

Summary of key EU and US regulatory developments relating to derivatives

June 2016

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| Our Global Derivatives and Structured Products Practice |

Hogan Lovells advises clients across the world on a complete range of derivative and structured product transactions across all asset classes.

Our practice is truly global. With dedicated derivatives and structured products lawyers in Europe, the United States and Asia and capital markets lawyers across our global network of offices, we have one of the most integrated teams in the market.

We understand the considerable and complex legal, regulatory and tax implications of these products, including the cross-border implications of their use. Working closely with lawyers in our renowned finance, disputes, tax, regulatory and insolvency departments, we provide our clients with practical, timely advice on all aspects of their business. We have significant experience in advising clients on various regulatory matters applicable to derivatives across the world: from the United States under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"), the European Union under the European Market Infrastructure Regulation ("**EMIR**") to the local regulations in various jurisdictions across Asia. In addition, our team is particularly strong in structured finance and structured finance-related derivatives, having established and updated many securitization and repackaging programs that contain swaps and repos.

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| **"Respected for its formidable international brand and high-quality work in varied capital markets transactions."** |
| Chambers Global, 2015 |

Our clients include major financial institutions, funds, government sponsored entities, asset managers and commercial end-users. Our size, global reach, experience and specialization enable us to provide clients with a competitive, knowledge-based service for all derivatives and structured products transactions.

**Areas of focus**

* Energy and commodities
* Regulatory matters
* Securitized derivatives and repackaging programmes
* Soft commodities and metals
* Equity derivatives
* Credit derivatives
* Fund derivatives
* Portfolio acquisitions and disposals
* Structured finance, securitization-related, fixed income and other treasury related matters
* Longevity and insurance linked derivatives
* Distressed derivatives

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| Overview |

Following the G20 commitment to implement measures to increase transparency and reduce counterparty credit risk and operational risk in the derivative markets, the European Commission (the **Commission**) introduced a new EU Regulation on over-the-counter derivatives (OTC), central counterparties (CCPs) and trade repositories (also known as the European Market Infrastructure Regulation, EMIR). In addition, the European Parliament and the European Council have adopted a directive and regulation replacing the Markets in Financial Instruments Directive (known as MiFID II). Simultaneously, in the United States, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) seeks to deal with similar risk issues in relation to derivatives markets. In summary, the new regulations introduced the following requirements:

* clearing obligations and risk mitigation techniques for certain derivative contracts;
* trade reporting;
* registration, financial and risk management requirements for clearing organizations; and
* new trade execution requirements.

Although EMIR entered into force on 16 August, 2012 some of the requirements under EMIR, such as the first clearing obligations, are only just starting to apply.

On 21 May, 2015 the Commission published a consultation document on the review of EMIR, seeking feedback from stakeholders on those aspects of EMIR which have already been implemented. The Commission is expected to submit a report on EMIR to the European Parliament and European Council in the near future, together with any appropriate proposals.

Although EMIR is already in force, some of the definitions in EMIR cross refer to definitions under MiFID so the ongoing changes in MiFID II have a significant impact on derivatives.

The MiFID II legislative framework consists of an EU Directive (the **MiFID II Directive**) and the Markets in Financial Instruments Regulation (MiFIR). The final texts of the MiFID II Directive and MiFIR were published in the Official Journal of the EU in 2014.

Most of the provisions in MiFID II were originally intended to become effective on 3 January, 2017. However, the European Parliament has voted that MiFID II will be delayed by up to a year (that is, until 3 January, 2018).

Much of the detailed application of MiFID II, including in relation to derivatives, will be contained in delegated acts and technical standards. Between April and June 2016, the Commission published a draft delegated directive and two delegated regulations. In addition, on 20 April, 2016, the Commission announced the outcome of its review of three of ESMA's draft technical standards.  The technical standards related to transparency for non-equities (including derivatives), the ancillary activity exemption test for firms trading commodity derivatives, and the position limits regime for commodity derivatives. Over the course of the following months, the Commission has published further draft technical standards, including a technical standard on the trading obligation under MiFID II.

In the US, the Commodity Futures Trading Commission (**CFTC)** has adopted many of the swaps rules pursuant to Dodd-Frank, while the Securities and Exchange Commission (**SEC**) is in the process of introducing rules that will apply to security based swaps, with many regulatory areas- such as those pertaining to recordkeeping and security-based swap execution facilities – not yet subject to a final rule. Position limits have gone through severe rounds of proposals but have not yet been adopted. The next major area of compliance will be the requirement to post and collect margin for uncleared trades, with staggered compliance dates beginning on 1 September,2016.

A list of acronyms used in this summary is included at the end of this summary.

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| Summary of key EU and US regulatory developments relating to derivatives |

