non-standardised or non-centrally cleared products that continue to be traded over-the-counter.

Reporting to trade repositories

G-20 Leaders agreed that OTC derivative contracts should be reported to trade repositories. By providing information to authorities, market participants and the public, trade repositories will be a vital source of increased transparency in the market, and support authorities in carrying out their responsibilities, including (i) assessing systemic risk and financial stability; (ii) conducting market surveillance and enforcement; (iii) supervising market participants; and (iv) conducting resolution activities. Trade repositories also can fulfil an important function as a source of data and downstream event processing services for market participants. We recommend the following:

15. Authorities should ensure that trade repositories are established to collect, maintain, and report (publicly and to regulators) comprehensive data for all OTC derivative transactions regardless of whether transactions are ultimately centrally cleared. Authorities should establish a clear framework for the regulation of trade repositories based on their essential functions as a source of information to authorities, market participants and the public. Trade repositories should be subject to robust and consistently applied supervision, oversight and regulatory standards that, at a minimum, meet evolving international standards developed jointly by CPSS and IOSCO.

16. Market regulators, central banks, prudential supervisors and resolution authorities must have effective and practical access to the data collected by trade repositories that they require to carry out their respective regulatory mandates. Access to trade repository information by official international financial institutions also should be permitted in appropriate form where consistent with their mandates.

17. In addition to current efforts to obtain client consents for regulatory reporting of relevant data, authorities should, where necessary, propose legislative measures to address legal barriers to data collection and dissemination by trade repositories. Authorities should ensure that appropriate dissemination and confidentiality arrangements are in place so that relevant authorities have full and timely access to the data relevant to their respective mandates.

18. Authorities must require market participants to report all OTC derivatives transactions, both centrally-cleared and non-centrally cleared, accurately and in a timely manner to trade repositories, or, in exceptional circumstances, to the relevant authority if it is not possible to report a particular transaction to a trade repository. Where transactions are centrally cleared or otherwise terminated early, reporting to trade repositories also must capture and preserve information on the original terms of the transaction.

19. Authorities with the legal mandate to set requirements for the reporting of transactions to trade repositories should consider the recommendations set out in the forthcoming report of the FSB Data Gaps and Systemic Linkages Group, and consult with the Committee on the Global Financial System (CGFS),

the Bank for International Settlements (BIS), the ODSG and ODRF, to identify the data that should be reported to trade repositories to enable authorities to carry out their respective tasks and monitor, among other things, implementation of the G-20 commitments to central clearing and exchange or electronic platform trading.

Further, as the data must be able to be readily aggregated on a global basis, by end- 2011 CPSS and IOSCO, in consultation with authorities, and with the ODRF, should develop both for market participants reporting to trade repositories and for trade repositories reporting to the public and to regulators: (i) minimum data reporting requirements and standardised formats, and (ii) the methodology and mechanism for the aggregation of data on a global basis.

Assessing progress and cooperating in OTC derivatives market reforms

Many OTC derivatives markets are global, with the same products traded in multiple jurisdictions and by multinational institutions. Given that these markets function on a crossborder basis, it is important that there is international cooperation and coordination to fulfil enforcement and supervision responsibilities, minimise the potential for regulatory arbitrage, and fully and consistently implement the G-20's commitments. We recommend the following to achieve these objectives:

20. The ODSG, working with the standard setters, the BIS, other relevant authorities and market participants, should develop appropriate reporting metrics to measure to what extent the recommendations of this report, and more generally, the G-20 commitments to central clearing, exchange or electronic platform trading, and reporting to trade repositories, are being met. These metrics should be developed, and necessary data identified, on a timeline that will enable the FSB to assess implementation status as of the end-2012 deadline.

21. Authorities should continue to use, promote, and where necessary, develop bilateral or multilateral arrangements to facilitate consultation, cooperation and the exchange of information concerning OTC derivatives markets and participants among all relevant authorities across financial sectors. Authorities should ensure appropriate coordination for the mandatory clearing of OTC derivatives contracts involving parties or instruments in multiple jurisdictions and ensure such contracts are appropriately reported to trade repositories. In addition, the ODRF, working with CPSS and IOSCO, should continue to foster development of common frameworks for effective cooperation and coordination on oversight arrangements and information sharing among the relevant authorities for individual trade repositories and systemically important OTC derivatives CCPs.

This is another example of a harmonization story we have seen in other contexts since the financial crisis. Here, regulators had noted some potential regulatory issues before the crisis. When the crisis hit, those regulators revisited this earlier work. The political response to the crisis did not focus just on credit derivatives, but was a less targeted approach. The G20 made some general statements about fixing the derivatives problem and the FSB followed up with some more details on what a new system for controlling risk in the derivatives market would look like. G20 member states and the EU began to work on implementing the new rules.

Before reading the following material I would like you to read Clifford Chance and ISDA's publication Regulation of OTC Derivatives Markets: A Comparison of EU and US Initiatives (Sep. 2012) which can be found via the class blog.

A excerpt from the **Commodity Futures Trading Commission Strategic Plan 2011-2015**[13] outlines the situation in the US

... Congress created the CFTC in 1974 as an independent agency with the mandate to regulate commodity futures and option markets in the United States. The Commission's mandate was renewed and/or expanded in 1978, 1982, 1986, 1992, 1995, 2000, 2008, and 2010. The Dodd-Frank Act significantly broadened the CFTC's regulatory authority to include the OTC derivatives, or "swaps", markets. The CFTC's short and long-term goals include significant rule-writing and implementation in the swaps marketplace.

The CFTC was established to assure the economic utility of the futures markets by encouraging competitiveness and efficiency; protecting market participants against fraud, manipulation, and abusive trading practices; and ensuring the financial integrity of the clearing process. Through effective oversight, the CFTC enables the futures markets to serve the important function of providing a means for price discovery and offsetting price risk. The CFTC will spend the next year bringing similar protections to the OTC derivatives marketplace.

Derivatives have been around the United States since the Civil War, when grain merchants came together to hedge the risk of changes in the price of corn, wheat, and other grains on a central exchange. These derivatives are called futures. Nearly 60 years and a financial crisis—the Great Depression—after they first traded, Congress brought Federal regulation to the markets. It wasn't until the 1930s that the CEA, which created the CFTC's predecessor, became law. At the time the CFTC was established in 1974, the vast majority of futures trading took place on commodities in the agricultural sector.

Over the years, the futures industry has become increasingly diversified. While agricultural interests continue to use the futures markets to lock in prices for their crops and livestock, highly complex financial contracts based on interest rates, foreign currencies, Treasury bonds, securities indexes, and other products far exceed agricultural contracts in trading volume. In fact, only about eight percent of on-exchange commodity futures and options trading activity occur in the agricultural sector, while financial commodity futures and option contracts make up approximately 79 percent of trading activity on futures exchanges. Other contracts, such as those on metals and energy products, make up about 13 percent.

The increase in trading activity, number of participants, and complexity and number of contracts available for trading has transformed the futures marketplace into a $40 trillion industry. The rapid evolution in trading technologies, cross-border activities, product innovation, and competition has made the futures markets an integral and significant part of the global economy. In addition to the rapid growth of the futures marketplace, the global economy has also seen the development of a new derivatives market—the OTC swaps market. The first OTC derivative transaction took place in 1981. Since then, the swaps market has grown to $300 trillion notional amount in the United States. The emergence of this new marketplace has brought new challenges to the financial regulatory system. The Dodd-Frank Act authorizes the CFTC to bring regulation to the OTC marketplace. Implementing that legislation will remain a significant goal of the Commission in the next few years...

In summary, the CFTC regulates a futures and options industry that increased from 580 million contracts in 2000 to more than 3.1 billion contracts in 2010. The value of customer funds held in Futures Commission Merchants Accounts, during the same period, increased from $56.7 billion to more than

[13] Available at http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/2015strategicplan.pdf.

$170.1 billion, and the value of these contracts is notionally estimated at $40 trillion. As noted, with the passage of the Dodd-Frank Act, the CFTC is tasked with regulating the swaps markets with an estimated notional value of approximately $300 trillion—roughly eight times the size of the regulated futures markets.

To address the scope of the swaps marketplace and ensure that the CFTC is well-situated to fulfill its expanded mission of overseeing swaps markets, the CFTC will need to reorganize. The Commission is committed to implementing the reorganization in the near term to better implement the Dodd-Frank Act. While the details remain to be worked out, some aspects of this reorganization are already clear. First, the CFTC will create a new group for oversight of swap dealers and intermediaries. This group will report to the Chairman's office, and will facilitate standing up the new regulatory regime for the swaps marketplace by creating a group whose primary focus is on the regulation and oversight of swap dealers. It will also provide consolidated oversight of other regulated intermediaries, as well. Exact details on the transfer of responsibilities from existing divisions and offices remain to be worked out.

Second... technology will play a critical role in leveraging financial and human resources as the CFTC executes its expanded oversight and surveillance responsibilities over both the futures and swaps markets pursuant to the Dodd-Frank Act. Accordingly, the Commission will reorganize its technology programs by establishing a new group reporting to the Chairman's office for the collection, management, and some analysis of data. This group will be staffed by personnel drawn from multiple disciplines and existing divisions and offices, and will facilitate the improved oversight and enforcement of the derivatives markets through the use of technology and data. It will also serve as the primary interface for market participants in adapting to the new data standards and reporting requirements for market data required under the Dodd-Frank Act. Exact details on the transfer of responsibilities from existing divisions and offices remain to be worked out.

The CFTC's current funding is far less than what is required to properly fulfill its significantly expanded role. The CFTC has requested additional funds, and without the requested resources the Commission may not be able to meet its strategic goals, nor its statutory and regulatory obligations. Simply stated, the degree of success the CFTC will have in achieving the goals and objectives in this Strategic Plan depends upon its ability to secure funding necessary to support its expanded mission and necessary transformation.

The development of a CFTC Strategic Plan at this time creates a unique situation in that the mission expanding Dodd-Frank Act was passed in July 2010. The Dodd-Frank Act will greatly increase the scope of regulation by the CFTC by bringing oversight to the swaps marketplace. The futures marketplace that the CFTC currently oversees is a $40 trillion industry in notional value. The swaps market that the Dodd-Frank Act tasks the CFTC with regulating is far larger; the Office of the Comptroller of the Currency estimates it at $217 trillion notional value (2010), while others estimate it being as high as $300 trillion.

Congress gave this swaps oversight responsibility to the CFTC because of its strengths in regulating the futures and options markets. While the swaps marketplace has only been around since the 1980s, the futures marketplace has existed since the 1860s. The CFTC and its predecessor agencies have been regulating and working with the futures markets since the 1920s.

The regulation of the swaps markets included in the Dodd-Frank Act builds upon:
- the Commission's strengths applicable to oversight of the futures markets;
- the benefits of clearing in the futures markets;
- the transparency and price discovery that centralized trading brings to the futures markets;
- the concept that intermediaries should be regulated to lower risk in the markets; and

- the understanding that effective oversight can only be accomplished if the regulator has access to all relevant information about activity in the markets.

The goals of the CFTC largely remain the same with the regulation of swaps being incorporated within the regulatory structure currently applied to the futures and options markets. The CFTC's primary focus will be to write the rules to regulate the swaps markets, implement those rules, test and adjust those rules, and write new rules as necessary to bring effective regulation to all derivatives markets over the next five years. The Commission will also adopt as policy President Obama's Executive Order signed on January 18, 2011, entitled "Improving Regulation and Regulatory Review." The Commission will apply this standard to all future and pending rulemakings under the Dodd-Frank Act and seek to streamline its existing rules and regulations as well. To sustain a focus on its expanded scope and new swaps regulation, the Commission must review and properly align its organizational structure, ensure it is appropriately staffed, and ensure the CFTC is technologically ready to address greatly increased data and analysis requirements.....

Goal 1: Market Integrity... Protect the public and market participants by ensuring market integrity; promoting transparency, competition, and fairness; and lowering risk in the system.

Derivatives markets are designed to provide a means for market users to offset price risks inherent in their businesses and to act as a public price discovery platform from which prices are broadly disseminated for public use. For derivatives markets to fulfill their role in the national and global economy, they must operate efficiently and fairly, and serve the needs of market users. The markets best fulfill this role when they are open, competitive, and free from fraud, manipulation, and other abuses such that the prices discovered on the markets reflect the forces of supply and demand.

The Commission strives to assure that Goal 1 is effectively met through the combined use of four oversight strategies: 1) the review of new contracts and rules and changes to contracts and rules; 2) continual surveillance of trading activity in the futures and swaps markets; 3) the review of regulated exchanges, **designated contract markets** (DCMs), and SEFs[14] to ensure that they are fulfilling their self-regulatory obligations; and 4) the adoption of policies and strategies to promote market transparency.

Review of New Contracts and Rules and Changes

The Commission routinely reviews new rules and rule changes adopted by exchanges to assure that they meet the statutory core principles of the CEA and the CFTC’s regulations. The Commission also reviews and/or approves newly listed contracts and rules for compliance with applicable core principles related to susceptibility to manipulation and speculative position limits.

In addition to the Commission’s traditional role in the oversight of DCMs[15], the recent enactment of the Dodd-Frank Act created a new market category of designated trading facility, referred to as a **swap execution facility** (SEF). As with traditional exchanges, staff will be responsible for reviewing new SEF registration applications and for conducting annual examinations of their operations to ensure compliance with the core principles. The Commission, based on industry comments, expects that 30-40 entities will apply to become SEFs, adding to the current number of 17 DCMs, potentially tripling the CFTC’s oversight requirements in this area..

Surveillance of Trading Activity

The Commission monitors trading and the positions of market participants on an ongoing basis. Under the Dodd-Frank Act, the Commission’s oversight will expand from futures and options contracts traded

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[14] Swap Execution Facility.

[15] Designated Contract Market.

on DCMs to also include swaps traded on DCMs and SEFs. Commission staff, through their surveillance programs, screen for potential market manipulations and disruptive trading practices, as well as trade practice violations such as wash trading, prearranged trading, accommodation trading, customer fraud, fictitious sales, trading ahead, and trading against and front running customer orders. Staff also monitor changing market conditions and developments, such as shifting patterns of commercial or speculative trading, or the introduction of new trading activities, such as index trading or high frequency and algorithmic trading, to assess possible market impacts. Where appropriate, staff adapt its surveillance and trading review techniques to account for and target these areas of change, and also consider the impact that such changes may have on exchange trading rules and contract design.

Under the Dodd-Frank Act, the Commission must establish new regulations to register **SDRs**[16] and ensure that swaps data is reported consistent with the Dodd-Frank Act. Such data must be collected, maintained, and made available to the Commission and other regulators consistent with new statutory and regulatory mandates which include requirements for real-time public reporting. Initial estimates are that the Commission will receive at least five SDR applications—one for each major asset class of swaps—and possibly as many as 10, if some current international data repositories seek to register as SDRs. This will require a significant number of staff and information technology (IT) effort to develop the systems to permit the Commission to access this data from SDRs and to compile and analyze it to carry out the Commission's statutory responsibilities.

The CFTC will continue to increase its use of technology to implement new procedures and automated market surveillance systems to monitor and analyze trading patterns and ownership and control of positions within and across the futures, options, and swaps markets. Staff are developing a rule to establish SDRs, which will provide them with real-time access to trades and aggregation of positions as required under the Dodd-Frank Act.

Review of Designated Contract Markets and Swap Execution Facilities

To ensure that DCMs, and in the future SEFs, are enforcing their rules, the Commission conducts regular reviews to assess ongoing compliance with core principles through the self-regulatory programs operated by the exchange in order to enforce its rules, prevent market manipulation, and customer and market abuses, and ensure the recording and safe storage of trade information. These reviews are known as rule enforcement reviews (RERs).

In conducting an RER, Commission staff examine trading and compliance activities at the exchange in question over an extended time period, typically the 12 months immediately preceding the start of the review. Staff conduct extensive review of documents and systems used by the exchange in carrying out its self-regulatory responsibilities, interview compliance officials and staff of the exchange, and prepare a detailed written report of their findings. In nearly all cases, the RER report is made available to the public and posted on www.CFTC.gov.