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| Subject | Summary of EU provisions | Summary of US provisions | |
| Definitions | Definition of derivative  EMIR applies to all standardized eligible OTC derivatives, including interest rate, credit, equity, foreign exchange derivatives and commodity OTC derivative contracts, the execution of which does not take place on a regulated market (EMIR, Article 2(5)).  The definition of a derivative in EMIR cross-refers to the list of financial instruments in MiFID. However, the definitions of MiFID financial instruments have been transposed in different ways across the various EU member states. As a result, there is no single, commonly accepted definition of a derivative across the European Union.  Definition of foreign exchange derivative  The treatment of foreign exchange derivatives under EMIR is subject to some uncertainty. In particular, the dividing line between a foreign exchange (**FX**) spot transaction and an FX forward is unclear.  In July 2014, the Commission stated that there was a broad consensus in favor of particular criteria to define spot FX transactions, generally by reference to a settlement period of 2 trading days or less, or ending on a standard delivery date.  On 25 April, 2016, the Commission adopted this approach in its proposal for a draft delegated Regulation.  This differs from the approaches adopted in some EU member states, including the United Kingdom (UK). The Financial Conduct Authority (the FCA) has confirmed that, until further notice, in the UK, the following transactions are outside the scope of MiFID and should not therefore fall within EMIR:   * forward foreign exchange instruments undertaken for commercial purposes; * a non-deliverable currency forward that is not a future for the purposes of UK legislation because it is made for commercial purposes; and * spot transactions in both foreign exchange and commodities.   Under current UK legislation, an FX forward is regarded as being "for commercial purposes" if it has a settlement period of less than seven days.  Definition of commodity derivative  The lack of a definition of derivative in MiFID has also led to uncertainty regarding the scope of EMIR with respect to commodity derivatives. In particular, this related to the following categories of derivatives that are defined as MiFID financial instruments in Sections C6 and C7 of Schedule I in MiFID.  The uncertainty related to whether:   * physically settled forwards traded on a regulated market (RM) or multilateral trading facility (MTF) should be included within the C6 definition; and * what is meant by "physically settled" in both categories.   ESMA published guidelines on the application of the C6 and C7 definitions of commodity derivatives on 6 May, 2015 (the guidelines were reissued in final form on 20 October, 2015). The guidelines applied with effect from August 2015, and will only apply as long as MiFID I remains in force.  On 25 April, 2016, the European Commission published a draft delegated Regulation which contains more detailed definitions of C6 and C7 derivatives, particularly with regard to the meaning of "physically settled".  Definition of energy derivatives  The Commission's draft delegated Regulation dated 25 April, 2016 contained definitions of:   * certain physically settled wholesale energy contracts that are outside the scope of MiFID II; and * certain physically settled oil and coal derivatives that are subject to a transitional regime under MiFID II. | Definition of swap  Dodd-Frank Section 721(a)  Commodity Exchange Act 7 USC 1A(47)  Divided into "swaps" and "security-based swaps."  In November 2012, the US Secretary of the Treasury exempted FX swaps from the definition of "swap."  Final Rule 17 CFR Parts 1, 230, 240 and 241  "**Swaps**" include interest rate swaps, rate floors, rate caps, rate collars, cross-currency rate swaps, basis swaps, currency swaps, total return swaps, equity index swaps, equity swaps, debt index swaps, debt swaps, credit spreads, credit default swaps, credit swaps, weather swaps, energy swaps, metal swaps, agricultural swaps, emission swaps and commodity swaps. "Swaps" also include any agreement, contract, or transaction that is, or in the future becomes, commonly known to the trade as a swap.  Forward contracts in non-financial commodities are excluded from the definition of “swap.”  In May 2015, the Commodity Futures Trading Commission (the CFTC) published its final interpretation as to when forward contacts “with embedded volumetric optionality” would fall within the “forward contract exclusion” from the definition of a swap.  Forward contracts “with embedded volumetric optionality” are forward contracts for the sale of a commodity, but where one party has the right — but not the obligation—to increase or decrease the volume of the commodity intended to be physically settled or delivered under the forward contract.  The final interpretation provides a seven-part test to determine whether such a contract would be excluded from the definition of a “swap”. The seven-part test requires that:   * the embedded optionality does not undermine the overall nature of the agreement, contract, or transaction as a forward contract; * the predominant feature of the agreement, contract, or transaction is actual delivery; * the embedded optionality cannot be severed and marketed separately from the overall agreement, contract, or transaction in which it is embedded; * the seller of a non-financial commodity underlying the agreement, contract, or transaction with embedded volumetric optionality intends, at the time it enters into the agreement, contract, or transaction, to deliver the underlying nonfinancial commodity if the embedded volumetric optionality is exercised; * the buyer of a non-financial commodity underlying the agreement, contract or transaction with embedded volumetric optionality intends, at the time it enters into the agreement, contract, or transaction, to take delivery of the underlying non-financial commodity if the embedded volumetric optionality is exercised; * both parties are commercial parties; and * the embedded volumetric optionality is primarily intended, at the time that the parties enter into the agreement, contract, or transaction, to address physical factors, or regulatory requirements that reasonably influence demand for, or supply of, the non-financial commodity.   Securities Exchange Act of 1934 Section 3(a)(68)(A).  A "**security-based swap**" is defined as an agreement, contract or transaction that is a swap and is based on:   * an index that is a narrow-based security index, including any interest therein or on the value thereof; * a single security or loan, including any interest therein or on the value thereof; * the occurrence, non-occurrence or extent of occurrence, or of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index, provided that such event directly affects the financial statements, financial condition, or financial obligations of the issuer. | |
| Significant participants | EMIR Article 10  The application of certain parts of EMIR will depend on which of the following categories an entity falls in:   * financial counterparties (broadly, banks, insurers, investment firms, pension schemes, certain alternative investment funds (**AIFs**) and UCITS funds) established in the EU (**FCs**); * non-financial counterparties (**NFCs**) established in the EU whose aggregate positions exceed the clearing thresholds (see below) (**NFC+s**) (this is conceptually analogous to the "MSP" designation in US regulations); and * NFCs established in the EU whose aggregate positions are below the clearing threshold (NFC-).   NFC+s (i.e. NFCs that exceed the clearing threshold) must notify ESMA and their EU Member State competent authority (NFC notification).  Clearing thresholds (EMIR Article 10 (3))  The clearing threshold values which, if exceeded, would subject NFCs to the clearing obligation are:   * credit derivatives - EUR 1 billion in gross notional value; * equity derivatives - EUR 1 billion in gross notional value; * interest rate derivatives - EUR 3 billion in gross notional value; * FX derivatives - EUR 3 billion in gross notional value; and * commodity and any other OTC derivatives - EUR 3 billion in gross notional value.   The notional value adds up the notional amount of all outstanding OTC derivative contracts of the group of the relevant NFC on a worldwide basis, whether they are in or out of the money.  If an NFC exceeds the clearing threshold in respect of any of the above asset classes, the clearing obligation will apply to all of its OTC derivatives that are required to be cleared, irrespective of the asset class, but subject to the exemptions set out in the section entitled "Exemptions from the clearing exemption" below. | Dodd-Frank Section 761  7 USC 1a(11), 7 USC 1a(33), 7 USC 1a(49)  "**Major swap participant**" (**MSP**) is someone who is not a dealer and (i) maintains a substantial position in swaps for any of the major swap categories as determined by CFTC (except positions held for hedging or mitigating commercial risk or maintained by employee benefit plans); (ii) whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the US banking system or financial markets; or (iii) a financial entity that is highly leveraged relative to the amount of capital it holds and that is not subject to capital requirements established by an appropriate Federal banking agency and maintains a substantial position in outstanding swaps in any major swap category as determined by CFTC.  "**Commodity pool operator**" is someone who is engaged in a business that is of the nature of a commodity pool, investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property for the purpose of trading in commodity interests, including any:   * commodities for future delivery, security futures products, or swaps; * commodity options; and * leverage transactions.   De minimis exception from registering as a commodity pool operator:   * The aggregate initial margin, premiums, and required minimum security deposit for retail forex transactions required to establish commodity interest positions, determined at the time the most recent position was established, does not exceed 5 per cent of the liquidation value of the pool's portfolio; or * The aggregate net notional value of commodity interest positions, determined at the time the most recent position was established, does not exceed 100 per cent of the liquidation value of the pool's portfolio, after taking into account unrealized profits and unrealized losses on any such positions it has entered into.   "Swap dealer" is any person who: (i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or (iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps, provided however, in no event shall an insured depository institution be considered to be a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer.  A person may be designated as a swap dealer for one category of swaps and not be considered a swap dealer for another category of swaps. 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, is not a "swap dealer." Entities that engage in a de minimis quantity of swap dealing are exempt from the swap dealer definition.  Swap dealer registration   * There is an exemption from registration as a swap dealer for firms that have an aggregate gross notional amount of swaps entered into over the prior 12-month period that is not greater than $3 billion, although the threshold initially will be set at $8 billion for at least a three-year phase-in period that ends in December 2017. * In November 2015, CFTC staff released a preliminary report on the de minimis exemption, which report is designed to seek public comments and to consider those comments before making a final report to the CFTC regarding the appropriate de minimis level and whether the phase-in period should extend beyond December 2017. The preliminary report did not take a position with respect to the level at which the threshold should be set in December 2017. * For firms engaging in security-based swaps business, the exemption threshold is $3 billion in notional value over a 12-month period for credit default swaps (CDS) and $150 million for other types of security-based swaps. * The exemptions will be phased-in at $8 billion in notional value for swaps and CDSs and $400 million in notional value for other types of security-based swaps. * In August 2015, the Securities and Exchange Commission (SEC) adopted final rules regarding the registration of security-based swap dealers. However, the compliance date for these rules has not yet been determined and depends on the timing of further rulemaking with respect to security-based swap dealers by the SEC. * 104 entities have provisionally registered with the CFTC as swap dealers.   Swaps that satisfy certain hedging criteria or are entered into in conjunction with loans originated by a federally backed bank will not be counted towards the swap dealer threshold.  On 18 November, 2015, the CFTC staff issued a preliminary report on the $8 billion gross notional swap dealing activity *de minimis* threshold for swap dealer registration. Unless the CFTC acts, the threshold will decrease to $3 billion in December 2017.  Major Swap Participant: Substantial position   * The rule applies two different tests to determine whether a person has a "substantial position" in swaps or security-based swaps. * A substantial position is a daily average current uncollateralized exposure of at least $1 billion for the applicable swap or security-based swap category (or $3 billion for the rate swap category) or a daily average current uncollateralized exposure plus potential future exposure of $2 billion for the applicable swap or security-based swap category (or $6 billion for the rate swap category). A position satisfying either test will constitute a "substantial position."   Major Swap Participant: Substantial counterparty exposure   * "Substantial counterparty exposure" is calculated using the same method as "substantial position," but substantial counterparty exposure is not limited to major categories of swaps and does not exclude hedging or employee benefit plan positions. * The swap thresholds across the entirety of a person’s swap positions are $5 billion of current uncollateralized exposure or $8 billion of current uncollateralized exposure and potential future exposure. * The security-based swap thresholds across the entirety of a person’s security-based swap positions are $2 billion of current uncollateralized exposure or $4 billion of current uncollateralized exposure and potential future exposure.   Financial entity and highly leveraged  A financial entity is "highly leveraged" where the ratio of its liabilities to its equity exceeds 12-to-1.  Major swap participant and major security-based swap participant safe harbors.  Persons that satisfy any one of three alternatives are exempt from the daily calculations required by the "substantial position" tests. | |
| Clearing | EMIR Article 4  Under Article 4 of EMIR, all FCs, as well as NFC+s, will have to clear OTC derivative transactions that are within a class of OTC derivatives which ESMA has declared to be subject to mandatory clearing. Transactions with NFC-s will not be subject to the clearing obligation.  There are two approaches for assessing whether a class of OTC derivatives is subject to clearing.   * When a competent authority notifies ESMA that it has authorized a CCP to clear a class of OTC derivatives, ESMA will conduct a public consultation to determine whether the clearing obligation should apply and develop regulatory technical standards (the "bottom up" approach); and * ESMA will identify classes of derivatives which should be subject to the clearing obligation but for which no CCP has received authorization (the "top down" approach).   To date 16 CCPs established in the EU have been authorized and 18 non-EU CCPs recognized under EMIR.  ESMA must develop regulatory technical standards within 6 months of receiving a notification from a competent authority.  To date, ESMA has published final regulatory technical standards (RTS) in respect of the clearing of certain classes of derivatives.  Interest rate swaps  The following classes of interest rate swaps (the "G4 IRS swaps") are subject to the clearing obligation (with no optionality and with a single settlement currency):   * Float-to-float "basis" swaps and Fixed-to-float interest rate swaps, referencing either EURIBOR or LIBOR, with a maturity of 28 days to 50 years (this includes instruments which settle in Euros, US dollars, GBP or Japanese yen); * Forward Rate Agreements, referencing either EURIBOR or LIBOR, with a maturity of 3 days to 3 years (this includes instruments which settle in Euros, US dollars or GBP); and * Overnight Index Swaps referencing EONIA, FedFunds or SONIA, with a maturity of 7 days to 3 years (this includes instruments which settle in Euros, US dollars or GBP).   Phase-in timing  The clearing obligations will take effect following a phased implementation, depending on the types of counterparties concerned. The date on which the clearing obligation takes effect for the G4 IRS swaps are set out below.  Category 1 (clearing members): 21 June, 2016;  Category 2 (FCs and AIFs which are NFC+s but not in Category 1 and which belong to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives for January, February and March 2016 is above EUR 8 billion): 21 December, 2016;  Category 3 (FCs and AIFs that are NFC+s and not in Category 1 or 2): 21 June, 2017; and  Category 4 (NFC+s not in any of the above categories): 21 December, 2018.  Frontloading requirement  EMIR requires the application of the clearing obligation to contracts concluded after the notification to ESMA of the authorisation of a CCP to clear a class of derivatives but before the date on which the clearing obligation takes effect, provided that the contracts meet the relevant minimum remaining maturity.  The timing of the frontloading requirement for the G4 IRS swaps is as set out below.  **Category 1**: Counterparties will need to frontload relevant contracts which meet the minimum remaining maturity from **21 February, 2016**; and  **Category 2**: Counterparties will need to frontload relevant contracts which meet the minimum remaining maturity from **21 May, 2016**.  There is a temporary derogation for certain intragroup transactions with non-EU entities, which meet certain conditions.  Where a contract is concluded between two counterparties in different categories, the date from which the clearing obligation takes effect will be the latest date. There is an exemption for contracts associated with covered bond programs which meet certain conditions.  ESMA has also proposed that the following classes should be subject to the clearing obligation:   * Fixed-to-float interest rate swaps denominated in CZK, DKK, HUF, NDK, PLN, with a maturity of 28 days to 50 years; and * Forward rate agreements denominated in NDK, PLN and SEK with a maturity of 3 days to 1 year.   Credit derivatives  The final regulatory technical standards relating to the clearing of specified credit default swaps were published in the Official Journal and entered into force on 9 May 2016. Counterparties will need to start clearing these credit default swaps from 9 June 2017.  This clearing obligation will be phased in over a 3 year period and the dates on which the clearing obligation takes effect are set out below.  **Category 1**: 9 February 2017  **Category 2**: 9 August 2017  **Category 3**: 9 February 2018  **Category 4**: 9 May 2018  The following classes of credit default swaps will need to be cleared:   * Index CDS (untranched index) referencing iTraxx Europe Main); and * iTrax Europe Crossover indices;   in each case with a series of 11 onwards and a maturity period of 5 years.  Category 1 and Category 2 counterparties will need to frontload relevant contracts which meet the minimum remaining maturity from 9 October 2016.  FX non-deliverable forwards (FX NDFs)  Based on the feedback it received to its consultation on FX NDFs, ESMA has said that it is not proposing a clearing obligation on the FX NDF classes at this stage.  In order to comply with the clearing obligation, counterparties will need to establish clearing arrangements by becoming a clearing member or a client of a clearing member or by establishing indirect clearing arrangements (which must not increase counterparty risk).  The International Swaps and Derivatives Association, Inc. (ISDA) has published: (i) the ISDA/FOA Client Cleared OTC Derivatives Addendum, which is a market standard document for use by counterparties and their clearing members which covers all types of derivative trades to be cleared by CCPs; and (ii) the ISDA/FIA Europe Cleared Derivatives Execution Agreement, for use by two swap counterparties in respect of their OTC derivative trades that are subject to the clearing obligation.  Parties to OTC derivative contracts that are not cleared by a CCP will be required to put in place risk mitigation techniques to mitigate operational risk and counterparty credit risk under Article 11 of EMIR (see below). | Dodd-Frank Section 723(a)(3)  Commodity Exchange Act (7 USC 2(h)(1))  Final Rule 17 CFR Parts 1, 23, 37, 38 and 39  Swaps that are required to be cleared must be cleared by CCPs known as derivatives clearing organizations (DCOs) as soon as technologically practicable after execution of the swap, but no later than the close of business on the day of execution.  If a swap is not required to be cleared but is accepted for clearing by a DCO, and the swap dealer or major swap participant and its counterparty agrees that the swap will be submitted for clearing, the swap must be submitted for clearing no later than the next business day after execution, or the agreement to clear, if later than execution.  Each swap dealer or major swap participant that is a clearing member of a DCO shall coordinate with each DCO on which it clears to establish systems that enable the clearing member, or the DCO acting on its behalf, to accept or reject each trade submitted to the DCO for clearing by or for the clearing member as quickly as would be technologically practicable if fully automated systems were used.  Mandatory Swap Clearing  Mandatory clearing for specified classes of interest rate and credit default swaps went into effect in March 2013 for certain entities.  Interest rate swaps subject to mandatory clearing are fixed-to-floating swaps, basis swaps and forward rate agreements that are specified in U.S dollar, Euro and British pound. To fall under the clearing requirement, the swaps must be based on specified floating rate indexes and must have termination dates that fall into prescribed ranges. The four classes selected for mandatory clearing account for more than 80% of the interest rate swap market. Swaps with optionality, multiple currency swaps and swaps with conditional notional amounts are not subject to mandatory clearing.  Credit default swaps subject to mandatory clearing include North American Untranched CDS Indices Class and European Untranched CDS Indices Class.  Swap dealers, major swap participants, security-based swap dealers and major security-based swap participants are referred to as "Category 1 entities."  Commodity pools, private funds as defined in Section 202(a) of the Investment Advisers Act of 1940 other than active funds, and persons predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature as defined in Section 4(k) of the Bank Holding Company Act of 1956, are referred to as "Category 2 entities."  Dodd-Frank Section 763(a)  Securities Exchange Act of 1934 (15 USC 78c-1(3C))  Security-based swaps that are required to be cleared must be cleared by a clearing agency. The SEC has not yet issued any mandatory clearing determinations for security-based swaps. | |
| Exemptions from the clearing obligation | Commercial hedging exemption for NFCs  Trades entered into by NFCs for the purposes of commercial hedging or treasury activities which are "objectively measureable as reducing risks directly in relation to the commercial activity of the group or treasury financing activity of the NFC or of that group" will not count towards the determination of a NFC's clearing thresholds (Article 10(2) of EMIR). This exclusion encompasses OTC derivatives which (i) cover risks arising from the potential change in value of assets in the normal course of business (including proxy hedging and options arising from employee benefits), (ii) indirect risks or (iii) qualify as a hedging contract pursuant to the International Financial Reporting Standards (IFRS) principles on hedge accounting.  The definition of 'group' under EMIR is determined by reference to whether an entity is consolidated for the purposes of the relevant accounting standards.  A report issued by ESMA in August 2015 suggests that regulators could modify the way the hedging exemption affects the determination of NFC+/NFC- by looking at aggregate positions irrespective of their hedging or non-hedging nature.  Intragroup exemption  Entities can apply for an intragroup exemption from the clearing obligation under Article 3 of EMIR if, broadly, both counterparties are consolidated on a full basis and are subject to appropriate centralized risk and control procedures and, if a non-EU entity, the EU Commission has recognized the equivalence of requirements in that non-EU country. Certain disclosure requirements will still apply however.  There is a temporary derogation for G4 IRS and credit default swaps that are subject to the clearing obligation between an EU counterparty (other than a counterparty in Category 4) and a non-EU counterparty which are part of the same group. The clearing obligation will apply to such trades on:   * 21 December, 2018 in respect of G4 IRS or 9 May 2019 in respect of credit default swaps, if no equivalence decision in respect of the relevant third country has been adopted; or * if the European Commission has adopted an equivalence decision in respect of the relevant third country, the later of: (i) 60 days after such equivalence decision; or (ii) the date on which the clearing obligation takes effect pursuant to the RTS in respect of the G4 IRS or credit default swaps, as relevant.   There is also an intragroup exemption from the margin requirements if certain conditions are met. There must be no current or foreseen practical or legal impediment to the prompt transfer of own funds or repayment of liabilities between counterparties.  Pension schemes  Certain pension schemes are initially exempt from the clearing obligations until 16 August, 2017. In order to benefit from this exemption, some pension schemes will need to apply to their competent authority. On 15 February, 2016 the FCA published a list of the types of pension scheme entities and arrangements for which it has granted an exemption from the clearing obligation.  Supranational bodies  Entities such as the ECB, national EU public debt management bodies, specified multilateral development banks, and certain guaranteed public entities benefit from exemptions from EMIR. | Commercial end-user exception  A commercial end-user exception applies to counterparties who are non-financial entities that are using security-based swaps to hedge or mitigate commercial risk. (15 USC 78c-1(3C)(g)(1)).  17 CFR Part 39  The clearing requirements do not apply to CFTC swaps if one of the counterparties is:   * a non-financial entity; * is using the swap to hedge or mitigate commercial risk; and * notifies the CFTC how it generally meets its financial obligations associated with non-cleared swaps.   A swap is used to hedge or mitigate commercial risk if:   * the swap is economically appropriate to the reduction of the person’s risks in the conduct and management of a commercial enterprise; and * the risks arise from changes in values of assets and liabilities, including changes related to movements of interest rates and foreign exchange rates.   Swaps eligible for the end-user exception cannot be used for speculation, investing or trading.  To determine whether a counterparty is a nonfinancial entity, the following needs to be considered:   * the CEA defines a financial entity as a swap dealer, a security-based swap dealer, an MSP, a major security-based swap participant, a commodity pool, a private fund, certain types of benefit plans under ERISA, or a person predominantly engaged in activities that are in the business of banking or in activities that are financial in nature as defined in section 4(k) of the Bank Holding Company Act of 1956; * to be predominantly engaged in financial activities, the entity generally must either devote 85% or more of its assets to or derive 85% or more of its revenues from financial activities; * the list of financial activities in section 4(k) is broad and includes activities such as insurance underwriting and agency, securities brokerage, investment advisory activities, and financial data processing; and * small ($10 billion or less in total assets) depository institutions, credit unions and farm credit system institutions are also eligible for the commercial end-user exception.   In the case of a '34 Act filer, the use of this exception must be reviewed and approved by an appropriate committee of the company's board.  Captive finance companies  Commodity Exchange Act (7 USC 2(h)(7)(C))  CFTC Letter No. 15-27A “captive finance company” is permitted to elect the commercial end-user exception because it is excluded from the definition of "financial entity". To be a captive finance company, an entity must satisfy a four-prong test:   * the entity’s primary business is providing financing; * the entity uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures; * 90% or more of such exposures arise from financing that facilitates the purchase or lease of products; and * 90% or more of such products are manufactured by the parent company or another subsidiary of the parent company.   The CFTC has also taken a position, in an interpretive letter dated 4 May, 2015 that a wholly-owned special purpose vehicle of a captive finance company can also be treated as a captive finance company and rely on the commercial end-user exception.  Treasury affiliates  CFTC Letter No. 13-22  Swaps entered into by eligible treasury affiliates are exempt from clearing provided certain conditions are met, including the following:   * treasury affiliate is directly, wholly-owned by a non-financial entity or another eligible treasury affiliate and is not indirectly majority-owned by a financial entity; * treasury affiliate’s ultimate parent is not a financial entity, and the majority of the ultimate parent’s wholly and majority-owned affiliates qualify for the end-user exception; * treasury affiliate is a financial entity solely as a result of acting as principal to swaps with, or on behalf of, one or more of its related affiliates, or providing other financial services to such affiliates; * treasury affiliate enters into the exempted swap for the sole purpose of hedging or mitigating the commercial risk of one or more related affiliates that was transferred to the treasury affiliate via one or more swaps with such related affiliates; and * certain information regarding the uncleared swap is reported to a swap data repository.   Inter-affiliate exception  17 CFR Part 50  The clearing requirements do not apply for swaps between affiliates provided the following conditions are met:   * affiliates have common ownership: -- (i) one counterparty, directly or indirectly, holds a majority ownership interest in the other counterparty, or (ii) a third party, directly or indirectly, holds a majority ownership interest in both affiliate counterparties; * affiliates report for each swap that they are eligible to elect the inter-affiliate exception; * annual reporting of how each affiliate meets its financial obligations associated with entering into non-cleared swaps; * swap documentation; * centralized risk management; and * external swaps of affiliates must either (i) be cleared in the US or pursuant to comparable home country regulations or (ii) be exempt from clearing under the Dodd-Frank Act or a comparable foreign jurisdiction exception.   In recognition that most jurisdictions have not fully implemented clearing regimes, the final rule established an alternative compliance regime under which parties can claim the exemption during a transitional period until 11 March, 2014 (pursuant to CFTC no-action relief, such date extended to 31 December, 2016 and (b) with respect to a particular jurisdiction, 60 days after the CFTC announces a comparability determination with respect to a foreign jurisdiction's clearing mandate). The alternative regime is subject to a number of conditions which vary depending on the jurisdiction in which a non-US counterparty is located.  FX exclusion  In November 2012, the US Secretary of the Treasury exempted FX swaps from the definition of "swap." As a consequence, foreign exchange swaps and foreign exchange derivatives which are physically settled are excluded from the clearing requirements. | |