Promotion of Market Transparency

The CFTC is committed to transparency in the marketplace, and has a long history of publishing reports and data on market activity. The most well known report published by the Commission is the Commitments of Traders report. This report, published on a weekly basis, provides a breakdown of each Tuesday's open interest for markets in which 20 or more traders hold positions equal to or above the reporting levels established by the CFTC. On September 4, 2009, the Commission enhanced the report when it began disaggregating the data to break out managed money and swap dealer activity in the futures and option markets. The Commission also produces an index investment data report, which

[16] Swap Data Repository.

summarizes index investment activity in commodity markets, a bank participation in futures and option markets report, and a Cotton On-Call report. As the Commission implements the elements of the Dodd-Frank Act, staff will continue efforts to promote transparency in the swaps market through the development and publication of similar reports for that market...

Objective 1.3 Promote transparency by producing and publishing summary market statistics for the futures, options, and swaps markets.

The term transparency can refer to various levels of information availability in a market. In a narrow sense it refers to the ability of traders to observe order flow on an exchange; that is, to see information such as the size and direction of orders, or the timing of orders. However, transparency can more broadly describe information pertaining to the reporting of price and volume of trading on an exchange and to the composition of participants involved in trading. Such information is important to both direct participants on the exchange, and more broadly to other individuals or businesses that use market information to make business decisions, even though they do not directly transact on the exchange. Market transparency also allows for assessments by market participants and regulators as to whether markets appear to be functioning properly, and the overall robustness of the market.

The Commission has long been committed to assuring that information about markets is broadly and freely disseminated to the public. Currently the Commission publishes periodic reports on market activity and participant composition. These include a weekly Commitments of Traders report, a monthly Bank Participation report, a monthly Index Investment Data report, and a weekly Cotton On-Call report.

With the passage of the Dodd-Frank Act, the Commission now has a responsibility to oversee trading in the swaps market. Part of this responsibility includes assuring that certain trading activity and information produced in these markets is reported, not only to regulators, but generally to the public. The Dodd-Frank Act requires publication, by the Commission, of semi-annual reports summarizing activity in the swaps markets. To fulfill this obligation, and generally to assure that the swaps, futures, and options markets are transparent, the Commission will initiate several strategies to update its current public transparency efforts as well as to launch new transparency efforts with respect to the swaps markets.

Strategy 1.3.1 Develop and publish swaps market reports.

A key goal of the Dodd-Frank Act is to create greater transparency in the swaps markets. The Dodd-Frank Act strives to achieve this goal by bringing standardized swaps onto exchanges and to have information on all swaps reported to swaps data repositories.

The trading of swaps on exchanges and the reporting of all swap transactions to swaps data repositories assures that information in these markets is consolidated in centralized locations. To further assure that the information collected by swaps data repositories is made public, the Commission will collect information on trading and participation in the swaps markets and produce periodic reports summarizing activity and changes observed in the swaps markets.

In creating these reports, staff will need to develop methods to aggregate data on varied but related swaps transactions for the purpose of reporting activity in product categories. For certain markets, such as interest rate swaps, where a relatively high degree of standardization already exists in the underlying assets, such efforts will be fairly straightforward. For swaps markets based on physical commodities, a more complex scheme will likely be required to define product categories and develop methods to aggregate transactions.

Goal 2: Financial Integrity..Protect the public and market participants by ensuring the financial integrity of derivatives transactions, mitigation of systemic risk, and the fitness and soundness of intermediaries and other registrants..

In fostering financially sound markets, the Commission’s main priorities are to avoid disruptions to the system for clearing and settling contract obligations and to protect the funds that customers entrust to futures commission merchants (FCMs). Clearing organizations and FCMs are integral to the financial integrity of derivatives transactions—together, they protect against the financial difficulties of one trader becoming a systemic problem. Several aspects of the regulatory framework that contribute to the Commission achieving this goal are: 1) requiring that market participants post margin to secure their ability to fulfill financial obligations; 2) requiring participants on the losing side of trades to meet their obligations, in cash, through daily (sometimes intraday) margin calls; 3) requiring FCMs to maintain minimum levels of operating capital; and 4) requiring FCMs to segregate customer funds from their own funds.

The Commission works with the exchanges and the National Futures Association (NFA) to closely monitor the financial condition of the FCMs themselves, who must provide the Commission, exchanges, and NFA with various monthly, quarterly, and annual financial reports. The exchanges and NFA conduct routine, periodic audits and daily financial surveillance of their respective member FCMs. As a regulator, the Commission reviews the audit and financial surveillance programs of the exchanges and NFA and also monitors the financial condition of FCMs directly, as appropriate. This includes reviewing each FCM's exposure to risk from large customer positions that it carries. The Commission also conducts extensive daily surveillance of risks posed by traders, firms, and **derivatives clearing organizations** (DCOs) and periodically reviews clearing organization procedures for monitoring risks and protecting customer funds.

The Commission works with the NFA to ensure that those seeking registration as intermediaries meet high qualification and fitness standards through the registration process. The Commission also drafts and interprets rules that apply to the conduct of business by these intermediaries. In 2010, the Commission adopted new registration, capital, and other requirements for retail foreign exchange dealers (RFEDs) that may act as counterparties for off-exchange foreign currency transactions involving retail participants. RFEDs are subject to similar financial requirements, and similar oversight, as the FCMs.

Under the CEA, DCOs must demonstrate compliance with core principles that require, among other things: 1) adequate financial, operational, and managerial resources; 2) appropriate standards for participant and product eligibility; 3) adequate and appropriate risk management capabilities; 4) the ability to complete settlements on a timely basis under varying circumstances; 5) standards and procedures to protect member and participant funds; 6) efficient and fair default rules and procedures; 7) adequate rule enforcement and dispute resolution procedures; and 8) adequate and appropriate systems safeguards, emergency procedures, and plans for disaster recovery. The Commission conducts periodic reviews of DCOs for their compliance with core principle requirements. The Commission surveys DCO exposures on a daily basis and compares such exposures to DCO financial resources. Additionally, the CFTC may review and approve DCO rules.

With the implementation of the Dodd-Frank Act, the Commission will have substantially greater responsibilities, including oversight of newly registered derivatives dealers, as well as implementation of enhanced compliance requirements for intermediaries and new core principle requirements for DCOs. The Commission also will be responsible for determining the initial eligibility or the continuing qualification of a DCO to clear swaps, as well as for the review of swaps submitted to the Commission for a determination as to whether the swaps are required to be cleared. The Commission also will be implementing new statutory provisions regarding review of new rules and rule amendments submitted by DCOs. In addition, the scope of the Commission's reviews of DCOs, designated self-regulatory organizations (DSROs), and intermediaries will be expanded to include swap transactions and swap intermediaries.

The Dodd-Frank Act creates a new category of **systemically important DCOs**. These entities will have to comply with heightened risk management and other prudential standards. The Commission will be required to examine systemically important DCOs at least yearly. The Commission also has to ensure that all DCOs comply and bring their rules up to the new Dodd-Frank Act core principles and thus, the Commission intends to examine all DCOs on an annual basis. The Commission likely will see an increase in the number of DCOs seeking registration, including entities that are located outside the United States, from 15 (January 10, 2011) to at least 20. The additional clearinghouses that will register as DCOs likely will clear many more products that will require analysis. The risk profile of these cleared products will be more complex than traditional futures and options. As such, the clearing oversight program's risk surveillance function will have to grow so that the CFTC can continue to effectively discharge its statutory duty to reduce systemic risk.

To implement these authorities, the CFTC will create a new group for the oversight of swaps dealers and intermediaries. A significant increase in staff focused on the development and implementation of regulations and programs in this previously unregulated arena will also be necessary..

Objective 2.1 Clearing organizations and firms participating in the derivatives industry are financially sound.

In ensuring the financial integrity of transactions and the mitigation of systemic risk, the Commission's main priorities are to avoid disruptions to the system for clearing and settling contract obligations and to protect the funds that customers entrust to FCMs. Clearing organizations and FCMs are integral to the operation of a sound clearing and settlement system as their financial well being mitigates the systemic risk posed by the financial difficulties of one market participant. The Commission will have to expand its program to assess the way these entities, and new entrants into the regulatory environment, mitigate these risks...

Objective 2.2 Registered intermediaries meet standards for fitness and conduct.

Pursuant to the CEA and Commission regulations, all intermediaries registered with the Commission are mandated to satisfy certain standards regarding fitness and conduct to ensure the protection of market participants and the financial soundness of the market. The Dodd-Frank Act will increase the number of entities required to register, including swap dealers, thus increasing the portion of the Commission's resources required to execute this function.

Strategy 2.2.1 Review swap dealers and major swap participants to ensure that they comply with the CEA and Commission regulations.

Under the Dodd-Frank Act, entities operating as and meeting the definition of a **swap dealer** or **major swap participant** will be required to register and to comply with applicable requirements regarding business conduct, reporting and record-keeping, and capital and margin. These entities will be subject to review by the Commission or a self-regulatory organization (SRO) with respect to their compliance with the applicable requirements....

Objective 2.3 Ensure that SROs fulfill their financial surveillance responsibilities.

As a key aspect of assuring financial integrity of CFTC-regulated transactions and the mitigation of systemic risk, the Commission oversees futures industry SROs, which include exchanges and RFAs, to ensure that they fulfill their responsibilities for monitoring and ensuring the financial integrity of market intermediaries and for protecting customer funds. As more entities enter the regulatory arena, due to the Dodd-Frank Act provisions all demands on SROs and their oversight will increase, and in some areas such increase might be larger than others.

Strategy 2.3.1 Conduct oversight of the financial surveillance programs of SROs.

The Commission has initiated a program to increase the frequency of its assessments of financial surveillance programs. The goal is to conduct an annual assessment of certain core regulatory functions carried out by SROs. This effort allows the Commission to have current information on the effectiveness of the surveillance programs and to identify and address potential issues on a more timely basis. The number of entities that must be assessed may increase significantly as a result of the Dodd-Frank Act, which could limit any increases in the frequency of assessments...

Objective 2.4 Ensure that IT systems support the Commission's existing and expanded responsibilities to ensure financially sound markets, mitigate systemic risk, and monitor intermediaries.

To fulfill its mission successfully, the Commission must continuously work to refine and improve its technology systems to allow more efficient examination and monitoring of clearing organizations, SROs, and intermediaries. This will also include new functionality with respect to swaps activities, such as reviewing swaps that may be required to be cleared; new registration requirements; and oversight of swap dealers. Further, under the Dodd-Frank Act the Commission is required to collect new systemic risk data from commodity pool operators (CPOs) and commodity trading advisors (CTAs) that advise private funds. While this data collection is in a proposed rule, with the proposed collection delegated to an existing RFA, the Commission will need regular and complete access to that new data collection to fulfill its responsibilities under the Dodd-Frank Act.

More broadly, it is critical that the Commission works to identify data relationships and overlapping business needs, reduce inefficiencies and duplications in transmission and processing of data, and develop strategies to integrate its technology systems, in order to maximize its resources. Modernizing current systems, fully implementing the electronic submission of documents and data, and improving access to and integration with SROs' and other regulators' systems and data will allow staff to increase the amount of time they spend on analysis and allow staff to conduct analysis with more effective tools...

Goal 3: Robust Enforcement..

An increasing segment of the population has money invested in the derivatives markets, either directly or indirectly through pension funds or ownership of shares in publicly held companies that participate in the markets. Commission staff work to protect market users and the public by promoting compliance with and deterring violations of the CEA and Commission regulations. The range of available enforcement actions (including manipulation, disruptive trading practices, and anti-fraud, for example) will broaden beginning July 2011 when relevant provisions of the Dodd-Frank Act become effective. By providing a formalized structure and government oversight, the commodity laws carefully balance the desire for open, accessible, and competitive markets with the need to protect market users.

This third Strategic Goal is to ensure that firms and individuals who come to the marketplace to fulfill their business and trading needs are in compliance with laws and regulations. In addition, market users and others must be protected from possible wrongdoing that may affect or tend to affect the integrity of the markets. The derivatives markets provide a great benefit to the U.S. economy; preserving the integrity of the markets ensures their continued vibrancy and promotes public confidence. Continuing IT investment in the eLaw program will support all Goal 3 objectives by improving staff productivity, providing staff with a level IT playing field with those it investigates and effective tools to collaborate internally with oversight and clearing staff as well as with other regulators, and facilitating the use of information to identify high impact enforcement actions...

Objective 3.2 Increase cooperative enforcement.

The Commission will refer matters that may involve misconduct within the civil or criminal jurisdiction of its domestic counterparts, for their investigation and potential civil or criminal prosecution.

In addition, the CFTC works extensively with foreign authorities to sustain and encourage cooperative relationships in nations with both developed and emerging markets. The Commission's strategies to enhance international enforcement efforts are outlined in Goal 4...

Goal 4: **Cross-Border Cooperation**..Enhance integrity of U.S. markets by engaging in cross-border cooperation, promoting strong international regulatory standards, and encouraging ongoing convergence of laws and regulation worldwide...

The Commission recognizes that markets are global as the result of electronic access, linkages, mergers, and cooperative business arrangements. The CFTC historically has supported programs that facilitate cross-border access to markets and products, such as the Commission's recognition program for intermediaries and its registration category for foreign boards of trade. Both of these programs are based on recognition of foreign home country regulators that comparably and comprehensively provide oversight, allowing the CFTC to rely on this foreign regulation. These programs reflect the understanding that no one regulator alone will have all of the information or authority to supervise global business. Effective regulation of such markets therefore requires international coordination, and necessitates that the Commission cooperate with foreign market authorities to supervise U.S. markets and protect U.S. customers. Additionally, the Commission works closely with its regulatory counterparts abroad, as well as with relevant international organizations, to promote high-quality derivatives regulation worldwide and convergence where possible. The CFTC also provides technical assistance to emerging and recently-emerged markets to help these jurisdictions in establishing and implementing laws and regulations that foster global market integrity.

The Dodd-Frank Act increases the need for international outreach. Section 752 of that Act states that the Commission "shall consult and coordinate" with foreign authorities to establish "consistent international standards" regarding regulation of swaps. Many of the new entities subject to regulation under the Dodd-Frank Act are located abroad and the Commission will closely coordinate with foreign regulators in order to supervise these global entities...

Objective 4.2 Promote high levels of internationally accepted standards of best practice.

Derivatives markets under the Commission's jurisdiction are part of a global industry. Promoting high standards internationally supports the Commission's regulatory efforts in the United States and encourages strengthened oversight worldwide. In addition, the use of consistent standards around the world allows market participants to determine where to deploy their capital based on objective factors such as cost, innovation, and an appropriate regulatory environment, rather than a perceived gap in regulation in one jurisdiction that might distort competition and result in regulatory arbitrage. This can be achieved through active CFTC participation in standard-setting bodies that encourage the development of high regulatory standards.

Strategy 4.2.1 Promote high-quality principles internationally.

The Commission participates in the International Organization of Securities Commission (IOSCO), the standard setting body for derivatives and securities regulation. Within IOSCO, the Commission participates in five of the seven standing committees and various task forces, including co-chairing the Task Force on Commodity Futures Markets and the OTC Derivatives Task Force. Additionally, the Commission participates in the Financial Stability Board, G20 Working Groups, and other international bodies that facilitate the development of best practices. When participating in international standard setting bodies and working groups, the CFTC will strive to ensure that high-quality principles or best practices are promulgated in a manner consistent with the Commission's overall regulatory policies...

Objective 4.3 Provide global technical assistance.

The CFTC provides technical assistance to emerging and recently-emerged markets to assist these jurisdictions in establishing and implementing laws and regulations that minimize the likelihood of regulatory arbitrage and promote cross-border enforcement and supervisory assistance. The passage of

the Dodd-Frank Act is likely to increase the number of requests for technical assistance in developing OTC policies.
Strategy 4.3.1 Provide technical assistance to foreign regulators.
The CFTC will continue to provide technical assistance to foreign regulators in a wide variety of subject areas. Such technical assistance may take various forms, including targeted programs in specific areas of concern, such as enforcement training and oversight of the OTC market.

This document outlines the regulatory regime the CFTC has been managing as well as the changes Dodd_frank makes to the CFTC's responsibilities. There are a number of points where the CFTC notes the additional costs involved in implementing the new swaps regime. But this is also an expansion of the authority of the agency.

The CFTC's strategic plan states that the derivatives markets are "part of a global industry" and contains a number of references to issues relating to regulating cross-border activity (e.g. the "Commission recognizes that markets are global as the result of electronic access, linkages, mergers, and cooperative business arrangements") and to engaging with foreign regulators and participating in the development of international standards.

The EU adopted a Regulation on OTC Derivatives Central Counterparties and Trade Repositories (**European Market Infrastructure Regulation (EMIR)**) in 2012.[17] EMIR provides for Central Clearing for certain classes of OTC derivatives; the application of risk mitigation techniques for non-centrally cleared OTC derivatives; reporting to trade repositories; the application of regulatory requirements to CCPs with respect to organization, conduct of business and prudential requirements; and requirements for Trade repositories, including a duty to make certain data available to the public and relevant authorities.

The recitals to EMIR follow. The recitals are not part of the operative part of the regulation - they do not establish what the rules are - but they do explain the background to and objectives of the rules and may be used to interpret the legally effective provisions. These recitals are extremely long and complex and refer to many other measures of EU financial regulation. Thus this document can be seen as a good example or illustration of regulatory complexity.

(1) At the request of the Commission, a report was published on 25 February 2009 by a High-Level Group chaired by Jacques de Larosière and concluded that the supervisory framework of the financial sector of the Union needed to be strengthened to reduce the risk and severity of future financial crises and recommended far-reaching reforms to the structure of supervision of that sector, including the creation of a European System of Financial Supervisors, comprising three European supervisory authorities, one each for the banking, the insurance and occupational pensions and the securities and markets sectors, and the creation of a European Systemic Risk Council.
(2) The Commission Communication of 4 March 2009, entitled "Driving European Recovery", proposed to strengthen the Union's regulatory framework for financial services. In its Communication of 3 July 2009 entitled "Ensuring efficient, safe and sound derivatives markets", the Commission assessed the role

[17] O J L 201/1 (Jul. 27, 2012) at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF.

of derivatives in the financial crisis, and in its Communication of 20 October 2009 entitled "Ensuring efficient, safe and sound derivative markets: Future policy actions", the Commission outlined the actions it intends to take to reduce the risks associated with derivatives....

(4) Over-the-counter derivatives ("OTC derivative contracts") lack transparency as they are privately negotiated contracts and any information concerning them is usually only available to the contracting parties. They create a complex web of interdependence which can make it difficult to identify the nature and level of risks involved. The financial crisis has demonstrated that such characteristics increase uncertainty in times of market stress and, accordingly, pose risks to financial stability. This Regulation lays down conditions for mitigating those risks and improving the transparency of derivative contracts.

(5) At the 26 September 2009 summit in Pittsburgh, G20 leaders agreed that all standardised OTC derivative contracts should be cleared through a **central counterparty** (CCP) by the end of 2012 and that OTC derivative contracts should be reported to **trade repositories**. In June 2010, G20 leaders in Toronto reaffirmed their commitment and also committed to accelerate the implementation of strong measures to improve transparency and regulatory oversight of OTC derivative contracts in an internationally consistent and non-discriminatory way.

(6) The Commission will monitor and endeavour to ensure that those commitments are implemented in a similar way by the Union's international partners. The Commission should cooperate with third-country authorities in order to explore mutually supportive solutions to ensure consistency between this Regulation and the requirements established by third countries and thus avoid any possible overlapping in this respect. With the assistance of ESMA, the Commission should monitor and prepare reports to the European Parliament and the Council on the international application of principles laid down in this Regulation. In order to avoid potential duplicate or conflicting requirements, the Commission might adopt decisions on equivalence of the legal, supervisory and enforcement framework in third countries, if a number of conditions are met. The assessment which forms the basis of such decisions should not prejudice the right of a CCP established in a third country and recognised by ESMA to provide clearing services to clearing members or trading venues established in the Union, as the recognition decision should be independent of this assessment. Similarly, neither an equivalence decision nor the assessment should prejudice the right of a trade repository established in a third country and recognised by ESMA to provide services to entities established in the Union.

(7) With regard to the recognition of third-country CCPs, and in accordance with the Union's international obligations under the agreement establishing the World Trade Organisation, including the General Agreement on Trade in Services, decisions determining third-country legal regimes as equivalent to the legal regime of the Union should be adopted only if the legal regime of the third country provides for an effective equivalent system for the recognition of CCPs authorised under foreign legal regimes in accordance with the general regulatory goals and standards set out by the G20 in September 2009 of improving transparency in the derivatives markets, mitigating systemic risk, and protecting against market abuse. Such a system should be considered equivalent if it ensures that the substantial result of the applicable regulatory regime is similar to Union requirements and should be considered effective if those rules are being applied in a consistent manner.

(8) It is appropriate and necessary in this context, taking account of the characteristics of derivative markets and the functioning of CCPs, to verify the effective equivalence of foreign regulatory systems in meeting G20 goals and standards in order to improve transparency in derivatives markets, mitigate systemic risk and protect against market abuse. The very special situation of CCPs requires that the provisions relating to third countries are organised and function in accordance with arrangements that are specific to these market structure entities. Therefore this approach does not constitute a precedent for

other legislation.
(9) The European Council, in its Conclusions of 2 December 2009, agreed that there was a need to substantially improve the mitigation of counterparty credit risk and that it was important to improve transparency, efficiency and integrity for derivative transactions. The European Parliament resolution of 15 June 2010 on "Derivatives markets: future policy actions" called for mandatory clearing and reporting of OTC derivative contracts.
(10) ESMA should act within the scope of this Regulation by safeguarding the stability of financial markets in emergency situations, ensuring the consistent application of Union rules by national supervisory authorities and settling disagreements between them. It is also entrusted with developing draft regulatory and implementing technical standards and has a central role in the authorisation and monitoring of CCPs and trade repositories.
(11) One of the basic tasks to be carried out through the European System of Central Banks (ESCB) is to promote the smooth operation of payment systems. In this respect, the members of the ESCB execute oversight by ensuring efficient and sound clearing and payment systems, including CCPs. The members of the ESCB are thus closely involved in the authorisation and monitoring of CCPs, recognition of third-country CCPs and the approval of interoperability arrangements. In addition, they are closely involved in respect of the setting of regulatory technical standards as well as guidelines and recommendations. This Regulation is without prejudice to the responsibilities of the European Central Bank (ECB) and the national central banks (NCBs) to ensure efficient and sound clearing and payment systems within the Union and with other countries. Consequently, and in order to prevent the possible creation of parallel sets of rules, ESMA and the ESCB should cooperate closely when preparing the relevant draft technical standards. Further, the access to information by the ECB and the NCBs is crucial when fulfilling their tasks relating to the oversight of clearing and payment systems as well as to the functions of a central bank of issue.
(12) Uniform rules are required for derivative contracts set out in Annex I, Section C, points (4) to (10) of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments.[18]
(13) Incentives to promote the use of CCPs have not proven to be sufficient to ensure that standardised OTC derivative contracts are in fact cleared centrally. Mandatory CCP clearing requirements for those OTC derivative contracts that can be cleared centrally are therefore necessary.
(14) It is likely that Member States will adopt divergent national measures which could create obstacles to the smooth functioning of the internal market and be to the detriment of market participants and financial stability. A uniform application of the clearing obligation in the Union is also necessary to ensure a high level of investor protection and to create a level playing field between market participants.
(15) Ensuring that the clearing obligation reduces systemic risk requires a process of identification of classes of derivatives that should be subject to that obligation. That process should take into account the fact that not all CCP-cleared OTC derivative contracts can be considered suitable for mandatory CCP clearing.
(16) This Regulation sets out the criteria for determining whether or not different classes of OTC derivative contracts should be subject to a clearing obligation. On the basis of draft regulatory technical standards developed by ESMA, the Commission should decide whether a class of OTC derivative contract is to be subject to a clearing obligation, and from when the clearing obligation takes effect including, where appropriate, phased-in implementation and the minimum remaining maturity of

[18] MiFID.

contracts entered into or novated before the date on which the clearing obligation takes effect, in accordance with this Regulation. A phased-in implementation of the clearing obligation could be in terms of the types of market participants that must comply with the clearing obligation. In determining which classes of OTC derivative contracts are to be subject to the clearing obligation, ESMA should take into account the specific nature of OTC derivative contracts which are concluded with covered bond issuers or with cover pools for covered bonds.

(17) When determining which classes of OTC derivative contracts are to be subject to the clearing obligation, ESMA should also pay due regard to other relevant considerations, most importantly the interconnectedness between counterparties using the relevant classes of OTC derivative contracts and the impact on the levels of counterparty credit risk as well as promote equal conditions of competition within the internal market as referred to in Article 1(5)(d) of Regulation (EU) No 1095/2010.[19]

(18) Where ESMA has identified that an OTC derivative product is standardised and suitable for clearing but no CCP is willing to clear that product, ESMA should investigate the reason for this.

(19) In determining which classes of OTC derivative contracts are to be subject to the clearing obligation, due account should be taken of the specific nature of the relevant classes of OTC derivative contracts. The predominant risk for transactions in some classes of OTC derivative contracts may relate to settlement risk, which is addressed through separate infrastructure arrangements, and may distinguish certain classes of OTC derivative contracts (such as foreign exchange) from other classes. CCP clearing specifically addresses counterparty credit risk, and may not be the optimal solution for dealing with settlement risk. The regime for such contracts should rely, in particular, on preliminary international convergence and mutual recognition of the relevant infrastructure.

(20) In order to ensure a uniform and coherent application of this Regulation and a level playing field for market participants when a class of OTC derivative contract is declared subject to the clearing obligation, this obligation should also apply to all contracts pertaining to that class of OTC derivative contract entered into on or after the date of notification of a CCP authorisation for the purpose of the clearing obligation received by ESMA but before the date from which the clearing obligation takes effect, provided that those contracts have a remaining maturity above the minimum determined by the Commission.

(21) In determining whether a class of OTC derivative contract is to be subject to clearing requirements, ESMA should aim for a reduction in systemic risk. This includes taking into account in the assessment factors such as the level of contractual and operational standardisation of contracts, the volume and the liquidity of the relevant class of OTC derivative contract as well as the availability of fair, reliable and generally accepted pricing information in the relevant class of OTC derivative contract.

(22) For an OTC derivative contract to be cleared, both parties to that contract must be subject to a clearing obligation or must consent. Exemptions to the clearing obligation should be narrowly tailored as they would reduce the effectiveness of the obligation and the benefits of CCP clearing and may lead to regulatory arbitrage between groups of market participants.

(23) In order to foster financial stability within the Union, it might be necessary also to subject the transactions entered into by entities established in third countries to the clearing and risk-mitigation techniques obligations, provided that the transactions concerned have a direct, substantial and foreseeable effect within the Union or where such obligations are necessary or appropriate to prevent the evasion of any provisions of this Regulation.

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[19] This is the ESMA Regulation. See http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:331:0084:0119:EN:pdf.

(24) OTC derivative contracts that are not considered suitable for CCP clearing entail counterparty credit and operational risk and therefore, rules should be established to manage that risk. To mitigate counterparty credit risk, market participants that are subject to the clearing obligation should have risk-management procedures that require the timely, accurate and appropriately segregated exchange of collateral. When preparing draft regulatory technical standards specifying those risk-management procedures, ESMA should take into account the proposals of the international standard setting bodies on margining requirements for non-centrally cleared derivatives. When developing draft regulatory technical standards to specify the arrangements required for the accurate and appropriate exchange of collateral to manage risks associated with uncleared trades, ESMA should take due account of impediments faced by covered bond issuers or cover pools in providing collateral in a number of Union jurisdictions. ESMA should also take into account the fact that preferential claims given to covered bond issuers counterparties on the covered bond issuer's assets provides equivalent protection against counterparty credit risk.

(25) Rules on clearing OTC derivative contracts, reporting on derivative transactions and risk-mitigation techniques for OTC derivative contracts not cleared by a CCP should apply to financial counterparties, namely investment firms... credit institutions... insurance undertakings.. assurance undertakings...reinsurance undertakings... undertakings for collective investments in transferable securities (UCITS) and, where relevant, their management companies... institutions for occupational retirement provision... and alternative investment funds managed by alternative investment fund managers (AIFM)...

(26) Entities operating pension scheme arrangements, the primary purpose of which is to provide benefits upon retirement, usually in the form of payments for life, but also as payments made for a temporary period or as a lump sum, typically minimise their allocation to cash in order to maximise the efficiency and the return for their policy holders. Hence, requiring such entities to clear OTC derivative contracts centrally would lead to divesting a significant proportion of their assets for cash in order for them to meet the ongoing margin requirements of CCPs. To avoid a likely negative impact of such a requirement on the retirement income of future pensioners, the clearing obligation should not apply to pension schemes until a suitable technical solution for the transfer of non-cash collateral as variation margins is developed by CCPs to address this problem. Such a technical solution should take into account the special role of pension scheme arrangements and avoid materially adverse effects on pensioners. During a transitional period, OTC derivative contracts entered into with a view to decreasing investment risks directly relating to the financial solvency of pension scheme arrangements should be subject not only to the reporting obligation, but also to bilateral collateralisation requirements. The ultimate aim, however, is central clearing as soon as this is tenable.....

(29) Where appropriate, rules applicable to financial counterparties, should also apply to non-financial counterparties. It is recognised that non-financial counterparties use OTC derivative contracts in order to cover themselves against commercial risks directly linked to their commercial or treasury financing activities. Consequently, in determining whether a non-financial counterparty should be subject to the clearing obligation, consideration should be given to the purpose for which that non-financial counterparty uses OTC derivative contracts and to the size of the exposures that it has in those instruments. In order to ensure that non-financial institutions have the opportunity to state their views on the clearing thresholds, ESMA should, when preparing the relevant regulatory technical standards, conduct an open public consultation ensuring the participation of non-financial institutions. ESMA should also consult all relevant authorities, for example the Agency for the Cooperation of Energy Regulators, in order to ensure that the particularities of those sectors are fully taken into account.

Moreover, by 17 August 2015, the Commission should assess the systemic importance of the transactions of non-financial firms in OTC derivative contracts in different sectors, including in the energy sector.
(30) In determining whether an OTC derivative contract reduces risks directly relating to the commercial activities and treasury activities of a non-financial counterparty, due account should be taken of that non-financial counterparty's overall hedging and risk-mitigation strategies. In particular, consideration should be given to whether an OTC derivative contract is economically appropriate for the reduction of risks in the conduct and management of a non-financial counterparty, where the risks relate to fluctuations in interest rates, foreign exchange rates, inflation rates or commodity prices.
(31) The clearing threshold is a very important figure for all non-financial counterparties. When the clearing threshold is set, the systemic relevance of the sum of net positions and exposures per counterparty and per class of OTC derivative contract should be taken into account. In that connection, appropriate efforts should be made to recognise the methods of risk mitigation used by non-financial counterparties in the context of their normal business activity.
(32) Members of the ESCB and other Member States' bodies performing similar functions, other Union public bodies charged with or intervening in the management of the public debt, and the Bank for International Settlements should be excluded from the scope of this Regulation in order to avoid limiting their power to perform their tasks of common interest.
(33) As not all market participants that are subject to the clearing obligation are able to become clearing members of the CCP, they should have the possibility to access CCPs as clients or indirect clients subject to certain conditions.
(34) The introduction of a clearing obligation along with a process to establish which CCPs can be used for the purpose of this obligation may lead to unintended competitive distortions of the OTC derivatives market. For example, a CCP could refuse to clear transactions executed on certain trading venues because the CCP is owned by a competing trading venue. In order to avoid such discriminatory practices, CCPs should agree to clear transactions executed in different trading venues, to the extent that those trading venues comply with the operational and technical requirements established by the CCP, without reference to the contractual documents on the basis of which the parties concluded the relevant OTC derivative transaction, provided that those documents are consistent with market standards. Trading venues should provide the CCPs with trade feeds on a transparent and non-discriminatory basis. The right of access of a CCP to a trading venue should allow for arrangements whereby multiple CCPs use trade feeds of the same trading venue. However, this should not lead to interoperability for derivatives clearing or create liquidity fragmentation.
(35) This Regulation should not block fair and open access between trading venues and CCPs in the internal market, subject to the conditions laid down in this Regulation and in the regulatory technical standards developed by ESMA and adopted by the Commission. The Commission should continue to monitor closely the evolution of the OTC derivatives market and should, where necessary, intervene in order to prevent competitive distortions from occurring in the internal market with the aim of ensuring a level playing field in the financial markets.
(36) In certain areas within financial services and trading of derivative contracts, commercial and intellectual property rights may also exist. In instances where such property rights relate to products or services which have become, or impact upon, industry standards, licences should be available on proportionate, fair, reasonable and non-discriminatory terms.
(37) In order to identify the relevant classes of OTC derivative contracts that should be subject to the clearing obligation, the thresholds and systemically relevant non-financial counterparties, reliable data is needed. Therefore, for regulatory purposes, it is important that a uniform derivatives data reporting

requirement is established at Union level. Moreover, a retrospective reporting obligation is needed, to the largest possible extent, for both financial counterparties and non-financial counterparties, in order to provide comparative data, including to ESMA and the relevant competent authorities.