| Trade Execution | MiFID II  All sufficiently liquid derivative trades that are subject to the clearing obligation under EMIR will need to be traded on a RM, MTF, organized trading facility (OTF) or third country (i.e. non-EU) trading venue. This MiFID II requirement is known as the trading obligation.  This requirement is expected to apply to both FCs and NFC+s.  Once the European Commission has adopted a clearing obligation in relation to a class of derivatives, ESMA will be required to launch a consultation to determine whether such derivatives should be subject to the trading obligation.  On 26 May, 2016, ESMA published final draft regulatory technical standards on the criteria for determining whether derivatives subject to the clearing obligation should be subject to the trading obligation. When establishing whether a class of derivatives has sufficient third-party buying and selling interest to be considered sufficiently liquid for the trading obligation, ESMA shall take into consideration:   1. the average frequency of trades (number of days on which trading took place and the number of trades); 2. average size of trade (average daily turnover and value of trades); 3. number and type of active market participants (including the numbers of trading venues admitted to trading the class of derivatives and the number of market participants trading in that class of derivatives); and 4. average size of spreads (including volume weighted spreads over different periods of time and spreads at different points in time of trading sessions). | Dodd-Frank Section 723(a)(8)  Commodity Exchange Act (7 USC 2(h)(8))  17 CFR Parts 1, 16, 37, 38 and 40  Swaps that are required to be cleared must be traded on a designated contract market (DCM) or a swap execution facility (SEF), except where no DCM or SEF makes the swap available for trading.  Swaps traded on SEFs are divided into two different categories for the purposes of the trade execution regime. "Required transactions" are those swaps that are subject to the trade execution requirement. "Permitted transactions," are those transactions that do not involve swaps subject to the trade execution requirement. Block trades, illiquid swaps and bespoke swaps generally fall into the "permitted transactions" category.  A DCM or SEF may make a swap "available to trade" by first making a determination based on several factors, including that there are ready and willing buyers and sellers, the trading volume, the bid/ask spread and the frequency or size of transactions. If the DCM or SEF determines that the swap is available to trade, it may submit this determination to the CFTC. The CFTC may provide for a 30-day public comment period before determining that a swap is available to trade.  In February 2014, certain classes of USD, EUR and GBP-denominated fixed-to-floating interest rate swaps along with certain classes of index-based untranched credit default swaps were declared available to trade. However, pursuant to CFTC no-action relief, swaps between eligible affiliate counterparties that are subject to a trade execution requirement are not required to be cleared until 16 December, 2016.  A "**swap execution facility**" is defined as a trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce, including any trading facility, that:   * facilitates the execution of swaps between persons; and * is not a designated contract market. * DCM rules in force 20 August, 2012 (17 CFR Part 38)   On 22 January, 2016, the CFTC registered 18 SEFs.  SEF rules (17 CFR Part 37)   * Swaps subject to a clearing requirement must be traded on an SEF either through an Order Book or through a Request for Quote System (RFQ) that operates in conjunction with an Order Book. * Swap transactions are subject to the execution requirement upon the later of (a) the date the clearing requirement for such swap goes into effect, or (b) thirty days after the determination that such swap is available to trade is deemed approved or certified pursuant to CFTC rules. * An Order Book is defined as an electronic trading facility, a trading facility (each as defined in the Dodd-Frank Act) or a trading system or platform in which all market participants in the trading system or platform have the ability to enter multiple bids and offers, observe or receive bids and offers entered by other market participants, and transact on such bids and offers. * The RFQ system is a trading system or platform in which a market participant transmits a request for a quote to buy or sell a specific instrument to no less than a certain number of participants in the trading system or platform, to which all such participants may respond. * An SEF must provide any eligible contract participant and any independent software vendor with impartial access to its market(s) and market services, including any indicative quote screens or similar pricing data displays. * A minimum pause of 15 seconds between entry of two potentially matching customer-broker swap orders or two potentially matching customer-customer swap orders on SEFs’ Order Book (such that one side of the potential transaction is disclosed and made available to other market participants before the second side of the potential transaction is submitted for execution). The time delay is not applicable to trades executed through an RFQ system. * SEFs must provide that market participants transmit an RFQ to at least three potential counterparties in the trading system or platform, subject to a phase-in compliance period: * SEFs may offer any method of execution for permitted transactions as long as an Order Book is among the offered methods. * SEFs are not required to offer functionality for indicative quotes. * SEFs may use proprietary data or personal information for business or marketing purposes only if the person from whom they collect or receive such information consents to such use, and SEFs may not condition access to their facilities based upon such consent.   Trade reporting  Pursuant to US trade reporting rules, SEFs must report creation data to a registered swap data repository for any swaps executed on or pursuant to the rules of an SEF.  Continuation data reporting for uncleared swaps executed on or pursuant to the rules of an SEF is the obligation of the designated reporting counterparty, not the SEF. | |
| Derivatives Clearing Organizations / CCPs | EMIR Articles 14 - 50  CCPs need to be authorized by the relevant competent authority and comply with new organization, prudential, conduct of business and minimum capital requirements.  Non-EEA CCPs may be authorized by ESMA to provide clearing services in the EEA, provided that the CCP is subject to equivalent supervision and enforcement regime in the relevant non-EEA state. To date, the Commission has established implementing acts in respect of Australia, Hong Kong, Singapore and Japan. Accordingly, CCPs from those jurisdictions are able to obtain recognition under EMIR. CCPs from other jurisdictions are not yet able to obtain recognition under EMIR, but are currently able to continue providing any services they have been providing into the EU on the basis of transitional provisions under EMIR.  CCPs are subject to:   * detailed organizational requirements, including requirements as to the composition and structure of the board and senior management arrangements and internal control structures, such as risk, compliance, internal audit and technology management; * extensive and prescriptive Business Continuity Planning / Disaster Recovery requirements (including, for example, a requirement for the CCP to ensure recovery of critical functions within 2 hours); * prescriptive financial resource and liquidity requirements. This includes a base capital requirement of EUR 7.5m, together with risk based capital calculated on the basis of the approaches that are derived from those set out for banks in the Capital Requirements Directive; * a requirement to offer clearing members the ability to segregate client accounts with the CCP either at an omnibus or individual client level; * a requirement for CCPs contractually to commit themselves to transfer assets and positions of a defaulting member for the account of clients to another clearing member nominated by all such clients, on their request and without the consent of the defaulting clearing member; and * prescriptive requirements as to structure and operation of the default arrangements to be applied by CCPs, including: * requirements for a minimum size of default fund; and * an obligation on the CCPs to use their own dedicated resources before seeking recourse to the default fund contributions of non-defaulting members.   As indicated above, to date, 16 EU CCPs have been authorised and 18 non-EU CCPs recognized under EMIR. | Dodd-Frank Section 725  Commodity Exchange Act (7 USC 7a–1)  DCOs are subject to registration, financial and risk management requirements.  Final Rule  17 CFR Parts 1, 21, 39, and 140  DCOs are subject to registration, financial and risk management requirements, including:   * financial resources must be able to cover DCOs operating costs for at least one year; * DCOs must perform monthly stress tests to assess how much financial resources they need to meet their statutory requirements; * each DCO must "make a reasonable calculation of its projected operating costs over a 12 month period in order to determine the amount needed to meet" its statutory requirements; * DCOs cannot "set a minimum capital requirement of more than $50 million for any person that seeks to become a clearing member in order to clear swaps"; * DCOs must segregate, set aside or hold in a separate account customer funds and assets; and * in order for a DCO or its clearing members to commingle customer positions in swaps, options and futures, the DCO must file rules for approval with the CFTC. | |
| Trade Reporting | EMIR Article 9  EU derivatives contracts (including both listed and OTC and whether or not subject to the clearing obligation) must be reported to a trade repository (or, if unavailable, to ESMA) by no later than the next working day.  Counterparties are responsible for ensuring that the details of any OTC derivative transactions entered into (including modifications and amendments) are reported without duplication, although the reporting obligation can be delegated by prior agreement to one counterparty or a third party.  The details to be reported to trade repositories are set out in the delegated regulations and include the parties to the contract and the main commercial details of the transaction.  Counterparties should keep a record of any derivatives contracts they enter into and any modifications for at least 5 years after the termination of the contract.  The reporting obligation took effect on 12 February, 2014.  Trade repositories must be registered and monitored by ESMA and are subject to operational requirements.  ESMA has approved the registration of the following trade repositories:   * DTCC Derivatives Repository Ltd. (DDRL), based in the United Kingdom * Krajowy Depozyt Papierów Wartosciowych S.A. (KDPW), based in Poland * Regis-TR S.A., based in Luxembourg * UnaVista Ltd, (the London Stock Exchange's global hosted platform based in the United Kingdom) * ICE Trade Vault Europe Ltd. (ICE TVEL), based in the United Kingdom; and * CME Trade Repository Ltd. (CME TR), based in the United Kingdom.   The registered trade repositories cover all derivative asset classes – commodities, credit, foreign exchange, equity, interest rates and others – irrespective of whether the contracts are traded on or off exchange.  All FCs and NFC+s also need to report data on collateral and valuations.  **MiFID II transparency requirements**  Like MiFID I, MiFID II will require the publication of "pre-trade" information (including bid and offer prices) and "post-trade" information (containing the details of executed trades).  MiFID II will extend the existing pre- and post-trade transparency requirements in MiFID I beyond equities to cover equity-like instruments, bonds and derivatives.  MiFID II will also require greater detail and clarity on the content and format of trade reports by providing for a standardized format and content.  Trading venues will be required to make pre- and post-trade reporting data available on a reasonable commercial basis.  A key feature of MiFID II is that the cost of data will be reduced by requiring trading venues to unbundle pre-trade from post-trade data. These are currently commonly sold together as part of a single package. MiFID II will require such data packages to be unbundled.  Firms that execute transactions off-exchange will have to publish their trades through Approved Publication Arrangements (APAs). APAs will be subject to governance requirements and will have to be authorised by national regulators.  MiFiD II envisages that a consolidated tape will be introduced for all equity and equity-like trades in the EU; in the longer term, it is intended to create a similar tape for non-equities. A firm that consolidates data from across the EU will have to meet certain organizational requirements and be authorized as a consolidated tape provider (CTP).  MiFID II transaction reporting  MiFID II will extend the scope of the existing MiFID I regime for transaction reporting, under which firms are required to report transaction data to regulatory authorities. This transaction data will allow regulators to detect and investigate market abuse, assess compliance with MiFID II, and monitor wider market trends.  MiFID II will introduce more comprehensive transaction reporting requirements by requiring greater amounts of information on transactions in a wider range of financial instruments. The scope of the transaction reporting regime will be extended to cover the following types of instrument (including certain derivatives):   * financial instruments that are admitted to trading or traded on an RM, MTF or OTF, or for which a request for admission has been made; * financial instruments where the underlying is a financial instrument traded on an RM, MTF or OTF; and * financial instruments where the underlying is an index or basket composed of financial instruments traded on an RM, MTF or OTF.   The expansion in the number of fields required in transaction reports has been a contentious issue in the industry. ESMA previously proposed that a total of 81 fields should be included in the transaction report, which would be a very significant increase compared with current reporting requirements. In September 2015, ESMA stated that in response to industry feedback, the number of fields in the transaction report would be reduced. ESMA's latest proposals now specify a total of 65 fields in the transaction report.  Firms will be able to make transaction reports to regulatory authorities via an approved reporting mechanism (ARM). ARMs will have to be authorised by their national competent authorities and will also be subject to organizational requirements to ensure that they can discharge their responsibilities properly.  Although market participant have advocated for the reporting requirements under EMIR and MiFID II to be aligned, ESMA expressly rejected these requests when proposing MiFID II trade reporting requirements in September 2015. | Dodd-Frank Section 727  Commodity Exchange Act (7 USC 2(a)(13)  CFTC is authorized to require real-time public reporting for cleared and uncleared swaps, with appropriate time delays for reporting large notional swap transactions (block trades).  Final Rule  17 CFR Parts 43 and 45   * All primary economic terms data for the swaps must be reported; * reporting must be done "as soon as technologically practicable after execution" but no later than 1 hour after execution during the first year of compliance and 30 minutes after execution beginning with the second year of compliance; * however, if the non-reporting counterparty is neither a swap dealer nor an MSP and is not a financial entity as defined in the CEA and verification of economic terms does not occur electronically, then swaps must be reported as "soon as technologically practicable after execution" but no later than within 24 business hours after execution during the first year of compliance, 12 business hours after execution during the second year of compliance and 30 minutes after execution beginning with the third year of compliance; * requirement of continuation data reporting to ensure that all reported data remains accurate and up-to-date; * each swap is to be recorded using a unique swap identifier and each counterparty is to be identified using a single legal entity identifier; * swap products are to be identified using unique product identifiers and a product classification system; and * swap reporting is to a registered swap data repository (SDR) unless no SDR makes the swap available for reporting, in which case swaps are to be reported directly to the CFTC.   SBSR Registration and Reporting  On 14 January, 2015 the SEC adopted two new sets of rules that require security-based swap data repositories (SBSRs) to register with the SEC and prescribed reporting and public dissemination requirements for security-based swap transaction data. On 11 February, 2015, the SEC finalized certain additional rules, rule amendments and guidance related to the reporting and public dissemination of security-based swap transaction data (collectively, Regulation SBSR).  In connection with these rules, the SEC has proposed a new compliance schedule with respect to reporting of a particular asset class such that any person who has an obligation to report must commence reporting six months after the first registered SBSR commences operations and accepts reports of security-based swaps in that particular class (Compliance Date 1). The proposed compliance schedule also requires historical data to be reported, to the extent available, by Compliance Date 1.  The public dissemination requirements of Regulation SBSR go into effect 3 months after Compliance Date 1 for that particular asset class.  On 29 March, 2016, ICE Trade Vault LLC became the first firm to apply for registration as a SBSR. Comments on ICE Trade Vault LLC's application were due to the SEC by 31 May, 2016. After reviewing comments, the SEC will determine whether to register ICE Trade Vault LLC as an SBSR,  Block trades  17 CFR Part 43  CFTC has established initial appropriate minimum block sizes for publicly reportable swap transactions based on categories within these swap classes:   * Interest rate asset class   + Credit asset class   + Foreign exchange asset class   + Other commodity asset class   Block sizes are calculated using formulas based on 50 per cent, 67 per cent or 75 per cent of aggregate notional value of a "trimmed data set" of large notional transactions.  CFTC rules provide initial block sizes prior to the effective date of a CFTC determination to establish an applicable post-initial block size for a swap category.  CFTC rules also provide for time delays for public dissemination for certain block trades. These time delays vary depending on the parties involved. Currently, "year 2" time delays are in effect, and unless stated otherwise, these time delays will remain unchanged going forward. Where an SD/MSP counterparty is the regulatory reporting party, the time delays for pubic dissemination is 15 minutes for swaps executed on a SEF or a DCM; 15 minutes for off-facility swaps subject to mandatory clearing, 30 minutes for credit, equity, foreign exchange and interest rate off-facility swaps not subject to mandatory clearing, and 2 hours for all other off-facility swaps not subject to mandatory clearing.  Where a non-SD/MSP counterparty is the regulatory reporting party, the time delays for public dissemination is 15 minutes for swaps executed on a SEF or DCM, 2 hours for off-facility swaps subject to mandatory clearing (the time delay will be reduced to 1 hour starting year 3), and 36 business hours for off-facility swaps not subject to mandatory clearing (the time delay will be reduced to 24 business hours starting year 3).  Determining the reporting counterparty  17 CFR Part 45  The identity of the reporting counterparty is determined as follows:   * if only one counterparty is a swap dealer, then the swap dealer is the reporting counterparty; * if neither counterparty is a swap dealer but only one counterparty is an MSP, then the MSP is the reporting counterparty; * if neither counterparty is a swap dealer or an MSP but one counterparty is a financial entity as defined in Section 2(h)(7)(C) of the CEA, then the financial entity is the reporting counterparty; * if both counterparties have the same status, then they decide amongst themselves who will report; and * notwithstanding these rules, if neither party is a swap dealer or an MSP and only one party is a US person, then the US person reports. | |
| Record keeping | EU Directives, including MiFID, set out a wide range of record keeping requirements applicable to different types of regulated activities that have been transposed into national regulatory provisions.  These requirements include that firms should retain all records for at least 5 years (including the relevant data relating to all transactions in financial instruments) and that records of the rights and obligations of parties (i.e. contract terms, or terms of business) should be retained for at least the duration of the relationship with the client. The rules also specify how records should be held.  Article 9(2) of EMIR requires that counterparties keep a record of any derivative contract or modification for at least five years following the termination of that contract.  MiFID II includes some additional record keeping requirements, for example, with regard to the recording of telephone conversations and electronic communications.  On 25 April, 2016, the European Commission adopted a draft delegated regulation requiring investment firms to have arrangements in place to ensure compliance with requirements to record telephone conversations and electronic communications. A firm's management bodies must have effective oversight and control over the policies and procedures relating to such recordings.  Under EMIR, CCPs are required to comply with more detailed record keeping requirements. For example, CCPs are required to maintain transaction records, position records and general business records in accordance with detailed provisions set out in the technical standards underpinning EMIR, for a period of at least 10 years. | 17 CFR Part 45  Various swap participants are required to keep records of their swaps.  End users are required to "keep full, complete and systematic records, together with all pertinent data and memoranda, with respect to each swap in which they are a counterparty," including records proving that their swaps are exempt from mandatory clearing under Section 2(h)(7) of the CEA.  All participants must retain records through the life of the swap and for a period of five years after the swap is terminated.  End-users may keep records in electronic or paper form, as long as the information is retrievable and reportable.  Records kept by end-users should be retrievable within five business days, while records kept by other participants should be readily accessible via real-time electronic access throughout the life of the swap plus two years, and within three business days thereafter.  Records must be open to inspection by the Department of Justice, the CFTC, the SEC and representatives of prudential regulators. | |
| Risk mitigation techniques for uncleared trades | EMIR Article 11  Under EMIR, in respect of uncleared trades, counterparties need to have appropriate procedures in place to monitor and mitigate operational and counterparty credit risk, including timely confirmation of the terms of OTC derivative trades, portfolio reconciliation, portfolio compression and dispute resolution. FCs and NFC+s are also obliged to engage in timely, accurate and appropriately segregated exchange of collateral and conduct a daily mark-to-market (or, if market conditions do not allow, marking to model). In addition, FCs are required to hold appropriate and proportionate capital to manage the risks not covered by appropriate exchange of collateral.  The following is a summary of some of the key requirements.  Timely confirmation of uncleared derivative transactions (in force from 15 March, 2013)  Each counterparty to uncleared OTC derivative transactions must confirm trades as soon as possible and at the latest:   * for transactions between FCs and NFC+s: T+1 * for transactions with a NFC-: T+2   If a trade is concluded after 16:00 local time, confirmation must take place at the latest one business day following the deadline set out in the relevant category above.  In addition, FCs must report on a monthly basis to the competent authority the number of unconfirmed OTC derivative trades in the above categories that have been outstanding for more than 5 business days.  The confirmation requirements will apply to all non-cleared trades.  ISDA has issued a form of Timely Confirmation Amendment Agreement as a form of agreement that market participants can use as part of their tool kit for compliance with the obligation imposed by EMIR to provide timely confirmation of the terms of an uncleared OTC derivative contract.  Mark-to-market (in force from 15 March, 2013)  FCs and NFC+s need to mark-to-market on a daily basis (or, if market conditions do not allow, marking to model) and when the trade repositories are established, report these to the trade repository daily.  Portfolio reconciliation and portfolio compression (in force from 15 September, 2013)  Counterparties must agree in writing the terms of portfolio reconciliation for OTC derivatives trades, which must include reconciliation of key trade terms and any mark to-market valuations (see above).  The frequency with which portfolio reconciliation must be performed depends on whether the entity is a FC, NFC+ or NFC- and the number of outstanding OTC derivative contracts between the counterparties.  Portfolio compression applies where counterparties have 500 or more OTC derivative contracts outstanding with each other.  Dispute resolution (in force from 15 September, 2013)  Counterparties must have in place agreed detailed procedures and processes in place covering the identification, recording and monitoring of disputes which relate to the recognition or valuation of a transaction and any exchange of collateral.  Disputes must be resolved in a timely manner and the procedures must include a specific process for resolution of any dispute that is not resolved within 5 business days.  ISDA has published the 2013 EMIR Portfolio Reconciliation, Dispute Resolution and Disclosure Protocol to aid compliance with these requirements by allowing a counterparty to adhere to a single arrangement which will address these requirements with all other counterparties. ISDA has also published a bilateral standard amendment agreement, which is based on this Protocol and may be a useful tool for those counterparties who wish to amend their documentation on a bilateral basis.  Margin requirements  Please see below. | 17 CFR Part 23  The risk mitigation techniques apply to swaps where one or more of the counterparties are a swap dealer or MSP.  Timely confirmations of uncleared off-facility swap transactions  Each swap dealer and MSP entering into a swap transaction must execute a confirmation (and send an acknowledgment, if applicable) as soon as technologically practicable and at the latest:   * T+1 for the following:   Confirmation for credit swaps or interest rate swaps with swap dealer or MSP  Confirmation for equity swaps, foreign exchange swaps, or other commodity swaps with swap dealer or MSP  Acknowledgment for credit swaps or interest rate swaps with a non-swap dealer and non-MSP  Acknowledgment for equity swaps, foreign exchange swaps, or other commodity swaps with non-swap dealer and non-MSP  Confirmation for credit swaps or interest rate swaps with financial entity  Confirmation for equity swaps, foreign exchange swaps or other commodity swaps with financial entity   * T+2 for the following:   Confirmation for credit swaps or interest rate swaps with non-swap dealer that is not an MSP or financial entity  Confirmation for equity swaps, foreign exchange swaps, or other commodity swaps with non-swap dealer that is not an MSP or financial entity  An acknowledgment is a written or electronic record of all of the terms of a swap. An acknowledgment is not legally binding until it is signed or otherwise executed by a receiving counterparty, upon which it becomes a confirmation.  Prior to execution, the prospective counterparty may ask the swap dealer or MSP for a draft acknowledgment specifying all terms of the swap transaction other than the applicable pricing and other relevant terms that are to be expressly agreed at execution.  Mark-to-market  For cleared swaps, each swap dealer or MSP must notify its counterparties of their right to receive, upon request, the daily mark from the appropriate derivatives clearing organization.  For uncleared swaps, each swap dealer or MSP must provide its counterparties with a daily mark, which shall be the mid-market mark of the swap. The mid-market mark of the swap shall not include amounts for profit, credit reserve, hedging, funding, liquidity, or any other costs or adjustments. The daily mark shall be provided to the counterparty during the term of the swap as of the close of business or such other time as the parties agree in writing.  Portfolio reconciliation  For swaps where both counterparties are swap dealers and/or MSPs:   * terms to be agreed upon in writing; * may be performed on a bilateral basis or by a qualified third party; * portfolio to be reconciled no less frequently than: (a) each business day for each portfolio with ≥500 swaps; (b) weekly for each portfolio with >50 but <500 swaps on any business day during the week; (c) quarterly for each portfolio with ≤50 swaps during the calendar quarter; * each swap dealer and MSP must resolve immediately any discrepancy in a material term of a swap identified as part of a portfolio reconciliation or otherwise; and * each swap dealer and MSP must have policies reasonably designed to resolve any discrepancy in a valuation identified as part of a portfolio reconciliation or otherwise as soon as possible, but in any event within 5 business days.   For swaps with non-swap dealers and non-MSPs:   * terms to be agreed upon in writing, including agreement on the selection of any third-party service provider; * may be performed on a bilateral basis or by one or more third parties selected by counterparties; * portfolio to be reconciled no less frequently than: (a) quarterly for each portfolio with >100 swaps at any time during calendar quarter; (b) annually for each portfolio with ≤100 swaps at any time during calendar year; and * each swap dealer and MSP must have written procedures reasonably designed to resolve any discrepancies in the material terms or valuation of each swap identified as part of a portfolio reconciliation (difference between lower and higher valuations of ≤10% of the higher valuation need not be deemed a discrepancy).   Valuation disputes in excess of $20m to be reported to regulators if not resolved within 3 business days (for swaps with swap dealers and MSPs) or 5 business days (for all other swaps).  Portfolio compression for uncleared swaps  Each swap dealer and MSP must have policies for: (i) terminating each fully offsetting swap with another swap dealer or MSP in a timely fashion, when appropriate, (ii) periodically engaging in bilateral portfolio compression exercises, when appropriate, with other swap dealers and MSPs, and (iii) engaging in multilateral portfolio compression exercises, when appropriate, with other swap dealers and MSPs.  Each swap dealer and MSP must have policies for terminating fully offsetting swaps and for engaging in portfolio compression exercises with respect to swaps with non-swap dealers and non-MSPs, to the extent requested by any such counterparty. | |
| Margin requirements for uncleared trades | **EMIR Article 11 (3)**  FCs and NFC+s will be subject to initial and variation margin requirements for uncleared trades.  On 8 March 2016 the Joint Committee of the European Supervisory Authorities (the **ESAs**) published the final draft regulatory technical standards on the margin requirements for derivative trades not cleared by a CCP. Under EMIR, certain counterparties will need to exchange both initial and variation margin in respect of derivative trades not cleared by a CCP.  The rules follow the framework established by the international standards set out in the Basel Committee on Banking Supervision (**BCBS**) and International Organization of Securities Commission's(**IOSCO**) final report published on 18 March 2015.  For affected entities, all uncleared OTC derivatives (except physically settled FX swaps and forwards and currency swaps) are in scope for the initial margin requirements.  The margin requirements apply throughout the life of all new derivative contracts entered into after the applicable phase-in dates. Existing contracts will not be affected.  **Initial margin**  The requirement to exchange initial margin will be phased in over a 4 year period from 1 September 2016 (starting with the largest derivatives market participants) and will apply to new contracts as set out below.   |  |  | | --- | --- | | **Phase-in date** | **Trades subject to the initial margin rules** | | 1 September 2016 | If both counterparties have or belong to groups each of which has an  aggregate month-end average notional amount of uncleared derivatives for March, April and May 2016 that is above €3.0 trillion. | | 1 September 2017 | If both counterparties have or belong to groups each of which has an aggregate month-end average notional amount of uncleared derivatives for March, April and May 2017 that is above €2.25 trillion. | | 1 September 2018 | If both counterparties have or belong to groups each of which has an aggregate month-end average notional amount of uncleared derivatives for March, April and May 2018 that is above €1.5 trillion. | | 1 September 2019 | If both counterparties have or belong to groups each of which has an aggregate month-end average notional amount of uncleared derivatives for March, April and May 2019 that is above €0.75 trillion. | | 1 September 2020 | If both counterparties have or belong to groups each of which has an aggregate month-end average notional amount of uncleared derivatives that is above €8 billion. |   At the end of the phase-in period from 1 September, 2020 the initial margin requirements will apply to uncleared derivative transactions where both counterparties have or belong to groups, each of which has an aggregate average notional amount of uncleared derivatives of more than EUR 8 billion.  FCs and NFC+s do not need to exchange initial margin or variation margin where their counterparty is an NFC-.  Where the total initial margin for uncleared derivatives between the counterparties at group level is equal to or lower than EUR 50 million, no initial margin needs to be exchanged.  The collecting counterparty must segregate the initial margin either with a third party holder or custodian or via other legally binding arrangements so that it is protected from the default or insolvency of the collecting counterparty.  **Variation margin**  Counterparties will also need to exchange variation margin on a daily basis in respect of new contracts entered into:   * 1. from 1 September, 2016 (where both counterparties have, or belong to groups, each of which has an aggregate average notional amount of non-centrally cleared derivatives above EUR 3 trillion); and   2. from 1 March, 2017 (for all other counterparties).   The variation margin requirements apply throughout the life of all new derivatives contracts entered into after the applicable phase-in dates.  **Minimum transfer amount**  Counterparties that are subject to the margin requirements can agree a minimum transfer amount (not to be more than €500,000) such that where the full amount due to be collected is lower than this amount, no collateral needs to be collected. This can be shared with initial and variation margin.  **Eligible collateral**  Only certain collateral that is sufficiently liquid and not exposed to excessive credit, market and FX risk will be eligible for initial and variation margin. The list of eligible collateral broadly includes:   * cash; * allocated gold; * debt securities issued by government entities, international organizations, multilateral development banks, credit institutions or investment firms; * certain covered bonds; * corporate bonds; * the most senior tranche of a securitization (provided it is not a re-securitization); and * certain equities   There are also concentration limits for initial margin to ensure that the collateral is reasonably diversified and to the extent that the value of collateral is exposed to market and FX risk, risk-sensitive haircuts may need to be applied.  These rules will require amendments to collateral documentation. ISDA has recently published the ISDA 2016 Credit Support Annex for Variation Margin under English law which allows parties to agree collateral terms for variation margin that comply with the new requirements.  **Exemptions from the margin requirements**  There is an exemption that can be obtained for intragroup transactions, provided certain detailed requirements are met and communicated to the relevant competent authority.  Certain entities such as multilateral development banks, public sector entities that are owned by central government or have government guarantees, the European Financial Stability Fund, the European Stability Mechanism and the Bank for International Settlements are exempt from these requirements.  