(38) An intragroup transaction is a transaction between two undertakings which are included in the same consolidation on a full basis and are subject to appropriate centralised risk evaluation, measurement and control procedures.... OTC derivative contracts may be recognised within non-financial or financial groups, as well as within groups composed of both financial and non-financial undertakings, and if such a contract is considered an intragroup transaction in respect of one counterparty, then it should also be considered an intragroup transaction in respect of the other counterparty to that contract. It is recognised that intragroup transactions may be necessary for aggregating risks within a group structure and that intragroup risks are therefore specific. Since the submission of those transactions to the clearing obligation may limit the efficiency of those intragroup risk-management processes, an exemption of intragroup transactions from the clearing obligation may be beneficial, provided that this exemption does not increase systemic risk. As a result, adequate exchange of collateral should be substituted to the CCP clearing those transactions, where that is appropriate to mitigate intragroup counterparty risks.

(39) However, some intragroup transactions could be exempted, in some cases on the basis of the decision of the competent authorities, from the collateralisation requirement provided that their risk-management procedures are adequately sound, robust and consistent with the level of complexity of the transaction and there is no impediment to the prompt transfer of own funds or repayment of liabilities between the counterparties. Those criteria as well as the procedures for the counterparties and the relevant competent authorities to be followed while applying exemptions should be specified in regulatory technical standards adopted in accordance with the relevant regulations establishing the ESAs. Before developing such draft regulatory technical standards, the ESAs should prepare an impact assessment of their potential impact on the internal market as well as on financial market participants and in particular on the operations and the structure of groups concerned. All the technical standards applicable to the collateral exchanged in intragroup transactions, including criteria for the exemption, should take into account the prevailing specificities of those transactions and existing differences between non-financial and financial counterparties as well as their purpose and methods of using derivatives....

(41) It is important that market participants report all details regarding derivative contracts they have entered into to trade repositories. As a result, information on the risks inherent in derivatives markets will be centrally stored and easily accessible, inter alia, to ESMA, the relevant competent authorities, the European Systemic Risk Board (ESRB) and the relevant central banks of the ESCB.

(42) The provision of trade repository services is characterised by economies of scale, which may hamper competition in this particular field. At the same time, the imposition of a comprehensive reporting requirement on market participants may increase the value of the information maintained by trade repositories also for third parties providing ancillary services such as trade confirmation, trade matching, credit event servicing, portfolio reconciliation or portfolio compression. It is appropriate to ensure that a level playing field in the post-trade sector more generally is not compromised by a possible natural monopoly in the provision of trade repository services. Therefore, trade repositories should be required to provide access to the information held in the repository on fair, reasonable and non-discriminatory terms, subject to necessary precautions on data protection.

(43) In order to allow for a comprehensive overview of the market and for assessing systemic risk, both CCP-cleared and non-CCP-cleared derivative contracts should be reported to trade repositories.

(44) The ESAs should be provided with adequate resources in order to perform the tasks they are given in

this Regulation effectively.

(45) Counterparties and CCPs that conclude, modify, or terminate a derivative contract should ensure that the details of that contract are reported to a trade repository. They should be able to delegate the reporting of the contract to another entity. An entity or its employees that report the details of a derivative contract to a trade repository on behalf of a counterparty, in accordance with this Regulation, should not be in breach of any restriction on disclosure. When preparing the draft regulatory technical standards regarding reporting, ESMA should take into account the progress made in the development of a unique contract identifier and the list of required reporting data in Annex I, Table 1 of Commission Regulation (EC) No 1287/2006 implementing Directive 2004/39/EC and consult other relevant authorities such as the Agency for the Cooperation of Energy Regulators.

(46) Taking into consideration the principles set out in the Commission's Communication on reinforcing sanctioning regimes in the financial services sector and legal acts of the Union adopted as a follow-up to that Communication, Member States should lay down rules on penalties applicable to infringements of this Regulation. Member States should enforce those penalties in a manner that does not reduce the effectiveness of those rules. Those penalties should be effective, proportionate and dissuasive. They should be based on guidelines adopted by ESMA to promote convergence and cross-sector consistency of penalty regimes in the financial sector. Member States should ensure that the penalties imposed are publicly disclosed, where appropriate, and that assessment reports on the effectiveness of existing rules are published at regular intervals.

(47) A CCP might be established in accordance with this Regulation in any Member State. No Member State or group of Member States should be discriminated against, directly or indirectly, as a venue for clearing services. Nothing in this Regulation should attempt to restrict or impede a CCP in one jurisdiction from clearing a product denominated in the currency of another Member State or in the currency of a third country.

(48) Authorisation of a CCP should be conditional on a minimum amount of initial capital. Capital, including retained earnings and reserves of a CCP, should be proportionate to the risk stemming from the activities of the CCP at all times in order to ensure that it is adequately capitalised against credit, counterparty, market, operational, legal and business risks which are not already covered by specific financial resources and that it is able to conduct an orderly winding-up or restructuring of its operations if necessary.

(49) As this Regulation introduces a legal obligation to clear through specific CCPs for regulatory purposes, it is essential to ensure that those CCPs are safe and sound and comply at all times with the stringent organisational, business conduct, and prudential requirements established by this Regulation. In order to ensure uniform application of this Regulation, those requirements should apply to the clearing of all financial instruments in which the CCPs deal.

(50) It is therefore necessary, for regulatory and harmonisation purposes, to ensure that counterparties only use CCPs which comply with the requirements laid down in this Regulation. Those requirements should not prevent Member States from adopting or continuing to apply additional requirements in respect of CCPs established in their territory including certain authorisation requirements under Directive 2006/48/EC. However, imposing such additional requirements should not influence the right of CCPs authorised in other Member States or recognised, in accordance with this Regulation, to provide clearing services to clearing members and their clients established in the Member State introducing additional requirements, since those CCPs are not subject to those additional requirements and do not need to comply with them. By 30 September 2014, ESMA should draft a report on the impact of the application of additional requirements by Member States.

(51) Direct rules regarding the authorisation and supervision of CCPs are an essential corollary to the obligation to clear OTC derivative contracts. It is appropriate that competent authorities retain responsibility for all aspects of the authorisation and the supervision of CCPs, including the responsibility for verifying that the applicant CCP complies with this Regulation and with Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems, in view of the fact that those national competent authorities remain best placed to examine how the CCPs operate on a daily basis, to carry out regular reviews and to take appropriate action, where necessary.

(52) Where a CCP risks insolvency, fiscal responsibility may lie predominantly with the Member State in which that CCP is established. It follows that authorisation and supervision of that CCP should be exercised by the relevant competent authority of that Member State. However, since a CCP's clearing members may be established in different Member States and they will be the first to be impacted by the CCP's default, it is imperative that all relevant competent authorities and ESMA be involved in the authorisation and supervisory process. This will avoid divergent national measures or practices and obstacles to the proper functioning of the internal market. Furthermore, no proposal or policy of any member of a college of supervisors should, directly or indirectly, discriminate against any Member State or group of Member States as a venue for clearing services in any currency. ESMA should be a participant in every college in order to ensure the consistent and correct application of this Regulation. ESMA should involve other competent authorities in the Member States concerned in the work of preparing recommendations and decisions.

(53) In light of the role assigned to colleges, it is important that all the relevant competent authorities as well as members of the ESCB are involved in performing their tasks. The college should consist not only of the competent authorities supervising the CCP but also of the supervisors of the entities on which the operations of that CCP might have an impact, namely selected clearing members, trading venues, interoperable CCPs and central securities depositories. Members of the ESCB that are responsible for the oversight of the CCP and interoperable CCPs as well as those responsible for the issue of the currencies of the financial instruments cleared by the CCP, should be able to participate in the college. As the supervised or overseen entities would be established in a limited range of Member States in which the CCP operates, a single competent authority or member of the ESCB could be responsible for supervision or oversight of a number of those entities. In order to ensure smooth cooperation between all the members of the college, appropriate procedures and mechanisms should be put in place.

(54) Since the establishment and functioning of the college is assumed to be based on a written agreement between all of its members, it is appropriate to confer upon them the power to determine the college's decision-making procedures, given the sensitivity of the issue. Therefore, detailed rules on voting procedures should be laid down in a written agreement between the members of the college. However, in order to balance the interests of all the relevant market participants and Member States appropriately, the college should vote in accordance with the general principle whereby each member has one vote, irrespective of the number of functions it performs in accordance with this Regulation. For colleges with up to and including 12 members, a maximum of two college members belonging to the same Member State should have a vote and each voting member should have one vote. For colleges with more than 12 members, a maximum of three college members belonging to the same Member State should have a vote and each voting member should have one vote.

(55) The very particular situation of CCPs requires that colleges are organised and function in accordance with arrangements that are specific to the supervision of CCPs.

(56) The arrangements provided for in this Regulation do not constitute a precedent for other legislation

on the supervision and oversight of financial market infrastructures, in particular with regard to the voting modalities for referrals to ESMA.

(57) A CCP should not be authorised where all the members of the college, excluding the competent authorities of the Member State where the CCP is established, reach a joint opinion by mutual agreement that the CCP should not be authorised. If, however, a sufficient majority of the college has expressed a negative opinion and any of the competent authorities concerned, based on that majority of two-thirds of the college, has referred the matter to ESMA, the competent authority of the Member State where the CCP is established should defer its decision on the authorisation and await any decision that ESMA may take regarding conformity with Union law. The competent authority of the Member State where the CCP is established should take its decision in accordance with such a decision by ESMA. Where all the members of the college, excluding the authorities of the Member State where the CCP is established, reach a joint opinion to the effect that they consider that the requirements are not met and that the CCP should not receive authorisation, the competent authority of the Member State where the CCP is established should be able to refer the matter to ESMA to decide on conformity with Union law.

(58) It is necessary to reinforce provisions on exchange of information between competent authorities, ESMA and other relevant authorities and to strengthen the duties of assistance and cooperation between them. Due to increasing cross-border activity, those authorities should provide each other with the relevant information for the exercise of their functions so as to ensure the effective enforcement of this Regulation, including in situations where infringements or suspected infringements may be of concern to authorities in two or more Member States. For the exchange of information, strict professional secrecy is needed. It is essential, due to the wide impact of OTC derivative contracts, that other relevant authorities, such as tax authorities and energy regulators, have access to information necessary to the exercise of their functions.

(59) In view of the global nature of financial markets, ESMA should be directly responsible for recognising CCPs established in third countries and thus allowing them to provide clearing services within the Union, provided that the Commission has recognised the legal and supervisory framework of that third country as equivalent to the Union framework and that certain other conditions are met. Therefore, a CCP established in a third country, providing clearing services to clearing members or trading venues established in the Union should be recognised by ESMA. However, in order not to hamper the further development of cross-border investment management business in the Union, a third-country CCP providing services to clients established in the Union through a clearing member established in a third country should not have to be recognised by ESMA. In this context, agreements with the Union's major international partners will be of particular importance in order to ensure a global level playing field and financial stability.

(60) On 16 September 2010, the European Council agreed on the need for the Union to promote its interest and values more assertively and, in a spirit of reciprocity and mutual benefit, in the context of the Union's external relations and to take steps, inter alia, to secure greater market access for European business and deepen regulatory cooperation with major trade partners.

(61) A CCP should have robust governance arrangements, senior management of good repute and independent members on its board, irrespective of its ownership structure. At least one-third, and no less than two, members of its board should be independent. However, different governance arrangements and ownership structures may influence a CCP's willingness or ability to clear certain products. It is thus appropriate that the independent members of the board and the risk committee to be established by the CCP address any potential conflict of interests within a CCP. Clearing members and clients need to be adequately represented as decisions taken by the CCP may have an impact on them.

(62) A CCP may outsource functions. The CCP's risk committee should advise on such outsourcing. Major activities linked to risk management should not be outsourced unless this is approved by the competent authority.
(63) The participation requirements for a CCP should be transparent, proportionate, and non-discriminatory and should allow for remote access to the extent that this does not expose the CCP to additional risks.
(64) Clients of clearing members that clear their OTC derivative contracts with CCPs should be granted a high level of protection. The actual level of protection depends on the level of segregation that those clients choose. Intermediaries should segregate their assets from those of their clients. For this reason, CCPs should keep updated and easily identifiable records, in order to facilitate the transfer of the positions and assets of a defaulting clearing member's clients to a solvent clearing member or, as the case may be, the orderly liquidation of the clients' positions and the return of excess collateral to the clients. The requirements laid down in this Regulation on the segregation and portability of clients' positions and assets should therefore prevail over any conflicting laws, regulations and administrative provisions of the Member States that prevent the parties from fulfilling them.
(65) A CCP should have a sound risk-management framework to manage credit risks, liquidity risks, operational and other risks, including the risks that it bears or poses to other entities as a result of interdependencies. A CCP should have adequate procedures and mechanisms in place to deal with the default of a clearing member. In order to minimise the contagion risk of such a default, the CCP should have in place stringent participation requirements, collect appropriate initial margins, maintain a default fund and other financial resources to cover potential losses. In order to ensure that it benefits from sufficient resources on an ongoing basis, the CCP should establish a minimum amount below which the size of the default fund is not generally to fall. This should not, however, limit the CCP's ability to use the entirety of the default fund to cover the losses caused by a clearing member's default.
(66) When defining a sound risk-management framework, a CCP should take into account its potential risk and economic impact on the clearing members and their clients. Although the development of a highly robust risk management should remain its primary objective, a CCP may adapt its features to the specific activities and risk profiles of the clients of the clearing members, and if deemed appropriate on the basis of the criteria specified in the regulatory technical standards to be developed by ESMA, may include in the scope of the highly liquid assets accepted as collateral, at least cash, government bonds, covered bonds in accordance with Directive 2006/48/EC subject to adequate haircuts, guarantees callable on first demand granted by a member of the ESCB, commercial bank guarantees under strict conditions, in particular relating to the creditworthiness of the guarantor, and the guarantor's capital links with CCP's clearing members. Where appropriate, ESMA may also consider gold as an asset acceptable as collateral. CCPs should be able to accept, under strict risk-management conditions, commercial bank guarantees from non-financial counterparties acting as clearing members.
(67) CCPs' risk-management strategies should be sufficiently sound so as to avoid risks for the taxpayer.
(68) Margin calls and haircuts on collateral may have procyclical effects. CCPs, competent authorities and ESMA should therefore adopt measures to prevent and control possible procyclical effects in risk-management practices adopted by CCPs, to the extent that a CCP's soundness and financial security is not negatively affected.
(69) Exposure management is an essential part of the clearing process. Access to, and use of, the relevant pricing sources should be granted to provide clearing services in general. Such pricing sources should include those relating to indices that are used as references to derivatives or other financial instruments.
(70) Margins are the primary line of defence for a CCP. Although CCPs should invest the margins

received in a safe and prudent manner, they should make particular efforts to ensure adequate protection of margins to guarantee that they are returned in a timely manner to the non-defaulting clearing members or to an interoperable CCP where the CCP collecting these margins defaults.

(71) Access to adequate liquidity resources is essential for a CCP. It is possible for such liquidity to derive from access to central bank liquidity, creditworthy and reliable commercial bank liquidity, or a combination of both. Access to liquidity could result from an authorisation granted in accordance with Article 6 of Directive 2006/48/EC or other appropriate arrangements. In assessing the adequacy of liquidity resources, especially in stress situations, a CCP should take into consideration the risks of obtaining the liquidity by only relying on commercial banks credit lines.