There is also an exemption for CCPs where they are managing the portfolio of a defaulted clearing member.  **Delayed application for certain products**  There is a delayed application of the margin requirements to intragroup transactions with non-EU counterparties.  Given the inconsistent interpretation of FX derivatives across the EU, there is a delayed application of the variation margin requirements to physically settled FX forwards until the earlier of: (i) 31 December, 2018; or (ii) the date of entry into force of the delegated act under MiFID II which would provide a common definition of FX forwards.  There is also a three year phase-in of the initial margin and variation margin requirements for uncleared OTC derivatives on single-stock equity options and index options and an exemption for OTC derivatives associated to covered bonds subject to certain conditions being met.  An EU counterparty may not need to post or collect variation or initial margin for trades with a non-EU counterparty located in a jurisdiction where the enforceability of netting agreements or protection of collateral cannot be supported by an independent legal assessment. There are certain requirements which must be met and a strict limitation on the number of such trades.  Counterparties also need to put in place robust operational requirements, including clear senior management reporting, an escalation procedure and documentation requirements.  At the back of this summary brochure we have added a comparison section which provides a more generalized description of the margin requirements that apply across the EU, US and Hong Kong. | Dodd-Frank Sections 731 and 764  Requirements created by CFTC, SEC and prudential bank regulators.  Pursuant to amendments to the Dodd-Frank Act signed into law on 28 March, 2015 margin requirements will not apply to (a) non-financial entities entering into swaps to hedge and mitigate commercial risk, (b) affiliates acting on behalf of such an entity that use swaps to hedge or mitigate the commercial risk of such entity or another affiliate that is not a financial entity, and (c) cooperatives that meet certain regulatory parameters.  Rule 17 CFR Parts 23 and 140; Rule 12 CFR Parts 45, 237, 349, 624, 1221  In October 2015 and December 2015, the prudential regulators and the CFTC adopted their respective margin requirements for uncleared swaps. The rules containing these requirements went into effect on 1 April, 2016 with staggered compliance dates beginning on 1 September, 2016 and ending on 1 September, 2020.  The amount of margin required will vary based on the relative risk of the counterparty and of the non-cleared swap. The rules set forth staggered compliance dates depending on the combined average daily aggregate notional amount of covered swaps for March, April and May of a particular year, starting from September 1, 2016 between a Covered Swap Entity and its counterparty. Covered Swap Entities, whose swap trades will be subject to margin requirements, include banks, insurance companies, hedge funds, mutual funds, asset managers, pension plans and securitization vehicles, among other types of entities.  The compliance date for variation margin requirements is proposed to be 1 September, 2016 where both a swap dealer/MSP combined with all its affiliates and its counterparty combined with all its affiliates have an average daily aggregate notional amount of covered swaps for March, April and May of 2016 that exceeds $3 trillion+. The compliance dates with respect to all other types of counterparty relationships is 1 March, 2017  The compliance dates for initial margin requirements will be phased in from 1 September, 2016 to 1 September, 2020 depending on the average daily aggregate notional amounts of the counterparties and their affiliates.  Trades between swap dealers/MSPs and other swap dealers/MSPs: swap dealer/MSP must post and collect initial margin and variation margin for each trade.  Trades between swap dealers/MSPs and financial end users with a material swaps exposure: swap dealer/MSP must post and collect initial and variation margin for each trade. Trades between swap dealers/MSPs and financial end users without a material swaps exposure: swap dealer/MSP posts and collects initial margin as it determines to be appropriate and is required to post and collect variation margin. Trades between swap dealer/MSPs and affiliated financial end users: a CFTC-regulated swap dealer/MSP is required to post initial margin to affiliated prudentially-regulated swap entities. However, CFTC-regulated swap dealers/MSPs are not required to collect or post initial margin so long as their affiliate counterparty is not a prudentially-regulated swap dealer/MSP and two conditions are met: (1) the swaps are subject to a centralized risk management program that is reasonably designed to monitor and to manage the risks associated with the inter-affiliate swaps; and (2) the swap dealer/MSP exchanges variation margin with the margin affiliate.  Material swaps exposure is defined to mean that the entity and its affiliates have an average daily aggregate notional amount of non-cleared swaps, non-cleared security-based swaps, foreign exchange forwards and foreign exchange swaps with all counterparties for June, July and August of the previous year that exceeds $8 billion, where such amount is calculated only for business days.  Swap dealers/MSPs may adopt a maximum initial margin threshold amount of $50 million, below which the swap dealer/MSP need not collect or post initial margin from or to other swap dealers/MSPs and financial end users with material swaps exposure. The rules set forth a minimum transfer amount of up to $500,000. Thus, any transfer of margin with a value of less than $500,000 will not be required, but once the value of the payment exceeds $500,000, the entire payment (not just the excess over $500,000) will need to be made.  In May 2016, the CFTC adopted new rules with respect to cross-border application of the CFTC’s margin requirements under the Dodd-Frank Act for uncleared swaps entered into by CFTC-registered swap dealers and MSPs for which there is no prudential regulator. The new rules will go into effect on 1 August 2016, ahead of the first compliance date set out above. The new rules have their own definition of "U.S. person" which is broader than the definition under the CFTC's cross-border derivatives guidance and may result in a non-US entity being deemed a US person for margin purposes as a result of having a parent that is a separate legal entity based in the US.  Accordingly, the CFTC has two separate cross-border frameworks with respect to the application of certain rules promulgated pursuant to the Dodd-Frank Act (one framework with respect to the applicability of swap dealer/MSP rules and regulations to cross-border swap transactions and another framework for the applicability of uncleared margin requirements to cross-border transactions).  The new rules with respect to cross-border application of the CFTC’s uncleared margin requirements work as follows:   * U.S. covered swap entities (which refers to swap dealers/MSPs registered with the CFTC) will be required to comply with the CFTC’s margin rules for all uncleared swaps but would be eligible for substituted compliance with respect to margin that they post (but not that they collect) for swaps with certain non-U.S. counterparties. * Uncleared swaps of non-U.S. covered swap entities whose obligations under the relevant swap are guaranteed by a U.S. person will be treated the same as uncleared swaps of U.S. covered swap entities. * Uncleared swaps of non-U.S. covered swap entities whose obligations under the relevant swap are not guaranteed by a U.S. person but whose financial statements are included in those a of U.S. ultimate parent will be eligible for substituted compliance unless the counterparty to the swap is a U.S. covered swap entity or a non-U.S. covered swap entity whose obligations under the swap are guaranteed by a U.S. person.   Uncleared swaps between a non-U.S. covered swap entity and a non-U.S. person are excluded from the CFTC margin rules, if neither party’s obligations under the relevant swap are guaranteed by a U.S. person and neither party is a U.S. branch of a non-U.S. covered swap entity nor consolidated in the financial statements of a U.S. person. | |
| Position limits | MiFID II  MiFID II proposes transparent non-discriminatory position limits in relation to commodity derivatives that trading venues must apply.  MiFID II empowers ESMA to co-ordinate measures taken by EU competent authorities to manage positions, including the setting of position limits and ESMA will have specific powers when certain criteria are met and can demand information on the site and purpose of a position or exposure entered into via a derivative and request that steps be taken to reduce the site of the exposure or position.  Position limits will not apply to positions held by or on behalf of a non-financial entity and which are objectively measurable as reducing risks directly relating to the commercial activity of that non-financial entity.  The technical advice issued by ESMA in December 2014 and its draft technical standards published in September 2015 contained proposed requirements for position limits and position reporting in relation to commodity derivatives, together with a discussion of the scope of the application of MiFiD II to such derivatives.  On 20 April, 2016, the European Commission wrote to ESMA proposing several amendments to the position limits regime. ESMA agreed to these amendments, and published revised technical standards on 3 May.  On 25 April, 2016, the Commission published a draft delegated Regulation containing its proposals for position reporting based on ESMA's earlier technical advice.  The existing exemptions for commodities firms have largely been lifted, thereby bringing most, if not all, commodities trades under the scope of MiFID II. There remains some discussion regarding an exemption that will apply when an activity in commodity derivatives is ancillary to a group's main business. On 20 April, 2016, the Commission wrote to ESMA proposing amendments to ESMA's draft technical standards on this ancillary activity exemption. On 30 May, 2016, ESMA responded to the Commission's letter with its opinion on the changes and a revised draft technical standard. | Dodd-Frank Section 737  In November 2011, the CFTC issued a final rule on position limits. On 28 September, 2012 a US federal district judge vacated the final rule.  Following the court decision, the CFTC issued a new proposed rule in November 2013. The latest public comment period ended 22 January, 2015. The CFTC is expected to approve final rules after reviewing the comments.  Proposed Rule  17 CFR Part 150   * 28 Core Referenced Futures Contracts: * 9 "legacy" agricultural contracts * 10 "non-legacy" agricultural contracts * 4 energy contracts * 5 metal contracts   Two types of speculative limits: spot-month position limits and non-spot-month position limits.  Spot-month position limits apply in the period immediately before delivery obligations are incurred for physical delivery contracts or the period immediately before contracts are liquidated by the clearinghouse based on a reference price for cash-settled contracts.  Spot-month period is specific to each commodity contract, need not correspond to a month-long period, and may extend through the period when the contract is no longer listed for trade or available for transfer.  Generally, spot-month position limits for Referenced Contracts will be set at 25% of estimated deliverable supply.  Example: New York Mercantile Exchange Light Sweet Crude Oil spot-month limit: 3,000.  Aggregation is generally required if one entity owns 10% or more of another entity. However, any person with an ownership or equity interest in an entity (financial or non-financial) of between 10% and 50% may disaggregate the owned entity’s positions upon demonstrating independence of trading.  Disaggregation is allowed if one entity owns more than 50% of another entity only upon the approval of an application to the CFTC.  There is an exemption for bona fide hedging transactions, which mean any of the following:   * sales or purchases of Referenced Contracts that do not exceed a certain quantity; * offsetting sales or purchases of Referenced Contracts that do not exceed a certain quantity; * purchases or sales by an agent who does not own or has not contracted to sell or purchase the offsetting cash commodity at a fixed price; * anticipated royalty hedges; * anticipated service hedges; * cross-commodity hedges; * pass-through swaps; or * pass-through swap offsets. | |
| Extraterritorial Issues | EMIR Articles 4 and 11  Under EMIR, the obligation to clear OTC derivative transactions applies to OTC derivative transactions between a FC or NFC+ in the EU and a non-EU entity if the non-EU entity would be subject to the clearing obligation under EMIR if it were established within the EU.  The clearing obligation and requirement to put in place risk mitigation techniques (including the margin requirements) for uncleared trades under EMIR also applies to OTC derivative trades between two non-EU counterparties where both non-EU counterparties would be subject to the clearing obligation if they were established in the EU and the contract has a "direct, substantial and foreseeable effect or where such obligation is necessary or appropriate to prevent the evasion of any provisions of EMIR".  Under Commission Delegated Regulation No 285/2014 (which applied from 10 October, 2014), an OTC derivative contract shall be considered as having a direct, substantial and foreseeable effect within the EU where:   * the two non-EU entities that would be FCs if established in the EU execute transactions via their EU branches; or * one of the two non-EU entities benefits from a guarantee from an EU FC which meets certain conditions.   Where one or more counterparties is located in a third country that has been declared to be equivalent by the European Commission adopting an implementing act, EMIR can be disapplied if the third country framework allows reaching an outcome equivalent to that of EMIR and the counterparty will be deemed to comply with EMIR.  On 30 October, 2014 the European Commission announced the first equivalence decisions regarding the regulatory regimes of CCPs in Australia, Hong Kong, Japan and Singapore.  On 13 November, 2015 the European Commission announced that it has adopted a second set of equivalence decisions in relation to the regulatory regimes for CCPs in Canada, Mexico, South Africa, Switzerland and the Republic of Korea. Since then, certain CCPs from those jurisdictions have been recognized by ESMA as being qualifying CCPs.  MiFID II  Under the trading obligation in MiFID II, certain standardized derivatives contracts must be traded on regulated trading venues, which may include third country (non-EU) trading venues, provided that the third country:   * is deemed to have a legal and supervisory framework for trading venues equivalent to that of the EU; and * has an equivalent system for the recognition of EU trading venues for the purposes of any similar trading obligation in the third country's jurisdiction.   The trading obligation will also apply to non-EU entities that would be subject to the clearing obligation if they were established in the EU and which enter into derivative transactions that have a "direct, substantial and foreseeable effect" within the EU, or where the application of the trading obligation is necessary or appropriate to prevent the evasion of any provision of MiFIR. | CFTC approach  On 26 July, 2013 the CFTC issued final interpretative guidance concerning the cross-border application of certain swap provisions of the Commodity Exchange Act.  Definition of "US person"  Per the interpretive guidance, "US person" is any person that is:  (i) any natural person who is a resident of the United States;  (ii) any estate of a decedent who was a resident of the United States at the time of death;  (iii) any corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund or any form of enterprise similar to any of the foregoing (other than an entity described in prongs (iv) or (v), below) (a ‘legal entity), in each case that is organized or incorporated under the laws of a state or other jurisdiction in the United States or having its principal place of business in the United States;  (iv) any pension plan for the employees, officers or principals of a legal entity described in prong (iii), unless the pension plan is primarily for foreign employees of such entity;  (v) any trust governed by the laws of a state or other jurisdiction in the United States if a court within the United States is able to exercise primary supervision over the administration of the trust;  (vi) any commodity pool, pooled account, investment fund, or other collective investment vehicle that is not described in prong (iii) and that is majority-owned by one or more persons described in any of the above prongs, except any commodity pool, pooled account, investment fund, or other collective investment vehicle that is publicly offered only to non-US persons and not offered to US persons;  (vii) any legal entity (other than a limited liability company, limited liability partnership or similar entity where all of the owners of the entity have limited liability) that is directly or indirectly majority-owned by one or more persons described in prong (i), (ii), (iii), (iv), or (v) and in which such person(s) bears unlimited responsibility for the obligations and liabilities of the legal entity; and  (viii) any individual account or joint account (discretionary or not) where the beneficial owner (or one of the beneficial owners in the case of a joint account) is a person described in any of the above prongs.   * The above definition is non-exhaustive. Parties may ask CFTC staff for written advice or guidance as to their status. * A foreign branch of a US person would be covered by virtue of the fact that it is a part, or an extension, of a US person. * A US branch of a non-US swap dealer or non-US MSP is a non-US person (however, it is still subject to Dodd-Frank).   This latter requirement that a US branch of a non-US swap dealer, though a non-US person, is still subject to Dodd-Frank is based on footnote 513 of the Interpretive Guidance. In November 2013 the CFTC Staff issued a clarification with regards to this footnote, stating that non-US SDs/MSPs who regularly use personnel or agents located in the US to arrange, negotiate, or execute a swap with non-US person generally would be required to comply with Transaction-Level requirements. The CFTC Staff’s reasoning was based on the fact that such persons perform core, front-office activities in the US, and thus must be subject to Dodd-Frank. However, the CFTC has issued time-limited no-action relief from compliance with this requirement until 30 September, 2016.  Substituted compliance  Substituted compliance is a concept whereby counterparties may comply with their home jurisdiction’s laws and regulations in lieu of compliance with CFTC rules. The CFTC must first determine that such foreign jurisdiction’s requirements are comparable with and as comprehensive as the corollary areas of regulatory obligations encompassed by the entity-level and transaction-level requirements.  The CFTC’s substituted compliance determinations may be made on a requirement-by-requirement basis rather than on the basis of a regime as a whole. Thus, market participants eligible for substituted compliance may have to comply with US regulations for some requirements and may comply with their home jurisdiction rules for other requirements, depending on how much of their home jurisdiction regime is covered by CFTC substituted compliance determinations.  On 20 December, 2013 the CFTC issued entity-level comparability determinations for swap dealers and MSPs for the European Union, Switzerland, Hong Kong, Australia, Japan and Canada derivatives regulation regimes and transaction-level substituted compliance determinations for certain regulations for the European Union and Japan regimes.  Entity-level requirements  For entity-level requirements, swap dealers and major swap participants must comply with  Dodd-Frank or substituted compliance by the earlier of (1) 21 December, 2013 or (2) 30 days after the issuance of an applicable substituted compliance determination for relevant entity-level requirement of the relevant jurisdiction.  Transaction-level requirements  The CFTC’s swap dealer oversight division has issued an advisory stating that it believes that a non-US swap dealer (regardless of whether it is an affiliate of a US person) regularly using personnel or agents located in the US to arrange, negotiate, or execute a swap with a non-U.S. person generally would be required to comply with transaction-level requirements.  Pursuant to CFTC no-action relief, non-US swap dealers (regardless of whether they are affiliated with a US person) that enter into swaps with non-US persons that are not guaranteed affiliates or conduit affiliates of a US person using personnel or agents located in the US to arrange, negotiate or execute such swaps do not have to comply with transaction-level requirements until 30 September, 2016 (except that if such a swap is with a non-US swap dealer, then multilateral portfolio compression and swap trading relationship requirements are outside the scope of this relief). Accordingly, for those types of transactions, the following deadlines do not apply.  Clearing for swaps between US persons and non-US swap-dealers, non-US MSPs or foreign branches of US swap dealers or MSPs went into effect on 9 October, 2013.  For other transaction-level requirements (e.g., execution on an SEF, swap-trading relationship documentation) for swaps with non-US swap dealers and MSPs or foreign branches of US swap dealers or MSPs (in either situation, only those in the EU, Switzerland, Hong Kong, Australia, Canada and Japan), compliance with Dodd-Frank or substituted compliance is required by the earlier of (1) 21 December, 2013 or (2) 30 days after the issuance of an applicable substituted compliance determination for the relevant transaction-level requirement of the relevant jurisdiction.  Real-time reporting for swaps between foreign branches of US swap dealers and MSPs in EU, Switzerland, Hong Kong, Australia, Canada and Japan and guaranteed affiliates of US persons went into effect on 30 September, 2013.  Transaction-level requirements for swaps with foreign branches of US swap dealers and MSPs located outside the jurisdictions listed above went into effect on 9 October, 2013.  Swaps between guaranteed affiliates of US persons are subject to Dodd-Frank.  Swaps between non-US swap dealers and MSPs and guaranteed affiliates of US persons are subject to Dodd-Frank.  Foreign branches  The swap should be considered to be with the foreign branch of a US bank if:   1. the employees negotiating and agreeing to the terms of the swap (or, if the swap is executed electronically, managing the execution of the swap), other than employees with functions that are solely clerical or ministerial, are located in such foreign branch or in another foreign branch of the US bank; 2. the foreign branch or another foreign branch is the office through which the US bank makes and receives payments and deliveries under the swap on behalf of the foreign branch pursuant to a master netting or similar trading agreement, and the documentation of the swap specifies that the office for the US bank is such foreign branch; 3. the swap is entered into by such foreign branch in its normal course of business; 4. the swap is treated as a swap of the foreign branch for tax purposes; and 5. the swap is reflected in the local accounts of the foreign branch.   Guarantees and affiliate conduits  Transaction-level requirements apply to swaps with non-US persons that are guaranteed by, or "affiliate conduits" of, a US person.  "Guarantee’’ includes not only traditional guarantees of payment or performance of the related swaps, but also other formal arrangements that, in view of all the facts and circumstances, support the non-US person’s ability to pay or perform its swap obligations with respect to its swaps. It is the substance, rather than the form, of the arrangement that determines whether the arrangement should be considered a guarantee.  The following factors are relevant in determining whether a non-US person is an affiliate conduit:   1. the non-US person is majority-owned, directly or indirectly, by a US person; 2. the non-US person is controlled by, or is in common control with, the US person; 3. in the regular course of business, the non-US person engages in swaps with non-US third parties for the purpose of hedging or mitigating risks faced by, or to take positions on behalf of, its US affiliate(s), and enters into offsetting swaps or other arrangements with such US affiliates(s) in order to transfer the risks and benefits of such swaps with third parties to its US affiliate(s); and 4. the non-US person’s financial results are included in the consolidated financial statements of the US person.   SEC approach  On 10 February, 2016 the SEC adopted final cross-border rules for security-based swaps, which rules were originally proposed in May 2013. The final SEC rules are not as detailed as the CFTC rules and adopt a different definition of "U.S. person" than the CFTC rules. In addition, the SEC rules focus on the location of personnel arranging, negotiating or executing a security-based swap transaction on behalf of the dealer, regardless of whether such personnel are employed by the dealer or by the dealer's agent. The rules would require a non-US person using personnel located in a US branch or office to arrange, negotiate or execute a transaction to include such transaction in its de minimis threshold calculations even if the transaction was executed anonymously and cleared. The compliance date for the rules is dependent on further rulemaking by the SEC. | |
| Business Conduct | There are detailed existing conduct of business rules for investment firms and credit institutions under MiFID I that national regulators are required to have transposed into national regulation.  MiFID II will expand the existing MiFID I requirements and the main changes include:   * advisers in financial instruments will have to elect whether to be independent (i.e. advising on the whole market) or restricted (i.e. advising on a limited range of products); * payment of commission to third parties such as issuers or product providers will be restricted in certain circumstances; * ESMA, the EBA and national regulators will be permitted to intervene to ban or restrict products in certain circumstances; and * the conduct of business rules will be extended so that they apply to eligible counterparties. | 17 CFR Parts 4 and 23  "Know your counterparty" provisions: swap dealers must implement policies and procedures designed to obtain and retain a record of the essential facts concerning each known counterparty that are necessary for conducting business with the counterparty.  Prohibition on fraud, manipulation and other abusive practices.  Swap dealers and MSPs must verify that counterparties meet the eligibility standards for an eligible contract participant.  Prior to entering into a swap, swap dealers and MSPs must disclose to their counterparties (other than swap dealers, MSPs, security-based swap dealers or major security-based swap participants) material characteristics and risks of the swap as well as the swap dealer’s or MSP’s material incentives and conflicts of interest, amongst other disclosures.  Swap dealers and MSPs must inform their counterparties that they have the sole right to choose the DCO or, for swaps not subject to mandatory clearing, that they may elect to have the swap cleared.  Swap dealers that recommend a swap or a trading strategy involving a swap must undertake reasonable diligence to understand the potential risks and rewards and must have a reasonable basis to believe that the recommended swap or strategy is suitable for the counterparty, unless a safe harbor exception applies.  ***SEC approach***  On 13 May, 2016 the SEC adopted its final rules on business conduct standards for security-based swap dealers and major security-based swap participants; such rules become effective on 12 July, 2016. The SEC in developing these rules consulted with the CFTC, prudential regulators and foreign authorities with the aim of achieving harmonization across regimes. As a result, the SEC's rules are similar in several respect to those promulgated by the CFTC including certain fact-gathering or "know your counterparty" (**KYC**) requirements and making required disclosures to counterparties so that they may assess the "material risks and characteristics" of the security-based swap activity in which they are engaging.  The following business conduct requirements will not apply to major security-based swap participants:   * "Know your counterparty" (KYC) obligations; * Recommendations of security-based swaps or trading strategies; * Special obligations when acting as an advisor to a special entity; and * "Pay to Play" rules.   The cross-board application of the SEC's rules varies from the CFTC's approach. Entity-level requirements for security-based swap entities will apply to a registered foreign or U.S. security-based swap entity's business as a whole. However, the SEC does note that substituted compliance may be available in this respect.  In terms of transaction-level requirements, foreign security-based swap dealers will be subject to such rules if "U.S. business" is implicated. The SEC defines "U.S. business" in relation to foreign security-based swap dealers to mean (i) any transaction entered into, or offered to be entered into, by or on behalf of such foreign security-based swap dealer, with a U.S. person (other than a transaction conducted through a foreign branch of that person), or (ii) any security-based swap transaction that is arranged, negotiated, or executed by personnel of the foreign security-based swap dealer located in a U.S. branch or office, or by personnel of its agent located in a U.S. branch or office.  The compliance date for such rules is uncertain at this time, but it will certainly not occur before the compliance date mandating that security-based swap dealers and major security-based swap participants register with the SEC. | |
| EU/US Substituted Compliance and Equivalence | CCPs and DCOs  On 10 February, 2016 the European Commission and the CFTC announced a common approach on the cross-border recognition for allowing DCOs and CCPs to clear derivatives for counterparties outside of the home jurisdiction of their registration.  This agreement will be implemented over the coming months.  On 2 June, 2016, ESMA and the CFTC established a memorandum of understanding which provides for the cooperation arrangements including the exchange of information regarding CCPs which are established in the US and authorized or recognized by the CFTC and which have applied for recognition under EMIR.  CFTC substituted compliance  In the US, CFTC staff issued its comparability determination on 16 March, 2016. This determination provided for substituted compliance with respect to certain requirements for financial resources, risk management, settlement procedures, and default rules and procedures. This determination will allow EU CCPs registered with the CFTC as DCOs and those seeking registration to meet certain CFTC requirements by complying with corresponding EMIR requirements.  The CFTC specifically determined that the following areas under EMIR contain requirements that are sufficiently similar to corresponding requirements under U.S. law:   * **Financial Resources –** the EMIR requirements in this area are sufficiently similar to CFTC regulation 39.11 as they provide for regular stress-testing of financial resources, specific treatment of cash balances and mandate sufficient prefunding, which includes "dedicated resources". These measures are implemented to guard against a default caused by a clearing member that leaves the CCP with significant financial exposure. * **Risk Management –** the EMIR framework, similar to CFTC regulation 39.13, mandates the appointment of a Chief Risk Officer to perform functions vital to the management of risk within the CCP. Moreover, the EU regime includes other risk-control mechanisms such as margin requirements that must be implemented and based on figures produced by margin models, which themselves are regularly reviewed and back tested. Both U.S. and EU law also require at least a 99% confident level in determining whether the initial margin figure is adequate. * **Settlement Procedures –** the EMIR framework, similar to CFTC regulation 39.14, endeavors to limit, or remove entirely, a CCP's settlement risk exposure through measures including: (1) collection of margin on a daily basis; (2) imposition of a requirement that a CCP employs certain settlement arrangements to limit risk such as settlement bank risk, concentration risk and risk posed by the physical delivery of instruments; and (3) recordkeeping requirements. * **Default Rules and Procedures –** the EMIR framework, similar to CFTC regulation 39.16, establishes a standard by which a CCP should set forth its default procedures. The default procedures must be clear and detailed and should account for the orderly transfer and/or liquidation of customer or proprietary positions, auction participation and public disclosure of the process itself.   EU equivalence   * ESMA can now recognize specific US CCPs that meet the conditions set out in the European Commission's equivalence decision. Once recognized by ESMA, those US CCPs will be able to provide services in the EU by complying with US requirements. * The European Commission and the CFTC anticipate that CFTC registered CCPs will be in a position to be recognized by 21 June, 2016 the date on which the first phase of clearing obligations begin in the EU. * EU firms that are clearing members of those US CCPs that have been recognized by ESMA will then be able to treat those non-EU CCPs as "qualifying CCPs" (QCCPs) for the purposes of the Capital Requirements Regulation (CRR), thereby enabling them to take advantage of a more favorable capital treatment in respect of their exposures to those QCCPs. * In order to be eligible for relief under the European Commission's equivalence decision, CFTC-registered US CCPs will need to confirm that their internal rules and procedures ensure:   + for clearing members' proprietary positions in exchange-traded derivatives, the collection of initial margins are sufficient to take into account a two-day liquidation period;   + initial margin models include measures to mitigate the risk of procyclicality; and   + the maintenance of 'cover 2' default resources.   Trading venues  The European Commission is expected to propose shortly the adoption of an equivalence decision under EMIR whereby US trading venues will be deemed equivalent to EU regulated markets. | | |
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| The Volcker Rule - Proprietary Transactions in the US |

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| The final rules pursuant to the Volcker Rule were issued on 10 December 2013 and were published on 31 January, 2014 in 17 CFR Part 75.  Prohibited activities  The Volcker Rule generally prohibits "banking entities" from:   * engaging in proprietary trading; * acquiring and retaining any "ownership interest" in or sponsoring "covered funds"; * entering into (or their affiliates entering into) "covered transactions" with a covered fund that the banking entity sponsors or to which it provides investment advice or investment management services (the so-called "Super 23A prohibition" because it incorporates the restrictions under Section 23A of the Bank Holding Company Act but without the benefit of that provision's exclusions); and * engaging in transactions otherwise permitted under specified provisions of the Volcker Rule if the transaction involves or results in specified conflicts of interest.   Covered Funds  Volcker Rule  Dodd-Frank Section 619  17 CFR Part 75  All entities that rely on Section 3(c)(1) or Section 3(c) (7) of the US Investment Company Act of 1940 as an exemption from registration under such Act are "covered funds" unless an exclusion from being a covered fund applies.  Many structured finance and some ABS issuers rely on Section 3(c)(1) [less than 100 investors] or Section 3(c)(7) [only qualified institutional buyers/qualified purchasers] exemptions and thus are likely to be "covered funds". Excluding a fund from the definition of covered funds has significant beneficial consequences including that a banking entity may acquire and retain any "ownership interest" in or sponsor such fund and may engage in activities with the fund that would otherwise be prohibited covered transactions.  Under the "loan securitization exclusion" a banking entity is allowed to own and sponsor a fund that is an ABS issuer, the assets of which are solely composed of:   * loans (defined as any loan, lease, extension of credit or secured or unsecured receivable that is not a security or derivative); * rights or other assets designed to assure the servicing or timely distribution of proceeds to holders of asset-backed securities and rights or other assets that are related or incidental to purchasing or otherwise acquiring the loans (if such assets are securities, they must be cash equivalents or securities received in lieu of debts previously contracted with respect to the loans supporting the asset-backed securities); * interest rate or foreign exchange derivatives that (i) directly relate to the terms of such loans or contractual rights; and (ii) are used for hedging purposes with respect to the securitization structure (notional amount must be tied to the securitization exposure); and * special units of beneficial interest and collateral certificates that meet the following requirements.   Covered Transactions  Volcker Rule  Dodd-Frank Section 619  17 CFR Part 75   * extensions of credit; * investments in securities (other than fund ownership interests permitted under the Volcker Rule); * purchases of assets from the fund (including repos); * acceptance of securities from the covered fund as collateral for a loan made by the banking entity; * issuances of guarantees, acceptances or letters of credit on behalf of the covered fund; and * exposure to the covered fund arising out of derivative, repo and securities lending transactions.   For ABCP conduits and certain other ABS issuers, the Super 23A prohibition as written in the proposed rule was problematic because it would have prevented a bank sponsor/investment adviser/manager from providing credit, hedging or liquidity facilities to support such transactions. By excluding various structures from the definition of covered fund, the final rule will resolve this issue for many structured finance transactions. | | | | |
| Possible structured notes and structured finance exclusions  Volcker Rule  Dodd-Frank Section 619  17 CFR Part 75  Any structured finance entity that meets the requirements for an exclusion under Rule 3a-7 or section 3(c)(5) of the Investment Company Act, or any other exclusion or exemption from the definition of "investment company" under the Investment Company Act (other than sections 3(c)(1) or 3(c)(7) of the Investment Company Act), does not fall under the definition of "covered fund". Rule 3a-7 was adopted in 1992 to exclude asset backed structured finance issuers from the definition of investment company under the Act upon the satisfaction of certain conditions, including:   * that the issuer issues fixed-income or other securities which entitle their holders to receive payments that depend primarily on the cash flow from eligible assets; and * at the time of initial sale, the securities are rated in one of the four highest categories assigned to long-term debt, or an equivalent for short-term debt, by at least one nationally recognized statistical rating agency or are sold to "accredited investors" or "qualified institutional buyers" as such terms are defined in the Securities Act of 1933.   Foreign banking entities are permitted to acquire or retain ownership in, or to sponsor, a covered fund under the following circumstances:   * the banking entity must not be directly or indirectly controlled by a banking entity that is organized under federal or state laws; * to qualify for the exemption, the banking entity must either be a qualifying foreign banking organization conducting the activity in compliance with subpart B of the Federal Reserve Board’s Regulation K or meet at least two of the following on a fully consolidated basis:   + 1. total assets held outside of the US exceed total assets held in the US;     2. total revenues derived from outside of the US exceed total revenues derived from in the US; or     3. total net income derived from outside of the US exceeds total net income derived from in the US. * no ownership interest in the covered fund is offered for sale or sold to a resident of the US; and * the activity must have occurred solely outside of the US. | | | | |
| Conformance Period  Volcker Rule  Dodd-Frank Section 619  12 CFR Part 75  Regulations under the Volcker Rule went into effect on 1 April, 2014 but initially provided for a "conformance period" through 21 July, 2015. Banking entities have until 21 July, 2017 to divest or conform investments in and relationships with covered funds and foreign funds that were in place prior to 31 December, 2013 (known as “legacy covered funds”).  The Federal Reserve Board has issued guidance which provides that banking entities by statute have to conform all of their activities and investments to the Volcker Rule, and that "during the conformance period, banking entities should engage in good-faith planning efforts, appropriate for their activities and investments, to enable them to conform their activities and investments to the requirements of [the Volcker Rule] and final implementing rules by no later than the end of the conformance period."   * 30 June, 2014 – banking entities with $50 billion or more in consolidated trading assets and liabilities began reporting quantitative measurements to regulators * 21 July, 2015 – beginning of Volcker Rule compliance with respect to proprietary trading activities * 30 April, 2016 – banking entities with at least $25 billion but less than $50 billion in consolidated trading assets and liabilities must begin reporting quantitative measurements to regulators * 31 December, 2016 – banking entities with at least $10 billion but less than $25 billion in consolidated trading assets and liabilities must begin reporting quantitative measurements to regulators | | | | |
| Conflict of interest  Volcker Rule  Dodd-Frank Section 621  17 CFR Part 75  Banking entities cannot engage in permitted covered transactions or permitted proprietary trading activities if they would:   * + 1. involve or result in a material conflict of interest between the banking entity and its clients, customers or counterparties;     2. result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy; or     3. pose a threat to the safety and soundness of the banking entity or to the financial stability of the US.   A material conflict exists if the bank enters into any transaction, class of transactions or activity that would result in the bank’s interests being materially adverse to interests of its client, customer or counterparty, unless the bank has appropriately addressed and mitigated the conflict through timely and effective disclosure or informational barriers. | | | | |
| This comparison table is for guidance only and should not be relied on as legal advice in relation to a particular transaction or situation. | |  | This paper reflects key EU and US regulatory developments relating to derivatives as at 7 June 2016. | |
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| Margin Requirements for Non-Centrally Cleared OTC Derivatives  A Comparison of rules in the US, EU and Hong Kong |