(72) The "European Code of Conduct for Clearing and Settlement" of 7 November 2006 established a voluntary framework for establishing links between CCPs. However, the post-trade sector remains fragmented along national lines, making cross-border trades more costly and hindering harmonisation. It is therefore necessary to lay down the conditions for the establishment of interoperability arrangements between CCPs to the extent these do not expose the relevant CCPs to risks that are not appropriately managed.

(73) Interoperability arrangements are important for greater integration of the post-trading market within the Union and regulation should be provided for. However, as interoperability arrangements may expose CCPs to additional risks, CCPs should have been, for three years, authorised to clear or recognised in accordance with this Regulation, or authorised under a pre-existing national authorisation regime, before competent authorities grant approval of such interoperability arrangements. In addition, given the additional complexities involved in an interoperability arrangement between CCPs clearing OTC derivative contracts, it is appropriate at this stage to restrict the scope of interoperability arrangements to transferable securities and money-market instruments. However, by 30 September 2014, ESMA should submit a report to the Commission on whether an extension of that scope to other financial instruments would be appropriate.

(74) Trade repositories collect data for regulatory purposes that are relevant to authorities in all Member States. ESMA should assume responsibility for the registration, withdrawal of registration and supervision of trade repositories.

(75) Given that regulators, CCPs and other market participants rely on the data maintained by trade repositories, it is necessary to ensure that those trade repositories are subject to strict operational, record-keeping and data-management requirements.

(76) Transparency of prices, fees and risk-management models associated with the services provided by CCPs, their members and trade repositories is necessary to enable market participants to make an informed choice.

(77) In order to carry out its duties effectively, ESMA should be able to require, by simple request or by decision, all necessary information from trade repositories, related third parties and third parties to which the trade repositories have outsourced operational functions or activities. If ESMA requires such information by simple request, the addressee is not obliged to provide the information but, in the event that it does so voluntarily, the information provided should not be incorrect or misleading. Such information should be made available without delay.

(78) Without prejudice to cases covered by criminal or tax law, the competent authorities, ESMA, bodies or natural or legal persons other than the competent authorities, which receive confidential information should use it only in the performance of their duties and for the exercise of their functions. However, this should not prevent the exercise, in accordance with national law, of the functions of national bodies responsible for the prevention, investigation or correction of cases of maladministration.

(79) In order to exercise its supervisory powers effectively, ESMA should be able to conduct investigations and on-site inspections.
(80) ESMA should be able to delegate specific supervisory tasks to the competent authority of a Member State, for instance where a supervisory task requires knowledge and experience with respect to local conditions, which are more easily available at national level. ESMA should be able to delegate the carrying out of specific investigatory tasks and on-site inspections. Prior to the delegation of tasks, ESMA should consult the relevant competent authority about the detailed conditions relating to such delegation of tasks, including the scope of the task to be delegated, the timetable for the performance of the task, and the transmission of necessary information by and to ESMA. ESMA should compensate the competent authorities for carrying out a delegated task in accordance with a regulation on fees to be adopted by the Commission by means of a delegated act. ESMA should not be able to delegate the power to adopt decisions on registration.
(81) It is necessary to ensure that competent authorities are able to request that ESMA examine whether the conditions for the withdrawal of a trade repository's registration are met. ESMA should assess such requests and take any appropriate measures.
(82) ESMA should be able to impose periodic penalty payments to compel trade repositories to put an end to an infringement, to supply complete and correct information required by ESMA or to submit to an investigation or an on-site inspection.
(83) ESMA should also be able to impose fines on trade repositories where it finds that they have committed, intentionally or negligently, an infringement of this Regulation. Fines should be imposed according to the level of seriousness of the infringement. Infringements should be divided into different groups for which specific fines should be allocated. In order to calculate the fine relating to a particular infringement, ESMA should use a two-step methodology consisting of setting a basic amount and adjusting that basic amount, if necessary, by certain coefficients. The basic amount should be established by taking into account the annual turnover of the trade repository concerned and the adjustments should be made by increasing or decreasing the basic amount through the application of the relevant coefficients in accordance with this Regulation.
(84) This Regulation should establish coefficients linked to aggravating and mitigating circumstances in order to give the necessary tools to ESMA to decide on a fine which is proportionate to the seriousness of the infringement committed by a trade repository, taking into account the circumstances under which that infringement has been committed.
(85) Before taking a decision to impose fines or periodic penalty payments, ESMA should give the persons subject to the proceedings the opportunity to be heard in order to respect their rights of defence.
(86) ESMA should refrain from imposing fines or periodic penalty payments where a prior acquittal or conviction arising from identical facts, or from facts which are substantially the same, has acquired the force of res judicata as a result of criminal proceedings under national law.
(87) ESMA's decisions imposing fines and periodic penalty payments should be enforceable and their enforcement should be subject to the rules of civil procedure which are in force in the State in the territory of which it is carried out. Rules of civil procedure should not include criminal procedural rules but could include administrative procedural rules.
(88) In the case of an infringement committed by a trade repository, ESMA should be empowered to take a range of supervisory measures, including requiring the trade repository to bring the infringement to an end, and, as a last resort, withdrawing the registration where the trade repository has seriously or repeatedly infringed this Regulation. The supervisory measures should be applied by ESMA taking into account the nature and seriousness of the infringement and should respect the principle of

proportionality. Before taking a decision on supervisory measures, ESMA should give the persons subject to the proceedings an opportunity to be heard in order to comply with their rights of defence.
(89) It is essential that Member States and ESMA protect the right to privacy of natural persons when processing personal data, in accordance with Directive 95/46/EC of the European Parliament and of the Council of 24 October 1995 on the protection of individuals with regard to the processing of personal data and on the free movement of such data and with Regulation (EC) No 45/2001 of the European Parliament and of the Council of 18 December 2000 on the protection of individuals with regard to the processing of personal data by the Community institutions and bodies and of the free movement of such data..
(90) It is important to ensure international convergence of requirements for CCPs and trade repositories. This Regulation follows the existing recommendations developed by the Committee on Payment and Settlement Systems (CPSS) and International Organization of Securities Commissions (IOSCO) noting that the CPSS-IOSCO principles for financial market infrastructure, including CCPs, were established on 16 April 2012. It creates a Union framework in which CCPs can operate safely. ESMA should consider these existing standards and their future developments when drawing up or proposing to revise the regulatory technical standards as well as the guidelines and recommendations foreseen in this Regulation.
(91) The power to adopt acts in accordance with Article 290 of the Treaty on the Functioning of the European Union (TFEU) should be delegated to the Commission in respect of amendments to the list of entities exempt from this Regulation, further rules of procedure relating to the imposition of fines or periodic penalty payments, including provisions on the rights of the defence, time limits, the collection of fines or periodic penalty payments and the limitation periods for the imposition and enforcement of penalty payments or fines; measures to amend Annex II in order to take account of developments in the financial markets; the further specification of the type of fees, the matters for which fees are due, the amount of the fees and the manner in which they are to be paid. It is of particular importance that the Commission carry out appropriate consultations during its preparatory work, including at expert level. The Commission, when preparing and drawing up delegated acts, should ensure a simultaneous, timely and appropriate transmission of relevant documents to the European Parliament and to the Council.
(92) In order to ensure consistent harmonisation, power should be delegated to the Commission to adopt the ESAs' draft regulatory technical standards in accordance with Articles 10 to 14 of Regulations (EU) No 1093/2010, (EU) No 1094/2010 and (EU) No 1095/2010 for the application, for the purposes of this Regulation, of points (4) to (10) of Section C of Annex I to Directive 2004/39/EC and in order to specify: the OTC derivative contracts that are considered to have a direct, substantial and foreseeable effect within the Union or the cases where it is necessary or appropriate to prevent the evasion of any provision of this Regulation; the types of indirect contractual arrangements that meet the conditions set out in this Regulation; the classes of OTC derivative contracts that should be subject to the clearing obligation, the date or dates from which the clearing obligation is to take effect, including any phase-in, the categories of counterparties to which the clearing obligation applies, and the minimum remaining maturity of the OTC derivative contracts entered into or novated before the date on which the clearing obligation takes effect; the details to be included in a competent authority's notification to ESMA of its authorisation of a CCP to clear a class of OTC derivative contract; particular classes of OTC derivative contracts, the degree of standardisation of the contractual terms and operational processes, the volume and the liquidity, and the availability of fair, reliable and generally accepted pricing information; the details to be included in ESMA's register of classes of OTC derivative contracts subject to the clearing obligation; the details and type of the reports for the different classes of derivatives; criteria to determine which OTC derivative contracts are objectively measurable as reducing risks directly relating to the commercial activity or

treasury financing activity and values of the clearing thresholds, the procedures and the arrangements in regard to risk-mitigation techniques for OTC derivative contracts not cleared by a CCP; the risk-management procedures, including the required levels and type of collateral and segregation arrangements and the required level of capital; the notion of liquidity fragmentation; requirements regarding the capital, retained earnings and reserves of CCPs; the minimum content of the rules and governance arrangements for CCPs; the details of the records and information to be retained by CCPs; the minimum content and requirements for CCPs' business continuity policies and disaster recovery plans; the appropriate percentage and time horizons for the liquidation period and the calculation of historical volatility to be considered for the different classes of financial instruments taking into account the objective to limit pro-cyclicality and the conditions under which portfolio margining practices can be implemented; the framework for defining extreme but plausible market conditions which should be used when defining the size of the default fund and the resources of CCPs; the methodology for calculating and maintaining the amount of CCPs' own resources; the type of collateral that could be considered highly liquid, such as cash, gold, government and high-quality corporate bonds, covered bonds and the haircuts and the conditions under which commercial bank guarantees can be accepted as collateral; the financial instruments that can be considered highly liquid, bearing minimal credit and market risk, highly secured arrangements and concentration limits; the type of stress tests to be undertaken by CCPs for different classes of financial instruments and portfolios, the involvement of clearing members or other parties in the tests, the frequency and timing of the tests and the key information that the CCP is to disclose on its risk-management model and assumptions adopted to perform the stress tests; the details of the application by trade repositories for registration with ESMA; the frequency and the detail in which trade repositories are to disclose information relating to aggregate positions by class of OTC derivative contract; and the operational standards required in order to aggregate and compare data across repositories.

(93) Any obligation imposed by this Regulation which is to be further developed by means of delegated or implementing acts adopted under Article 290 or 291 TFEU should be understood as applying only from the date on which those acts take effect.

(94) As a part of its development of technical guidelines and regulatory technical standards, and in particular when setting the clearing threshold for non-financial counterparties under this Regulation, ESMA should organise public hearings of market participants.

(95) In order to ensure uniform conditions for the implementation of this Regulation, implementing powers should be conferred on the Commission. Those powers should be exercised in accordance with Regulation (EU) No 182/2011 of the European Parliament and of the Council of 16 February 2011 laying down the rules and general principles concerning mechanisms for control by Member States of the Commission's exercise of implementing powers.

(96) The Commission should monitor and assess the need for any appropriate measures to ensure the consistent and effective application and development of regulations, standards and practices falling within the scope of this Regulation, taking into consideration the outcome of the work performed by relevant international forums.

(97) In view of the rules regarding interoperable systems, it was deemed appropriate to amend Directive 98/26/EC to protect the rights of a system operator that provides collateral security to a receiving system operator in the event of insolvency proceedings against that receiving system operator.

(98) In order to facilitate efficient clearing, recording, settlement and payment, CCPs and trade repositories should accommodate in their communication procedures with participants and with the market infrastructures they interface with, the relevant international communication procedures and

standards for messaging and reference data.
(99) Since the objectives of this Regulation, namely to lay down uniform requirements for OTC derivative contracts and for the performance of activities of CCPs and trade repositories, cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale of the action, be better achieved at Union level, the Union may adopt measures, in accordance with the principle of subsidiarity as set out in Article 5 of the Treaty on European Union. In accordance with the principle of proportionality, as set out in that Article, this Regulation does not go beyond what is necessary in order to achieve those objectives,

Like Dodd-Frank, EMIR is conscious of the need for the EU to interact with other jurisdictions in the regulation of swaps. For example recital number 6 states “The Commission should cooperate with third-country authorities in order to explore mutually supportive solutions to ensure consistency between this Regulation and the requirements established by third countries and thus avoid any possible overlapping in this respect.”But notice that the terminology of the two regimes is different: the EU has CCPs and trade repositories whereas the US has SEFs, DCOs and SDRs. These documents don’t provide much of a basis to analyze the extent to which the two regimes are similar or divergent. But notice that EMIR and the CFTC acknowledge that regulators will need to determine the equivalence of foreign regulatory regimes to their own standards.

Derivatives Regulation: Fighting over the Details

The Dodd-Frank Act in the US and the EU Regulation set the outlines of regulatory regimes for derivatives that are designed to be implemented through more detailed rules.[20] Although both regimes have similar objectives with respect to the regulation of derivatives they are not identical. In the Dodd-Frank Act, Congress directed the SEC and CFTC to study and report to Congress on the regulation of swaps in the US, Asia, and Europe and to identify similarities in regulation and areas of regulation that could be harmonized.[21] The SEC and CFTC noted that members of their staffs were working with regulators in other jurisdictions in the Financial Stability Board’s OTC Derivatives Working Group and in technical dialogs. They noted that progress on implementing reforms to derivatives regulation was proceeding at a different pace in different jurisdictions:

The timing of legislative and regulatory developments differs across jurisdictions. In the United States, the DFA was enacted in July 2010. Most regulations required under Title VII have been proposed, and some regulations have been finalized. Other jurisdictions have been proceeding under different

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[20] For information on the CFTC and Dodd-Frank see http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/index.htm.

[21] *See* CFTC, SEC, Joint Report on International Swap Regulation (Jan. 31, 2012) at http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/dfstudy_isr_013112.pdf.

timeframes. For example, the Japanese legislature adopted statutory amendments in May 2010 that are applicable to the regulation of OTC derivatives, and full implementation is expected by November 2012. European legislators are debating legislation on clearing and TRs that was proposed in September 2010, and technical standards for implementation are expected to be proposed by June 2012. Other jurisdictions have not yet proposed or adopted statutory or regulatory changes, but have published consultation documents to gather public comment on the appropriate regulation of OTC derivatives.

Attempts to elaborate the details of the regimes have given rise to complaints among market participants. The CFTC and SEC published an advance notice of proposed rulemaking in August 2010 setting out proposed definitions relating to the swaps regime.[22] Commentators urged the agencies to clarify the definitions and to ensure that the regime would not involve unnecessary regulation. For example the Financial Services Roundtable wrote:

The Roundtable supports the goals of Title VII to increase regulation and transparency in the over-the-counter (OTC) derivatives market and to reduce the risks in the market. At the same time, we believe it is important to ensure that products and activities that already are subject to regulation or that do not pose systemic risk are not inadvertently captured by the provisions in Title VII.[23]

The American Bankers Association (ABA) and the ABA Securities Association (ABASA) wrote:

Title VII of the Dodd-Frank Act is an extraordinarily complex and, in the words of Treasury Secretary Geithner, "revolutionary" revision to the way swaps, swap markets, and swap market participants are regulated. ABA and ABASA have consistently supported making credit default swaps and other financial products of systemic importance subject to appropriate supervision and oversight designed to increase transparency and better manage these risks. We recognize the legislative directive to strengthen the regulatory framework and infrastructure for the over-the-counter (OTC) swap markets. It is critical, as the Commissions establish regulations to effectuate the Dodd-Frank Act that these regulations do not harm economic growth and job creation by inhibiting banks' ability to provide long-term credit to small business customers and carry out their critical risk management functions.
The activity of our members in the swap markets varies across the size and complexity of our diverse membership. While there are, according to a recent report of the Office of the Comptroller of the Currency (OCC), five large commercial banks that have generated 97% of the notional amount of trades reported by United States banks and hold 86% of its net counterparty swap exposure, many hundreds of our member banks use swaps as financial end -users. The vast majority of banks that use swaps, outside of the large commercial banks that are swap dealers, enter into swaps to mitigate the risks of their ordinary banking activities. In addition, they may provide interest rate swaps to commercial banking customers to hedge their floating rate loans, many of which do not qualify as "eligible contract participants"(ECPs) under the Dodd -Frank Act, and then hedge the interest rate exposure arising from

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[22] CFTC, SEC, Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act 75 Fed. Reg.51429 (Aug. 20, 2010).