|  | **US** | **EU** | **Hong Kong (Dec 2015)** |
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| **Entities in scope** | **Swap entities:** any swap dealer, major swap participant, security-based swap dealer and major security-based swap participant that is registered with the CFTC or the SEC.  **Financial End Users with material swaps exposure.** Financial End User would have "material swaps exposure" if that entity and its affiliates as a group, on a consolidated basis, have an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards and foreign exchange swaps for June, July and August of the previous calendar year that exceeds $8 billion. Transactions between entities and their affiliates should only be counted once, and swaps with end users that are exempt from clearing under Dodd-Frank need not be included in the calculation. The Final Rule provides a definition of “affiliate” for purposes of this calculation, which is based on accounting standards.  **Financial End Users without material swaps exposure.** | **Covered entities:** An EU financial counterparty (**FC**) , an EU non-financial counterparty (**NFC**) whose aggregated positions in derivatives exceed certain clearing thresholds (**NFC+**)  **FC:** EU banks, investment firms, insurers and reinsurers, occupational pension schemes, UCITS funds and where relevant their managers, as well as certain Alternative Investment Funds (AIF) managed by an EU authorised or registered AIF Manager.  **NFC+:** an EU entity that is not a FC whose aggregate OTC derivative positions of its group on a worldwide basis exceed any of the clearing thresholds below:   |  |  | | --- | --- | | Type of derivative contract | Clearing threshold (gross notional amount) | | OTC credit derivatives | EUR1 billion | | OTC equity derivatives | EUR 1 billion | | OTC interest rate derivatives | EUR 3 billion | | OTC foreign exchange derivatives | EUR 3 billion | | OTC commodity derivatives  and any other derivatives | EUR 3 billion |   **Non-EU entities**: Where a FC or NFC+ subject to the margin requirements trades with a non-EU counterparty which would be subject to the margin requirements if it was established in the EU, IM and VM may apply.  IM and VM will also apply to trades between 2 non-EU entities if both entities would be subject to the EU margin rules if they had been established in the EU and the transaction has a "direct, substantial and foreseeable effect" within the EU. Broadly, this will be the case where it is executed via two EU branches of non-EU entities and where there is a guarantee from an EU FC that is of a certain amount.  Note: Any covered entity may be subject to the obligation to exchange VM (depending on its counterparty and whether any exceptions are available). However, only covered entities which have an aggregate month end average notional amount of non-centrally cleared derivatives of EUR8 billion or more will ever be subject to an obligation to exchange IM. | HK incorporated and overseas-incorporated authorised institutions (AIs) when entering into in-scope derivatives with a covered entity.  **Covered entity:** a financial counterparty, a significant non-financial counterparty, or another entity designated by the HKMA.  **Financial counterparty:** AIs, most Licensed Corporations (LCs), regulated insurance companies, regulated money lenders, money lenders and remittance agents, mandatory provident fund schemes and occupational retirement schemes, entities that carry on a business outside HK that would be regulated and licensing as if it were carrying on business in HK, collective investment schemes, securitization SPVs, PE funds.  **Significant non-financial counterparty:** not a financial counterparty but has (on individual/group basis) a portfolio of non-centrally cleared derivatives >HKD60 billion in notional in a one-year period from 1 September each year to 31 August of the following year. |
| **Exempt entities** | Other counterparties (i.e. non-financial entities entering into swaps to hedge and mitigate commercial risk, affiliates acting on behalf of such entity that use swaps to hedge or mitigate the commercial risk of such entity or another affiliate that is not a financial entity; cooperatives that meet certain regulatory parameters; eligible treasury affiliates that the CFTC exempts from the margin requirements by rule; sovereigns; multilateral development banks; Banks for International Settlements). | Trades with NFCs below the clearing threshold (**NFC-s**) are not subject to IM or VM.  EU, US and Japanese sovereigns and central banks, multilateral development banks, public sector entities and the Bank for International Settlements (BIS) covered bond issuers under certain conditions. | Sovereign, central bank, public sector entity, multilateral development bank and the BIS. |
| **VM / IM** | VM: Covered Swap Entities and Financial End Users (each as defined in the final rules).  IM: as for VM except Financial End Users without "material swaps exposure" (as described above) are not in scope. | VM: FCs and NFC+s.  IM: FCs and NFC+s that have or belong to groups each of which has an aggregate month end average notional amount of non-centrally cleared derivatives of EUR8 billion or more will be subject to an obligation to exchange IM (see IM Phase-in Timelines below). | VM:   1. from 1 September 2016 to 28 February 2017, where both the AI and the covered entity have an average aggregate notional amount of non-centrally cleared derivatives > HKD 24 trillion; and 2. on a permanent basis (i.e. from 1 March 2017) for all non-centrally cleared derivatives an AI enters into with a covered entity.   IM: By an AI in respect of non-centrally cleared derivatives entered into with a covered entity except financial counterparties with less than HKD 60 billion gross notional amount of derivatives (*see IM Phase-in Timelines below*) on a consolidated group basis are not in scope. |
| **Product Scope** | VM & IM: Swaps and security-based swaps, depending on applicable regulator excluding physically settled FX forwards and swaps. | VM: All uncleared OTC derivatives (as defined in EMIR), physically settled FX forwards exempt until either 31 Dec 2018 or when defined under MIFID II. Equity options and options on equity indices exempt for 3 years.  IM: All uncleared OTC derivatives excluding physically settled FX forwards and swaps. Equity options and options on equity indices exempt for 3 years. | VM: all non-centrally cleared derivatives excluding physically settled FX forwards and swaps.  IM: all non-centrally cleared derivatives excluding physically settled FX forwards and swaps, and FX transactions embedded in cross-currency swaps associated with the exchange of principal.  Excluded: Transactions (e.g. repos and securities lending transactions) that are not themselves derivatives but share some attributes with derivatives and indirectly cleared derivatives that are intermediated through a clearing member on behalf of a non-member customer as long as the non-member customer is subject to the margin requirements of the clearing house; or the non-member customer provides margin consistent with the relevant corresponding clearing house’s margin requirements). |
| **Phase-In** | 1 Sept 2016: VM applies if > USD 3 trillion  1 Mar 2017: VM applies to all other entities  1 Sept 2016: IM applies if > USD 3 trillion for Mar – May 2016  1 Sept 2017: IM applies if > USD 2.25 trillion for Mar – May 2017  1 Sept 2018: IM applies if > USD 1.50 trillion for Mar – May 2018  1 Sept 2019: IM applies if > USD 0.75 trillion for Mar – May 2019  1 Sept 2020: IM applies to all other entities  Final and permanent IM annual threshold: USD 8 billion | 1 Sept 2016: VM applies if > EUR 3 trillion  1 Mar 2017: VM applies to all other entities  1 Sept 2016: IM applies if > EUR 3 trillion for Mar – May 2016  1 Sept 2017: IM applies if > EUR 2.25 trillion for Mar – May 2017  1 Sept 2018: IM applies if > EUR 1.50 trillion for Mar – May 2018  1 Sept 2019: IM applies if > EUR 0.75 trillion for Mar – May 2019  1 Sept 2020: IM applies if > EUR 8.00 billion for Mar – May 2020  Final and permanent IM annual threshold: EUR 8 billion | 1 Sept 2016: VM applies if > HKD 24 trillion  1 Mar 2017: VM applies to all other entities  1 Sept 2016: IM applies if > HKD 24 trillion for Mar – May 2016  1 Sept 2017: IM applies if > HKD 18 trillion for Mar – May 2017  1 Sept 2018: IM applies if > HKD 12 trillion for Mar – May 2018  1 Sept 2019: IM applies if > HKD 6 trillion for Mar – May 2019  1 Sept 2020: IM applies if > HKD 60 billion for Mar – May 2020  Final and permanent IM annual threshold: HKD 60 billion |
| **Inter-affiliate Trading** | Inter-affiliate trades are subject to VM requirements.  Prudentially-regulated Covered Swap Entities must collect IM from affiliates that are Financial End Users with "material swaps exposure"; CFTC-regulated swap dealers and major swap participants largely exempt from posting or collecting of IM between affiliates. | Exemption for intragroup transactions, subject to certain requirements being met.  Intragroup trades have IM threshold of EUR 10 million. No requirement to exchange IM on intragroup trades until 1 March 2017. | Non-centrally cleared derivatives between an AI and entities in the same consolidated group of companies are exempt.  Exemption limited to consolidated groups that are subject to group-wide supervision by HKMA or supervisory authorities in other jurisdictions plus such exempted groups must have a group-wide integrated risk management function in place. HKMA reserves the right to bring certain intragroup transactions within scope of the margin provisions. |
| **Eligible Collateral** | VM: USD cash, currency of underlying swap or major currency for covered swap entities; same as IM for financial end users.  IM: Eligible collateral includes cash, gold, certain government bonds, certain corporate bonds and certain equities and debt. | VM & IM: Cash, gold, certain government debt securities, certain corporate securities, certain equities and convertible bonds. Concentration limits may apply to IM collateral including custodian concentration limit for cash. | VM & IM: Cash; marketable debt securities issued or fully guaranteed by a sovereign associated with a credit quality grade 3 or above, a multilateral development bank, a public sector entity associated with a credit quality grade 3 or above or associated with a credit quality grade 3 or above; gold; publicly traded equities.  Not securities issued by FIs, securities with significant correlation with the creditworthiness of the counterparty or the value of the underlying non-centrally cleared derivatives portfolio in such a way that would undermine the effectiveness of the protection offered by the margin (“wrong way risk”). Specifically, eligible collateral should not include securities issued by the posting counterparty or entities which are part of the same group as the posting counterparty. |
| **Haircuts** | VM & IM: No haircuts for USD cash, currency of underlying swap or major currency. Standard or internal haircuts for other eligible collateral as well as 8% where the exposure and the collateral are in different currencies (subject to certain exceptions for trades utilizing an eligible master netting agreement). | VM: Standard or internal model haircuts. Additional 8% haircut where currency of non-cash collateral not contemplated in CSA. No 8% haircut for cash.  IM: Standard or internal model haircuts. Additional 8% haircut where currency of collateral differs from agreed termination currency. | VM & IM: No haircuts for cash in currency of underlying swap. Standard or internal haircuts for other eligible collateral as well as add on 8% where the exposure and the collateral are in different currencies (“add on haircut for currency mismatch”) |
| **Thresholds** | VM: Zero threshold.  IM: Max of USD 50 million between all entities in a consolidated group facing all entities in the counterparty consolidated group. | VM: Zero threshold.  IM: Max of EUR 50 million between all entities in a consolidated group facing all entities in the counterparty consolidated group. | VM: Zero threshold.  IM: Max of HKD 375 billion between all entities in a consolidated group facing all entities in the counterparty consolidated group. |
| **Min transfer amt.** | USD 500k | EUR 500k (approx USD 560 k) | HKD 3.75 million (approx USD 490 k) |
| **IM Models** | 99% confidence interval over 10-day horizon (or time to maturity, if shorter) calibrated to a time period of between 1 and 5 years. No cross-margining with other products. | 99% confidence interval over 10-day horizon calibrated to a period of less 3 years. No cross-margining with other products. | 99% confidence interval over a 10-day horizon (or time to maturity, if shorter) calibrated to a time period of between 3 and 5 years. No cross-margining with other products. |
| **Notes on non-netting jurisdictions.** |  | IM or VM may not need to be posted for trades (and in some cases and subject to an overall cap of 2.5% of its OTC derivatives business, not to collect margin from) with a non-EU counterparty located in a jurisdiction where the enforceability of netting arrangements or protection of collateral cannot be supported by an independent legal assessment  . | For transactions with a covered entity located in a non-netting jurisdiction, an AI will post and collect VM and collect IM, both calculated on a gross basis (i.e. transaction-by-transaction basis). The HKMA acknowledges that the amount of margin exchanged could increase substantially if margin has to be calculated on a gross basis. However, if netting is not enforceable, margin calculation on a net basis could lead to margin being insufficient for covering risks adequately as gross exposure and not net exposure would be the relevant measure of counterparty risk. Given these issues, an AI would not need to post IM to counterparties in non-netting jurisdictions. |