[23] *See* http://www.sec.gov/comments/s7-16-10/s71610-57.pdf.

these customer -facing swaps by entering into offsetting swaps in the financial market. Whether a bank is hedging its own balance sheet risk or risks related to individual customer transactions, these swaps are hedging bank assets (either the loans or the cash flows borrowers need to repay them) or bank liabilities (the balance sheet). As a result, many of our members consider themselves to be financial end - users of swaps under the Dodd - Frank Act whose swaps activities and positions are neither of a type nor volume, or do not have the risk characteristics, to warrant registration as a "swap dealer" or "major swap participant" (MSP).

We make these preliminary observations to reflect our concern that through the rulemaking process, our members, who function as financial end-users of swaps, could be designated inappropriately as "major swap participants". This would increase the cost of risk mitigation activities unnecessarily for these banks and their customers, without contributing to the achievement of the public policy aims of the relevant provisions of the new law.

We are also concerned that creditworthy borrowers will be unable or unwilling to hedge their loans under the new regime. Exchange traded derivatives may not provide the customer with an effective hedge, and small creditworthy borrowers may not be able to afford the increased costs associated with exchange-traded derivatives. This will adversely affect small businesses that are least able to afford the increase in end-user costs and will place them at a competitive disadvantage to larger companies that as ECPs are allowed to hedge with their banks. Rather than reducing risk, this result would make lending to non-ECP customers more risky, because it would prevent the customer from hedging the loan (a bank asset) and thereby protecting both the customer and the bank. Together, these outcomes would increase the costs of funds for small businesses and other commercial customers. Therefore, we offer the following comments to assist the Commissions in crafting clear definitions that will allow banks to be excluded from the definition of an MSP when they limit their swap activities to serving the commercial and hedging needs of customers in addition to hedging the institution's own financial risks. We also offer a suggestion regarding the ECP definition that will allow creditworthy small business customers to continue to hedge their loans with banks....[24]

The CFTC and SEC issued an NPR relating to definitions in December 2010 which stated:

The rules not only will help determine which entities will be subject to comprehensive regulation of their swap and security-based swap activities, but may also cause certain entities to modify their activities to avoid being subject to the regulations. As a result, we are aware of the importance of crafting these rules carefully to maximize the benefits of the regulation imposed by the Dodd-Frank Act, and to do so in a way that is flexible enough to respond to market developments. While we preliminarily believe that these proposals, if adopted, would appropriately effect the intent of the Dodd-Frank Act, we are very interested in commenters' views as to whether we have achieved this purpose, and, if not, how to improve these proposals.[25]

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[24] *See* http://www.sec.gov/comments/s7-16-10/s71610-26.pdf.

[25] CFTC, SEC, Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant"and "Eligible Contract Participant", 75 Fed. Reg. 80174 (December 21, 2010).

The American Bankers' Association expressed concern that banks that entered into swaps with their customers when they originated a loan (the Dodd-Frank Act contains an exemption relating to such activity) should not be treated as swap dealers:

The definition of swap dealer in the Dodd-Frank Act includes entities that hold themselves out as dealers or regularly enter into swaps as an ordinary course of business, but it exempts any insured depository institution "to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer."This exemption shows that Congress recognized that swaps are an important risk -mitigating tool for banks and borrowers.

Banks commonly enter into swaps with customers so that customers can hedge their interest rate or other loan-related risks. While some swaps are entered into simultaneously with loans, many swaps are entered into before or after a loan is made. For example, it is common for a customer to enter into a swap to lock in an interest rate in anticipation of a future loan. If a loan has a variable interest rate, it is also common for a customer to enter into a swap during the course of the loan to convert to fixed -rate payment obligations. A loan and swap may also be purchased by another lender or assigned and novated if the lender exits certain business lines. Banks entering into these and other common loan transactions should be exempt from the swap dealer definition
to the extent they would not otherwise be deemed to be swap dealers.

ABA urges the CFTC to implement an IDI exemption that encompasses all common lending transactions, in order to preserve the ability to manage risks and thereby protect a variety of credit options for businesses of all sizes working to create jobs and grow the economy. We also urge the CFTC to confirm that a bank entering into an offsetting swap to manage its own risk would not be deemed a swap dealing activity. Failing to take these steps would raise costs for banks and borrowers and discourage rather than encourage risk- mitigating transactions for ordinary business activities at a time when lending is most needed. If all common lending practices are not taken into consideration, a bank that is not excluded from the swap dealer definition might also have to create a separate entity to conduct certain swaps activities, because swap dealers will be ineligible for "federal assistance," defined under the statute (mistakenly) as extending to FDIC insurance. Forming an affiliate to continue to provide swaps to loan customers would be expensive and require additional regulatory capital, so it would not be an option for all banks. Instead, many banks would stop entering into certain types of swaps in connection with originating loans, which would raise costs for borrowers and limit their options for using swaps to hedge risk. It might cause those banks to lose loan business as well..

In the rule proposal, the CFTC has asked for comment on whether the IDI exemption should be limited to swaps entered into contemporaneously with loans. We believe that such a limitation would be too restrictive, since it would not take into account common lending practices that include entering into swaps to hedge or mitigate loan-related risk at other times during the lending relationship.

Origination is a broad concept in the context of a lending relationship, since both swaps and funding can occur at many points during the term of the financing. Banks and customers need the flexibility to manage risk during the entire course of a loan, and we concur with the Office of the Comptroller of the Currency (OCC) that the IDI exemption should be "tailored to allow for ongoing hedging that is connected to an extension of credit."Accordingly, we urge the CFTC to take into consideration all common bank lending practices in implementing the IDI exemption and enable banks to rely on the exemption during all phases of the lending relationship.

The Dodd-Frank Act requires that the swap must be in connection with originating a loan, but it does not require that the swap be done simultaneously with the origination or within any particular time period.

Rather, it requires that the swap be entered into "in connection with originating a loan." While we understand the CFTC faces a challenge in interpreting the phrase "originating a loan," we would like to emphasize that a bank may make the decision to originate a loan for many different reasons. In many cases, the bank might not have been willing to make the loan or extend credit unless the customer hedges its interest rate, commodity, currency, or other risk. For example, the customer may want to lock in an interest rate while negotiating the terms of a loan, and the bank may be more likely to extend credit if it knows the customer has already taken appropriate measures to hedge its exposure. Alternatively, a customer may not want to enter into a swap until it draws down on a revolving line of credit. Accordingly, while some swaps may be entered into simultaneously with a loan, common lending practices enable customers to hedge their loans at the time that makes the most economic sense from the customer's perspective. Some banks have estimated that only 50 -60% of their swaps done in connection with originating loans are entered into the same day they sign loan documents with a customer.

Many customers want to separate the time that they fix the interest rate from the time that the loan funds. Some customers may need to use a swap in anticipation of a loan so that they know what their costs will be before being able to determine the amount that they can or should borrow. Other customers may need the ability to use a swap during the course of the loan to convert a floating to a fixed interest rate so that there is an upper limit on their debt obligations. Borrowers need the flexibility to evaluate changes in the interest rate and economic environment during the course of a loan in order to determine their hedging needs. A bank should be able to rely on the IDI exemption and not be designated a swap dealer – and incur significant costs and additional regulatory oversight – simply because the bank is accommodating customer needs for flexible risk hedging options.

Some common examples of swaps entered into in connection with originating loans but not the same day as the loan include —

- Interest rate swaps to set a fixed interest rate in anticipation of a loan. These swaps are most common for real estate, equipment, or other loans related to assets with fixed cash flows, and the swaps are typically subject to termination if the loan does not close. They are most frequently entered into within ninety (90) days before a loan closes, but it is also common for a swap to be entered into a year or more before a real estate loan closes or funds if construction must be completed.
- Swaps entered into during the course of the loan to convert from a floating to a fixed interest rate or vice versa. If interest rates rise, entering into a swap to convert from a floating to a fixed rate simultaneously enables customer s to hedge loan exposure by fixing their maximum payment obligation and decreases default risk for banks. It also decreases the bank's credit exposure, because cash flows are predictable. If interest rates move lower, entering into a swap to convert from a fixed to a floating rate enables customers to lower their payment obligations, which increases their profit margins and thereby improves their ability to meet their payment obligations. Borrowers want to have the option to enter into a swap at any time during the course of a loan so that they have a low-cost way to retain a competitive cost structure in the prevailing interest rate environment.
- Swaps entered into pursuant to a hedging covenant in a loan agreement. These are most frequently entered into within ninety (90) days of the loan closing, but it is also common for them to be entered into 180 days, a year, or sometimes even longer after the loan closes. For example, the terms of a commercial loan facility may require the borrower to comply with certain conditions such as entering into a swap to hedge risk at any time before being able to draw on the facility.
- Swaps entered into at the time a borrower receives an advance or draws down on a line of credit.
- Swaps may be purchased by another lender, assigned and novated if the lender exits certain business

lines, or restructured during a debt workout[26]

In 2012 the CFTC and SEC adopted a **Final Rule with Respect to Swap Definitions** — the Federal Register notice was 170 pages long (and this is only one of the implementing rules with respect to Title VII).[27] Here is an excerpt from the Adopting Release:

The proposed rules to define the activities that would lead a person to be a "swap dealer" and "security-based swap dealer" were based closely on the corresponding language of the statutory definitions. The Proposing Release further noted that the Dodd-Frank Act defined the terms "swap dealer" and "security -based swap dealer" in a functional manner, and stated that those statutory definitions should not be interpreted in a constrained, overly technical or rigid manner, particularly given the diversity of the swap and security-based swap markets. The Proposing Release also identified potential distinguishing characteristics of swap dealers and security-based swap dealers based on the functional role that dealers fulfill in the swap and security-based swap markets, such as: dealers tend to accommodate demand from other parties; dealers generally are available to enter into swaps or security-based swaps to facilitate other parties' interest; dealers tend not to request that other parties propose the terms of swaps or security-based swaps, but instead tend to enter into those instruments on their own standard terms or on terms they arrange in response to other parties' interest; and dealers tend to be able to arrange customized terms for swaps or security-based swaps upon request, or to create new types of swaps or security-based swaps at the dealer's own initiative...

Consistent with the statutory definition, the proposed rule stated that the term "swap dealer" includes a person that "regularly enters into swaps with counterparties as an ordinary course of business for its own account," but also that "the term swap dealer does not include a person that enters into swaps for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business." The Proposing Release stated that these two provisions should be read in combination with each other, and explained that the difference between the two provisions is whether or not the person enters into swaps as a part of, or as an ordinary course of, a "regular business." Thus, the Proposing Release equated the phrases "ordinary course of business" and "regular business." The Proposing Release also stated that persons who enter into swaps as a part of a "regular business" are those persons whose function is to accommodate demand for swaps from other parties and enter into swaps in response to interest expressed by other parties. Such persons would be swap dealers. Conversely, the Proposing Release said that persons who do not fulfill this function in connection with swaps should not be deemed to enter into swaps as part of a "regular business," and thus would not likely be swap dealers.

In addition, the Proposing Release noted that the nature of swaps precludes importing concepts used to identify dealers in other areas. The Proposing Release explained that because swaps are typically not bought and sold, concepts such as whether a person buys and sells swaps, makes a two -sided market in swaps, or trades within a bid/offer spread cannot necessarily be used to determine if the person is a swap

[26] *See* http://www.sec.gov/comments/s7-39-10/s73910-138.pdf.

[27] CFTC, SEC, Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant"and "Eligible Contract Participant", 77 Fed. Reg. 30596 (May 23, 2012).

dealer, even if such concepts are useful in determining whether a person is a dealer in other financial instruments.

The Proposing Release further stated that swap dealers can be identified through their relationships with counterparties, explaining that swap dealers tend to enter into swaps with more counterparties than do non-dealers, and in some markets, non-dealers tend to constitute a large portion of swap dealers' counterparties. In contrast, the Proposing Release said, non-dealers tend to enter into swaps with swap dealers more often than with other non-dealers. The Proposing Release noted that it is likely that swap dealers are involved in most or all significant parts of the swap markets.

The Proposing Release concluded that this functional approach would identify as swap dealers those persons whose function is to serve as the points of connection in the swap markets. Thus, requiring registration and compliance with the requirements of the Dodd-Frank Act by such persons would thereby reduce risk and enhance operational standards and fair dealing in those markets. The Proposing Release also noted that the swap markets are diverse and encompass a wide variety of situations in which parties enter into swaps with each other, and invited comment as to what aspects of the parties' activities in particular situations should, or should not, be considered swap dealing activities. Specifically, the Proposing Release invited comment regarding persons who enter into swaps: (i) as aggregators; (ii) as part of their participation in physical markets; or (iii) in connection with the generation and transmission of electricity....

..several commenters addressed the extraterritorial application of the definitions of the terms "swap dealer," "security-based swap dealer," "major swap participant," "major security -based swap participant," and "eligible contract participant." In general, the commenters addressed when and how the definitions should be applied to persons based outside the U.S. and how the definitions should take account of non-U.S. requirements that may be applicable to such persons. The Commissions intend to separately address issues related to the application of these definitions to non-U.S. persons...

The final rule includes modifications from the proposed rule that are described below, including provisions stating that swaps entered into for hedging physical positions as defined in the rule, swaps between majority-owned affiliates, swaps entered into by a cooperative with its members, and certain swaps entered into by registered floor traders, are excluded from the swap dealer determination. The Commissions, in consideration of comments received, are also making certain modifications to the interpretive guidance set out in the Proposing Release with respect to various elements of the statutory definition of the term "swap dealer,"

The determination of whether a person is covered by the statutory definition of the term "swap dealer" requires application of various provisions of the rule further defining that term well as the interpretive guidance in this Adopting Release, depending on the person's particular circumstances. We intend that the determination with respect to a particular person would proceed as follows.

The person would begin by applying the statutory definition, and the provisions of the rule which implement the four statutory tests and the exclusion for swap activities that are not part of "a regular business,"in order to determine if the person is engaged in swap dealing activity. In that analysis, the person would apply the interpretive guidance described in this part.. which provides for consideration of the relevant facts and circumstances. As part of this consideration, the person would apply elements of the dealer- trader distinction, as appropriate...

The rule provides that certain swaps are not considered in the determination of whether a person is a swap dealer. In particular, swaps entered into by an insured depository institution with a customer in connection with originating a loan with that customer, swaps between majority-owned affiliates, swaps entered into by a cooperative with its members, swaps entered into for hedging physical positions as

defined in the rule, and certain swaps entered into by registered floor traders are excluded from the swap dealer determination.
If, after completing this review (taking into account the applicable interpretive guidance and excluding any swaps as noted above), the person determines that it is engaged in swap dealing activity, the next step is to determine if the person is engaged in more than a de minimis quantity of swap dealing. If so, the person is a swap dealer. When the person registers, it may apply to limit its designation as a swap dealer to specified categories of swaps or specified activities of the person in connection with swaps....

The statutory definition of the term "swap dealer" excludes an insured depository institution ("IDI") "to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer." Proposed CFTC Regulation § 1.3(ggg)(5) would implement this statutory exclusion by providing that an IDI's swaps with a customer in connection with originating a loan to that customer are disregarded in determining if the IDI is a swap dealer. In order to prevent evasion, the proposed rule further provided that the statutory exclusion does not apply where the purpose of the swap is not linked to the financial terms of the loan; the IDI enters into a "sham" loan; or the purported "loan" is actually a synthetic loan such as a loan credit default swap or loan total return swap. This exclusion does not appear in the definition of the term "security- based swap dealer."...
Nearly all the commenters on this issue were IDIs seeking a broad interpretation of the exclusion. The commenters addressed four primary issues: (I) the type of swaps that should be covered by the exclusion; (ii) the time period during which parties would be required to enter into the swap in order for the swap to be considered to be "in connection with originating a loan;" (iii) which transactions should be deemed to be "loans" for purposes of the exclusion; and (iv) which entities should be included within the definition of IDI.
First, regarding the type of swapthat should be covered by the exclusion, as proposed,§ 1.3(ggg)(5) would require that the rate, asset, liability or other notional item underlying the swap be, or be directly related to, a financial term of the loan (such as the loan's principal amount, duration, rate of interest or currency). Some commenters agreed with the principle of limiting the exclusion to swaps that are connected to the financial terms of the loan, stating that the exclusion should cover any swap between a borrower and the lending IDI, so long as the swap's notional amount is no greater than the loan amount, the swap's duration is no longer than the loan's duration, and the swap's index and payment dates match the index and payment dates of the loan. Another commenter, agreeing with the proposed approach, said that there is no basis to extend the loan origination exclusion to swaps related to the borrower's business risks, as opposed to the financial terms of the loan. Other commenters, though, said that this limitation to swaps connected to the financial terms of the loan was inappropriate or inconsistent with the Dodd-Frank Act, and that any swap required by the loan agreement or required by the IDI as a matter of prudent lending should be covered by the exclusion. Some of the commenters arguing for the broader exclusion emphasized that the exclusion should be available for any swap with the lending IDI which reduces the borrower's risks, such as a commodity swap the borrower uses for hedging, because reduction of commodity price risks faced by the borrower also reduces the risk that the loan will not be repaid to the IDI. Commenters said that if the exclusion does not apply to swaps hedging the borrower's commodity price risks, then only IDIs that are able to create a separately capitalized affiliate will be able to offer commodity swaps (because section 716 of the Dodd-Frank Act limits the ability of IDIs to offer commodity swaps), thereby reducing the availability of commodity swaps to borrowers that are smaller companies.
Second, regarding timing, the proposed rule requested comment on whether this exclusion should apply

only to swaps that are entered into contemporaneously with the IDI's origination of the loan (and if so, how "contemporaneously" should be defined for this purpose), or whether this exclusion also should apply to swaps entered into during part or all of the duration of the loan. In response, commenters said that the exclusion should apply to swaps entered into in anticipation of a loan or at a ny time during the loan term. Commenters said that application of the exclusion throughout the duration of the loan would give IDIs and borrowers flexibility as to when to fix interest rates in fixed/floating swaps relating to loans and would allow borrowers to make other hedging decisions over a longer time period. Commenters also said that loans such as construction loans, equipment loans and committed loan facilities may allow for draws of loan principal over an extended period of time, and that swaps entered into by the borrower and lending IDI through the course of such a loan should be covered by the exclusion.

Third, as to which transactions should be deemed "loans" for purposes of the exclusion, the proposal said that the exclusion should be available in connection with all transactions by which an IDI is a source of funds to a borrower, including, for example, loan syndications, participations and refinancings. Commenters agreed that the exclusion should be available for IDIs that are in a loan syndicate, purchasers of a loan, assignees of a loan or participants in a loan. On loan syndications and participations in particular, one commenter said that the exclusion should be available even if the notional amount of the swap is more than the amount of the loan tranche assigned to the IDI, so long as the swap notional amount is not more than the entire amount of the loan. Another commenter said that the exclusion should not be available if the IDI's participation in the loan drops below a minimum level (such as 20 percent) because such use of the exclusion by minimally-participating IDIs would invite abuse. Some commenters said that other types of transactions also should be treated as "loans" for purposes of the exclusion. The transactions cited by commenters in this regard include leases, letters of credit, financings documented as sales of financial assets, bank qualified tax exempt loans and bonds that are credit enhanced by an IDI. Other commenters said the exclusion should apply where entities related to an IDI provide financing, such as loans or financial asset purchases by bank -sponsored commercial paper conduits where the IDI provides committed liquidity, and transactions where a special purpose entity formed by an IDI is the source of financing and enters into the swap. Some commenters said the exclusion should encompass all transactions where an IDI facilitates a financing, or all extensions of credit by an IDI, or all transactions where an IDI provides risk mitigation to a borrower.

Fourth, with respect to the types of financial institutions that are eligible for the loan origination exclusion, three commenters said that IDIs, for purposes of this exclusion, encompass more than banks or savings associations with federally-insured deposits. The Farm Credit Council said the exclusion should be extended to Farm Credit System institutions because one of these institutions enters into interest rate swaps with borrowing customers identical in function to those offered by commercial banks and savings associations in connection with loans, and the institutions are subject to similar regulatory requirements and covered by a similar insurance regime. Another commenter said that the exclusion should be extended to other regulated financial institutions, such as insurers, so as not to create an unlevel playing field. And the Federal Home Loan Banks said that the exclusion should be available to them because they are subject to similar regulatory oversight and capital standards and engage in a similar function of extending credit as do commercial banks and savings associations. In addition, some commenters said the exclusion should be broadly construed as a general matter, to encourage competition in the swap market between smaller and larger banks and to increase borrowers' choice among potential swap providers. wo commenters asked for clarification of the following technical points in the proposed rule: (i) whether a swap would be covered by the exclusion even if it does not hedge all the risks under the loan, (ii) whether a swap that is within the exclusion could continue to be treated as covered by the exclusion by an IDI if the IDI transfers the loan, and (iii) whether an IDI should count swaps covered by the exclusion in determining if its dealing activity is above the de minimis thresholds. Another commenter asked whether an IDI with swaps that are covered by the exclusion could be a swap dealer based on other dealing activity. And others asked whether the exclusion would cover swaps used by an IDI to hedge its risks arising from a loan (i.e., a swap which the IDI enters into with a party other than the loan borrower).

Final rule

The CFTC believe s that the extent of this exclusion should be determined by the language of the statutory definition, which relates to an IDI that "offers to enter into a swap with a customer in connection with originating a loan with that customer." The expansive interpretation of the exclusion advanced by some commenters, however, would read the statute to exclude almost any swap that an IDI enters into with a loan customer. That is not the exclusion that was enacted. Instead, we interpret the statutory phrase "enter into a swap with a customer in connection with originating a loan with that customer" to mean that the swap is directly connected to the IDI's process of originating the loan to the customer.

Because of the statute's direct reference to "originating" the loan, it would be inappropriate to construe the exclusion as applying to all swaps entered into between an IDI and a borrower at any time during the duration of the loan. If this were the intended scope of the statutory exclusion, there would be no reason for the text to focus on swaps in connection with "originating" a loan. The CFTC recognizes the concern expressed by commenters that : (i) there be flexibility regarding when the IDI and borrower enter into a swap relating to a loan, and (ii) the expectation when an IDI originates a loan with a customer is often that the customer will enter into a swap with the IDI when there is a subsequent advance, or a draw, of principal on the loan. We do not believe, however, that the statutory term "origination" can reasonably be stretched to cover the entire term of every loan that an IDI makes to its customers. At some point, the temporal distance renders the link to loan origination too attenuated, and the risk of evasion too great, to support the exclusion. In order to balance these competing and conflicting considerations, the final rule applies the exclusion to any swap that otherwise meets the terms of the exclusion and is entered into no more than 90 days before or 180 days after the date of execution of the loan agreement, or no more than 90 days before or 180 days after the date of any transfer of principal to the borrower from the IDI (e.g., a draw of principal) pursuant to the loan, so long as the aggregate notional amount of the swaps in connection with the financial terms of the loan at any time is no more than the aggregate amount of the borrowings under the loan at that time.

Since a loan involves the repayment of funds to the IDI on particular terms, a swap that relates to those terms of repayment should be covered by the exclusion. In addition, we recognize that, as stated by commenters, requirements in an IDI's loan underwriting criteria relating to the borrower's financial stability are an important part of ensuring that loans are repaid. Therefore, the final rule modifies the proposed rule to provide that the exclusion applies to swaps between an IDI and a loan borrower that are connected to the financial terms of the loan, such as, for example, the loan's duration, interest rate, currency or principal amount, or that are required under the IDI's loan underwriting criteria to be in place as a condition of the loan in order to hedge commodity price risks incidental to the borrower's business. The first category of swaps generally serve to transform the financial terms of a loan for purposes of adjusting the borrower's exposure to certain risks directly related to the loan itself, such as risks arising from changes in interest rates or currency exchange rates. The second category of swaps mitigate risks faced by both the borrower and the lender, by reducing risks that the loan will not be repaid. Thus, both types of swaps are directly related to repayment of the loan. Although some commenters said that this exclusion should also apply to other types of swaps, we believe it would be inappropriate to construe this exclusion as encompassing all swaps that are connected to a borrower's other business activities, even if the loan agreement requires that the borrower enter into such swaps or otherwise refers to them. In contrast to a swap that transforms the financial terms of a loan or is required by the IDI's loan underwriting criteria to reduce the borrower's commodity price risks, other types of swaps serve a more general risk management purposes by reducing other risks related to the borrower or the loan. If the purpose of the exclusion were to cover the broad range of swaps cited by some commenters (such as all swaps reducing a borrower's business risks), then the terms of the statute limiting the exclusion to swaps that are "in connection with originating a loan with that customer" would be superfluous.

Regarding the types of transactions that will be treated as a "loan" for purposes of the exclusion, courts have defined the term "loan" in other statutory contexts based on the settled meaning of the term under common law. This definition encompasses any contract by which one party transfers a defined quantity of money and the other party agrees to repay the sum transferred at a later date. To give effect to the statutory text, the exclusion is limited to a swap that is connected to the financial terms of the loan or is required by the IDI's loan underwriting criteria to to be in place as a condition of the loan in order to hedge commodity price risks incidental to the borrower's business. Rather than examine at this time the many particularized examples of financing transactions cited by some commenters, the term "loan" for purposes of this exclusion should be interpreted in accordance with this settled legal meaning.

As stated in the proposed rule, this exclusion is available to all IDIs that are a source of a transfer of money to a borrower pursuant to a loan. The final rule adopts provisions from the proposed rule that the exclusion is available to an IDI that is a source of money by being part of a loan syndicate, being an assignee of a loan, obtaining a participation in a loan, or purchasing a loan. However, the proposed rule did not state explicitly how the notional amount of a swap subject to the exclusion must relate to the amount of money provided by an IDI that is in a loan syndicate or is an assignee of, participant in or purchaser of a loan. In this regard, some commenters said that a borrower and the IDIs in a lending syndicate need flexibility to allocate responsibility for the swap(s) related to the loan as they may agree. We believe that, to allow for this flexibility, the exclusion may apply to a swap (which is otherwise covered by the exclusion) even if the notional amount of the swap is different from the amount of the loan tranche assigned to the IDI. However, we also agree with a commenter that the IDI should have a substantial participation in the loan. The requirement of substantial participation would prevent an IDI from applying the exclusion where the IDI makes minimal lending commitments in multiple loan syndicates where it offers swaps, causing its swap activity to be far out of proportion to its loan activity. Therefore, the final rule includes a provision that the exclusion may apply regardless of whether the notional amount of the swap is the same as the amount of the loan, but only if the IDI is the sole source of funds under the loan or is committed to be, under the applicable loan agreements, the source of at least 10 percent of the maximum principal amount under the loan. If the IDI does not meet this 10 percent threshold, the final rule provides that the exclusion may apply only if the aggregate notional amount of all the IDI's swaps with the customer related to the financial terms of the loan is no more than the amount lent by the IDI to the customer. We also note that, in all cases, application of the exclusion requires that the aggregate notional amount of all swaps entered into by the borrower with any person in connection with the financial terms of the loan at any time is not more than the aggregate principal amount outstanding under the loan at that time.

We also reiterate the interpretation in the Proposing Release that the word "offer" in this exclusion includes scenarios where the IDI requires the customer to enter into a swap, or where the customer asks the IDI to enter into a swap, specifically in connection with a loan made by that IDI.

We also continue to emphasize, as stated in the Proposing Release, that the statutory language of the exclusion limits its availability to only IDIs as defined in the statute. Regarding some commenters' statements about the competitive effect of this interpretation of the term "insured depository institution," we believe that the scope of application of the swap dealer definition to various entities should be treated in the de minimis exception, which is available to all persons...

..we believe it is appropriate to require that an IDI claiming the exclusion report its swaps that are covered by the exclusion to a swap data repository (" SDR "). This requirement is consistent with the prevailing practice that IDIs handle the documentation of loans made to borrowers, and will provide for consistent reporting of swaps that are covered by the exclusion, thereby allowing the CFTC and other regulators to monitor the use of the exclusion.

In sum, the final rule balances the need for flexibility in response to existing lending practices, consistent with the constraints imposed by the statutory text as enacted, against the risk of establishing a gap in the regulatory framework enacted in Title VII.

Elisse Walter of the SEC spoke to the Senate Committee on Banking, Housing, and Urban Affairs in February 2013 about the SEC's work to implement Dodd-Frank (including comments on the issue of the territorial reach of the US swaps rules)

Among the key provisions of the Dodd-Frank Act are those that establish a new oversight regime for the over-the counter ("OTC") derivatives marketplace. Title VII of the Act requires the Commission to regulate "security-based swaps" and to write rules that address, among other things, mandatory clearing, reporting and trade execution, the operation of clearing agencies, data repositories and trade execution facilities, capital and margin requirements and business conduct standards for dealers and major market participants, and public transparency for transactional information....

In implementing Title VII, Commission staff is in regular contact with the staffs of the CFTC, the Board of Governors of the Federal Reserve System ("Board") , and other federal financial regulators, and in particular has consulted and coordinated extensively with CFTC staff.

Adoption of Key Definitional Rules

In July 2012, the Commission adopted final rules and interpretations jointly with the CFTC regarding key product definitions under Title VII. This effort follows the Commission's work on the entity definitions rules, which the Commission adopted jointly with the CFTC in April 2012.The completions of these joint rulemakings are foundational steps toward the complete implementation of Title VII.

The July joint rulemaking addressed certain product definitions and further defined the key terms "swap," "security-based swap," and "security-based swap agreement." It also adopted rules regarding the regulation of "mixed swaps" and the books and records requirements for security-based swap agreements. The April joint rulemaking further defined the key terms "swap dealer" and "security-based swap dealer," providing guidance as to what constitutes dealing activity, and distinguishing dealing from non-dealing activities such as hedging. The rulemaking also implemented the Dodd-Frank Act's statutory de minimis exception to the security-based swap dealer definition in a way tailored to reflect the different types of security-based swaps. Additionally, the rulemaking implemented the Dodd-Frank Act's "major security-based swap participant" definition through the use of three objective tests.

While foundational, these final rules did not trigger compliance with the other rules the Commission is adopting under Title VII. Instead, the compliance dates applicable to each final rule will be set forth in the adopting release for the applicable rule. In this way, the Commission is better able to provide for an orderly implementation of the various Title VII rules.

Adoption of Rules and Other Action related to Clearing
...In October 2012, the Commission adopted a rule that establishes operational and risk management standards for clearing agencies, including clearing agencies that clear security-based swaps.[28] The rule... is designed to help ensure that clearing agencies will be able to fulfill their responsibilities in the multi-trillion dollar derivatives market as well as in more traditional securities markets.
In June 2012, the Commission adopted rules that establish procedures for its review of certain actions undertaken by clearing agencies. These rules detail how clearing agencies will provide information to the Commission about the security-based swaps the clearing agencies plan to accept for clearing, which will then be used by the Commission to aid in determining whether those security-based swaps are required to be cleared...
In addition, in December 2012, the Commission issued an order providing exemptive relief in connection with a program to commingle and portfolio margin customer positions in cleared credit default swaps which include both swaps and security-based swaps. Portfolio margining may be of benefit to investors and the market by, among other things, promoting greater efficiency in clearing, helping to alleviate excessive margin calls, improving cash flow and liquidity, and reducing volatility. Previously, in March 2012, the Commission had adopted rules providing exemptions under the Securities Act of 1933 ("Securities Act"), the Securities Exchange Act of 1934 ("Exchange Act"), and the Trust Indenture Act of 1939 for security-based swaps transactions involving certain clearing agencies satisfying certain conditions....