This is a summary for information only and not as legal advice. For further information, please speak to your usual Hogan Lovells contact. All exchange rates are as at May 2016 and are for guidance only.

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| Acronyms and definitions |

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| Acronym | Definition |
| AIF | Alternative investment fund |
| AIFMD | Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers (AIFMs) |
| APA | Approved publication arrangement |
| BCBS | Basel Committee on Banking Supervision |
| CDS | Credit default swap |
| CCP | Central counterparty |
| CFTC | U.S. Commodities Futures Trading Commission |
| Commission | European Commission |
| Compliance  Date 1 | The date occurring 6 months after the first registered SBSR commences operations for a security based swap in particular asset class. |
| CTP | Consolidated tape provider |
| DCM | Designated contract market |
| DCOs | Derivatives clearing organizations |
| Dodd-Frank | Dodd-Frank Wall Street Reform and Consumer Protection Act |
| EBA | European Banking Authority |
| EIOPA | European Insurance and Occupational Authority |
| EIOPA | European Insurance and Occupational Pension Authority |
| EMIR | European Market Infrastructures Regulation – Regulation (EU) 648/2012 of the European Parliament and Council on OTC derivatives, central counterparties and trade repositories |
| ESAs | ESMA, EBA and EIOPA |
| ESMA | European Securities and Markets Authority |
| ETCs | Exchange traded commodities |
| EU | European Union |
| FC | Financial counterparty |
| FCA | The United Kingdom's Financial Conduct Authority |
| FX | Foreign exchange |
| IOSCO | International Organization of Securities Commissions |
| IRS | Interest rate swap |
| MiFID or MiFID I | Markets in Financial Instruments Directive – Directive 2004/39/EC of the European Parliament and the Council |
| MiFID II | Directive 2014/65/EU of the European Parliament and of the Council on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU |
| MiFIR | Regulation (EU) No 600/2014 of the European Parliament and of the Council on markets in financial instruments and amending Regulation (EU) No 648/2012 |
| MSP | Major swap participant |
| MTF | Multilateral trading facility |
| NCA | National competent authority |
| NDF | Non deliverable forward |
| NFC | Non-financial counterparty |
| NFC+ | NFC above the clearing threshold |
| OTC | Over-the-counter |
| OTF | Organized trading facility |
| Regulation SBSR | Collectively, the 2 regulations adopted by the SEC on 14 January, 2015 that (i) require SBSRs to register with the SEC and prescribed reporting and public dissemination requirements for security-based swap transaction data and (ii) relate to the reporting and public dissemination of security-based swap transaction data. |
| RFQ | Request for Quote System |
| RM | Regulated market |
| RTS | Regulatory Technical Standards |
| TR | Trade repository |
| SBSRs | Security-based swap data repositories |
| SDR | Swap data repository |
| SEC | Securities and Exchange Commission |
| SEF | Swap execution facility |
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| About Hogan Lovells |