Provision of Legal Certainty
Consistent with our commitment to an orderly Title VII implementation process, the Commission has taken a number of steps to provide legal certainty and avoid unnecessary market disruption that might otherwise have arisen as a result of final rules not having been adopted by the July 16, 2011 effective date of Title VII. Specifically, we have:
Provided guidance regarding which provisions in Title VII governing security-based swaps became operable as of the effective date and provided temporary relief from several of these provisions;
Provided guidance regarding – and, where appropriate, interim exemptions from – the various pre-Dodd-Frank provisions that otherwise would have applied to security-based swaps on July 16, 2011; and
Provided temporary relief for entities providing certain clearing services for security-based swaps.22

Next Steps for Implementation of Title VII: Application of Title VII in the Cross-Border Context
With very limited exceptions, the Commission has not addressed the application of the security-based swap provisions of Title VII in the cross-border context in its proposed or final rules. Rather than addressing these issues in a piecemeal fashion through each of the various substantive rulemakings implementing Title VII, we instead plan to address them holistically in a single proposing release. We believe this approach will provide investors, market participants, foreign regulators, and other interested parties with the opportunity to consider, as an integrated whole, the Commission's proposed approach to the application of the security-based swap provisions of Title VII in the cross-border context.

[28] SEC, Clearing Agency Standards, 77 Fed. Reg.66220 (Nov. 2, 2012).

As we have indicated previously, we expect the scope of the effort to be broad. The proposal will address the application of Title VII in the cross-border context with respect to each of the major registration categories covered by Title VII for security-based swaps: security-based swap dealers; major security-based swap participants; security-based swap clearing agencies; security-based swap data repositories; and security-based swap execution facilities. It also will address the application of Title VII in connection with reporting and dissemination, clearing, and trade execution, as well as the sharing of information with regulators and related preservation of confidentiality with respect to data collected and maintained by security-based swap data repositories.
The cross-border release will involve notice-and-comment rulemaking, not just interpretive guidance. As a rulemaking proposal, the release will consider investor protection and incorporate an economic analysis that considers, among other things, the effects of the proposal on efficiency, competition, and capital formation. Although the rulemaking approach takes more time, we believe there are a number of benefits to this approach, including the opportunity to benefit from public input and the opportunity to provide a full articulation of the rationales for, and consideration of reasonable alternatives to, particular approaches that achieve the statutory purpose.
The Dodd-Frank Act specifically requires that the Commission, the CFTC, and the prudential regulators "consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards" with respect to the regulation of OTC derivatives. The Commission has been actively working on a bilateral and multilateral basis with our fellow regulators abroad in such groups as the International Organization of Securities Commissions, the Financial Stability Board, and the OTC Derivatives Regulators Group, as we develop our proposed approach to cross-border issues under Title VII. Through these discussions and our participation in various international task forces and working groups, we also have gathered extensive information about foreign regulatory reform efforts, identified potential gaps, overlaps, and conflicts between U.S. and foreign regulatory regimes, and encouraged foreign regulators to develop rules and standards complementary to our own under the Dodd-Frank Act...[29]

The CFTC has addressed the territorial reach of its rules in a **Final Exemptive Order Regarding Compliance With Certain Swap Regulations**:[30]

In the two years since its enactment, the Commission has finalized 41 rules to implement Title VII of the Dodd-Frank Act... The Commission .. recognizes the critical role of international cooperation and coordination in the regulation of derivatives in the highly interconnected global market, where risks are transmitted across national borders and market participants operate in multiple jurisdictions. Close cooperative relationships and coordination with other jurisdictions take on even greater importance given that, prior to the recent reforms, the swaps market has largely operated without regulatory oversight and many jurisdictions are in differing stages of implementing their regulatory reform. To this end, the

[29] Elisse B. Walter, Testimony on "Wall Street Reform: Oversight of Financial Stability and Consumer and Investor Protections" Before the United States Senate Committee on Banking, Housing, and Urban Affairs (Feb. 14, 2013) at http://www.sec.gov/news/testimony/2013/ts021413ebw.htm.

[30] CFTC, Final Exemptive Order Regarding Compliance With Certain Swap Regulations, 78 Fed. Reg.858 (Jan. 7, 2013)

Commission staff has actively engaged in discussions with their foreign counterparts in an effort to better understand and develop a more harmonized cross-border regulatory framework. The Commission expects that these discussions will continue as it finalizes the cross-border interpretive guidance and as other jurisdictions develop their own regulatory requirements for derivatives...

...The Commission has determined not to take further action on the Proposed Guidance at this time. The Commission believes it will be beneficial to have further consultations with other domestic and international regulators in an effort to harmonize cross-border regulatory approaches prior to taking action with respect to the Proposed Guidance. The Commission also believes that further consideration of public comments, including the comments that may be received on the Further Proposed Guidance regarding the Commission's interpretation of the term ``U.S. person,'' and its guidance regarding aggregation for purposes of SD registration, will be helpful to the Commission in issuing final interpretive guidance. Nonetheless, the Commission has determined to issue the Final Order as a time-limited exemptive order that is substantially similar to the Proposed Order, except for the addition of provisions regarding registration and certain modifications and clarifications addressing public comments...The Commission believes that the Final Order strikes the proper balance between promoting an orderly transition to the new regulatory regime, while appropriately tailoring relief to ensure that the Commission can responsibly discharge its statutory duties...

Definition of ``U.S. Person'' Although at this time the Commission is not making any determinations as to the scope of the final interpretive guidance, the Commission believes that the comments received on the definition of U.S. person set forth in the Proposed Guidance are nonetheless relevant and helpful in determining the appropriate scope of exemptive relief in the Final Order.... To be clear, the Commission wishes to emphasize that the discussion here is not, and should not be construed as, an indication of, or a limitation on, the definition of the term ``U.S. person'' that the Commission may adopt in final cross-border interpretive guidance. As discussed further below, the Commission is seeking further comment on this issue. However, the Commission is aware that the terms ``U.S. person'' and ``non-U.S. person'' are commonly used in the discussion of these issues. For ease of reference, therefore, this release and the Final Order use the term ``U.S. person'' to refer to a person that is described by the criteria discussed below, and the term ``non-U.S. person'' to refer to any other person...

Proposed Definition in the Proposed Guidance

Under the Proposed Guidance, the term ``U.S. person'' would be defined by reference to the extent to which swap activities or transactions involving one or more such persons have the relevant connection with activities in, or effect on, U.S. commerce. As proposed, the term ``U.S. person'' would encompass both: (1) Persons (or classes of persons) located within the United States; as well as (2) persons that may be domiciled or operating outside the United States, but whose swap activities have a ``direct and significant connection with activities in, or effect on, commerce of the United States'' within the meaning of CEA section 2(i).That is, the term ``U.S. person'' identifies those persons whose swap activities--either individually or in the aggregate--satisfy the jurisdictional nexus under section 2(i) of the CEA...

In general, commenters stated that the proposed ``U.S. person'' definition presented significant interpretive issues and implementation challenges. The commenters contended that it would be difficult to determine U.S. person status because the proposed definition was, they said, overly broad, contained ambiguities, and would require collection of information not readily accessible at this time. The commenters, therefore, urged the Commission to provide market participants with sufficient time to implement a final definition of the term ``U.S. person'' and to reconsider the proposed definition in favor of ``a simpler, more easily applied'' definition of ``U.S. person.''.. A number of commenters requested that the Commission adopt an interim definition of ``U.S. person'' that would allow firms to rely on their existing systems and classifications and avoid the need to develop systems to achieve temporary compliance with standards that may change when a definition of the term ``U.S. person'' is finalized. IIB explained that applying any definition of ``U.S. person'' that departs from status based on residence or jurisdiction of organization, and in some cases principal place of business, will require time to implement relevant documentation conventions and diligence procedures. IIB, therefore, requested that the Commission implement a phased-in interim approach to the ``U.S. person'' definition that would encompass, in general, (1) a natural person who is a U.S. resident; and (2) a corporate entity that is organized or incorporated under the laws of the United States or has its place of business in the United States. SIFMA also urged the Commission to phase in the ``U.S. person'' definition, citing the implementation difficulties identified by IIB. Specifically, SIFMA recommended that the Commission allow market participants to apply an interim definition of ``U.S. person'' until 90 days after the final definition of ``U.S. person'' is published. SIFMA stated that its interim definition--which was identical to IIB's interim definition--should identify ``core'' U.S. persons and allow its members to phase in compliance with the Dodd-Frank requirements without building new systems that might have to be changed when a final definition is adopted.

Commission Determination on Definition of ``U.S. Person''

The Commission finds merit in the comments suggesting that it should adopt a phased approach to cross-border activities. The Commission understands, from the comments, that market participants may need additional time to assess their businesses in light of the Final Order and to institute necessary changes to their systems and operations. Therefore, for purposes of the Final Order, the Commission will apply a definition of the term ``U.S. person'' based upon the counterparty criteria set forth in CFTC Letter No. 12-22 [31] with certain modifications as described below. With respect to the other issues raised by commenters regarding the definition of ``U.S. person,'' the Commission believes that further public comment and consideration during the effectiveness of the Final Order will be helpful.

For purposes of the Final Order, the Commission will treat as a ``U.S. person'' any person identified by the following five criteria:

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

(ii) A corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund or any form of enterprise similar to any of the foregoing, in each case that is (A) organized or incorporated under the laws of a state or other jurisdiction in the United States or (B) effective as of April 1, 2013 for all such entities other than funds or collective investment vehicles, having its principal place of business in the United States;

(iii) A pension plan for the employees, officers or principals of a legal entity described in (ii) above, unless the pension plan is primarily for foreign employees of such entity;

(iv) An estate of a decedent who was a resident of the United States at the time of death, or a trust

[31] Footnote 39 here reads: "The counterparty criteria set forth in CFTC Letter No. 12- 22 are: (i) A natural person who is a resident of the United States; (ii) A corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund or any form of enterprise similar to any of the foregoing, in each case that is organized or incorporated under the laws of the United States; (iii) A pension plan for the employees, officers, or principals of a legal entity described in (ii) above, unless the pension plan is exclusively for foreign employees of such entity; (iv) An estate or trust, the income of which is subject to U.S. income tax, regardless of source; or (v) An individual account (discretionary or not) where the beneficial owner is a person described in (i) through (iv) above.

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; or

(v) An 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 (i) through (iv) above.

The modifications made by the Commission to the counterparty criteria set forth in CFTC Letter No. 12-22 relate to (1) the location of an entity's principal place of business, (2) the treatment of pension plans for foreign employees, (3) the treatment of estates and trusts, and (4) the treatment of joint accounts.

First, regarding the location of an entity's principal place of business, the Commission considered that the second counterparty criterion in CFTC Letter No. 12-22 is generally intended to cover legal entities that are physically located or incorporated within U.S. territory. For purposes of the Final Order, the Commission believes it is appropriate to treat as a ``U.S. person'' a legal entity that is not incorporated in the United States but that nonetheless has its ``principal place of business'' in the United States. The Commission believes that it is appropriate to consider an entity that is organized outside the United States but nonetheless has its ``principal place of business'' within the United States in the same manner as an entity organized or incorporated under the laws of the United States, because the center of direction, control and coordination of its business activities is located in the United States. However, the Commission understands from commenters that market participants will need a short period of time to implement the treatment of entities with a principal place of business in the United States as ``U.S. persons.'' Therefore, the Commission will not treat entities incorporated or organized outside the United States and with a principal place of business in the United States as U.S. persons until April 1, 2013 (i.e., approximately 90 days after effectiveness of the Final Order). The Commission also understands from commenters that the application of the principal place of business element may be complex for funds and collective investment vehicles and require further guidance in this regard; therefore, at this time for purposes of the Final Order, the Commission has determined that this element will not apply to funds or collective investment vehicles.

Second, regarding the treatment of pension plans... a pension plan that is ``primarily'' (rather than exclusively) for the foreign employees of an entity is also a ``U.S. person'' ...

Third, regarding the treatment of estates and trusts... for purposes of the Final Order, the Commission is of the view that an estate should be treated as a ``U.S. person'' if the decedent was a resident of the United States at the time of death, and a trust should be treated as a ``U.S. person'' if it is governed by the law of a state or other jurisdiction in the United States and a court within the United States is able to exercise primary supervision over the administration of the trust.

The Commission believes that this approach is appropriate in view of how estates and trusts use swaps, and is consistent with how they are treated for other purposes under law. For estates, if the decedent was a party to any swaps at the time of death, then those swaps would continue to be treated in the same way after the decedent's death, when the swaps would most likely pass to the decedent's estate. Also, this test will be predictable and easy to apply for natural persons planning for how their swaps will be treated after death, for executors and administrators of estates, and for the swap counterparties to natural persons and estates. With respect to trusts, the Commission considered that each trust is governed by the laws of a particular jurisdiction, which may depend on steps taken when the trust was created or other circumstances surrounding the trust. The Commission believes that if a trust is governed by U.S. law (i.e., the law of a state or other jurisdiction in the United States), then it is reasonable to treat the trust as a U.S. person for purposes of the Final Order. The definition also requires that a court within the United States be able to exercise primary supervision over the administration of the trust. Including this element of the definition will ensure that the treatment of the trust for purposes of the Final Order will be in line with how the trust is treated for other legal purposes.

Finally, regarding the treatment of joint accounts, the Commission is refining the fifth counterparty criterion in CFTC Letter No. 12-22 to include not only individual accounts where the beneficial owner is a person described in the preceding counterparty criteria, but also joint accounts where any of the beneficial owners is such a person.

Due Diligence.

As described above, many commenters said that the information necessary to accurately assess the status of their counterparties as U.S. persons may not be available, or may be available only through overly burdensome due diligence. For this reason, these commenters requested that the Commission allow for reasonable reliance on counterparty representations as to their ``U.S. person'' status. The Commission agrees with the commenters that a party to a swap, in order to rely upon the exemptive relief provided in the Final Order, should be able to reasonably rely on its counterparty's representation in determining whether the counterparty is a ``U.S. person.'' In this context, the Commission interprets the ``reasonable'' standard to mean that a party to a swap should conduct reasonable due diligence on its counterparties, with what is reasonable in a particular situation to depend on the relevant facts and circumstances. The Commission notes that under its external business conduct rules, an SD or MSP generally meets its due diligence obligations if it reasonably relies on counterparty representations, absent indications to the contrary. Similarly here, the Commission believes that allowing for reasonable reliance on counterparty representations provides for an objective standard and avoids subjective evaluations. This, in turn, facilitates a more consistent and foreseeable determination of whether a person is a ``U.S. person'' for purposes of relying on temporary exemptive relief.

Finally, the Commission confirms that this definition of ``U.S. person'' applies only for purposes of the Final Order. Further, the Commission confirms that the definition of ``U.S. person'' applies only to Commission regulations promulgated under Title VII's swap provisions. Thus, for example, it would not apply to the CEA provisions (and Commission regulations promulgated thereunder) relating to the futures markets.

Foreign Branch of U.S. Person.

The Commission views as a ``U.S. person'' the foreign branch of a U.S. person. As the Commission explained in the Proposed Guidance, a branch does not have a legal identity separate from that of its principal entity. In this respect, the Commission notes that branches are neither separately incorporated nor separately capitalized and, more generally, the rights and obligations of a branch are the rights and obligations of its principal entity (and vice versa). Under these circumstances, the Commission views the activities of a foreign branch as the activities of the principal entity..

Accordingly, the Commission declines to recognize foreign branches of U.S. persons separately from their U.S. principals for purposes of the Dodd-Frank swap provisions, including registration and Entity-Level and Transaction-Level Requirements. Therefore, if a foreign branch were to be an SD or MSP.. its U.S. principal would be required to register, and that registration would encompass the foreign branch. Based on the same rationale, the Dodd-Frank Act fully applies to a swap between a foreign branch of a U.S. person and a foreign branch of another U.S. person. Nevertheless, for purposes of the Final Order ... foreign branches of U.S. persons may comply only with transaction-level requirements as may be required in the location of the foreign branch with respect to swaps with foreign counterparties. Further, non-U.S. persons may exclude swaps with foreign branches of registered SDs for purposes of determining whether they have exceeded the de minimis level of swap dealing activity under the SD definition. Finally, for purposes of the Final Order... the Transaction-Level Requirements will not apply to a swap transaction between foreign branches of U.S. SDs or foreign branches of U.S. MSPs. The Commission believes that it is appropriate to extend the foregoing relief on a temporary basis while the Commission continues to consider, and works with foreign regulators regarding, the treatment of foreign branches of U.S. registrants.