Change is happening faster than ever, and to stay ahead, you need to anticipate what’s next. Legal challenges come from all directions. We understand and work together with you to solve the toughest legal issues in major industries and commercial centers around the world. Whether you’re expanding into new markets, considering capital from new sources, or dealing with increasingly complex regulation or disputes, we can help. Whether change brings opportunity, risk, or disruption, be ready by working with Hogan Lovells.

Straight talking. Understanding and solving the problem before it becomes one. Delivering clear and practical advice that gets your job done. Hogan Lovells offers extensive experience and insights gained from working in some of the world's most complex legal environments and markets for corporations, financial institutions and governments. We help you identify and mitigate risk and make the most of opportunities. Our 2,500 lawyers on six continents provide practical legal solutions wherever your work takes you.

A fast-changing and inter-connected world requires fresh thinking combined with proven experience. That's what we provide. Progress starts with ideas. And while imagination helps at every level, our legal solutions are aligned with your business strategy. Our experience in cross-border and emerging economies gives us the market perspective to be your global partner. We believe that when knowledge travels, opportunities arise.

Our team has a wide range of backgrounds. Diversity of backgrounds and experience delivers a broader perspective. Perspectives which ultimately make for more rounded thinking and better answers for you.

Giving back to communities and society is fundamental to good business. And, it’s part of our core. We are advocates of justice, equality, and opportunity. Everyone at Hogan Lovells is asked to volunteer at least 25 hours a year as part of their normal work duties. Around the world, our people are making a difference through pro bono activities, community investment, and social justice

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