

XIV. International Derivatives Policy and the CFTC's Proposed Rules on Overseas Swaps

A. Introduction

The financial swaps industry is a vast market with many international participants. Indeed, the largest U.S. banks conduct around half of their swap transactions with international clients.¹ The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act” or “Act”) mandated that U.S. regulatory agencies, including the Commodity Futures Trading Commission (“CFTC”), enact rules governing the previously unregulated swaps market.² In response, swaps participants have disputed the extent to which the United States may regulate international swaps trading.³ A key question is whether U.S. derivatives rules on swaps apply in foreign jurisdictions; CFTC Chairman Gary Gensler would extend the CFTC’s reach.⁴ Swap participants, however, caution that too much regulation could increase transaction costs.⁵

This article provides an overview of the swaps industry, recent regulation of swaps, and some important issues left open by the regulation. Part B describes examples of typical swap transactions and gives a brief history of swaps regulation. Part C discusses the key provisions of the Dodd-Frank Act relating to swaps, as well as some of the questions left unresolved by the Act. Part D highlights key points of the interpretive guidance released by the CFTC with regard to swaps, and Part E reviews the extent of that

¹ Robert Schmidt & Silla Brush, *Banks Said to Seize ‘Footnote 513’ to Keep Swaps Private*, BLOOMBERG (Oct. 23, 2013, 12:01 AM), <http://bloomberg.com/news/2013-10-23/banks-said-to-seize-footnote-513-to-keep-swaps-private.html>.

² *Alert Memo: Navigating Key Dodd-Frank Rules Related to the Use of Swaps by End Users*, CLEARY GOTTLIEB STEEN & HAMILTON LLP (Apr. 9, 2013), <http://cgsh.com/navigating-key-dodd-frank-rules-related-to-the-use-of-swaps-by-end-users>.

³ Schmidt & Brush, *supra* note 1.

⁴ *Id.* (“CFTC Chairman Gary Gensler has sought to extend U.S. authority to those transactions, arguing that the global nature of the 2008 credit crisis proved that American taxpayers could be at risk when banks book them in foreign units.”).

⁵ *See, e.g., CME Swap Data Repository Fee Schedule*, CME GROUP, <http://cmegroup.com/market-data/files/cme-repository-service-fee-schedule.pdf> (last visited Apr. 16, 2014).

regulation. Part F addresses the major banks' response to the recent legislation and regulation on swaps trades.

B. Background

1. Typical Swap Transactions

In a swap transaction, two parties agree to exchange cash flows over a specified period of time.⁶ The two most common forms of swaps are currency swaps and interest rate swaps.⁷ In a typical interest rate swap, Party *A* promises to pay Party *B* a fixed interest rate, and Party *B* promises to pay Party *A* a variable interest rate.⁸ The market for interest rate swaps frequently uses the London Interbank Offer Rate ("LIBOR") as the basis for a variable rate.⁹ In a currency swap, Party *A* and Party *B* each have similar loans, but in different currencies.¹⁰ The parties exchange their principal and fixed interest payments in order to hedge against fluctuations in currency valuation.¹¹

In comparison, stock trades take place between two parties who meet and agree on a price at a nationally regulated exchange, such as the New York Stock Exchange.¹² In the past, swap trades usually did not take place on an exchange.¹³ Rather, a swap was typically executed over the phone between the buyer and seller.¹⁴

⁶ James, *Introduction to Swaps*, FIN. TRAIN (Apr. 12, 2012), <http://financetrain.com/introduction-to-swaps> [hereinafter James, *Introduction to Swaps*].

⁷ See, e.g., Michael McCaffrey, *An Introduction to Swaps*, INVESTOPEDIA (Apr. 18, 2012).

⁸ *Id.*

⁹ James, *Plain Vanilla Interest Rate Swaps*, FIN. TRAIN (Apr. 12, 2012), <http://financetrain.com/plain-vanilla-interest-rate-swap> [hereinafter James, *Plain Vanilla Interest Rate Swaps*].

¹⁰ *The Basic Mechanics of FX Swaps and Cross-Currency Basis Swaps*, BANK FOR INT'L SETTLEMENTS (Sept. 1, 2008), http://bis.org/publ/qtrpdf/r_qt0803z.htm.

¹¹ *Id.*

¹² See David Harper, *Getting to Know the Stock Exchanges*, INVESTOPEDIA (Sept. 22, 2013).

¹³ *Evolution of the OTC Swaps Market*, BLOOMBERG (July 2013), <http://bloomberg.com/professional/files/2013/07/54104667-fi-us-garp-wnar-idoc.pdf>.

¹⁴ *Id.*

Thus, the swaps market existed primarily as an over-the-counter (“OTC”) market between private parties.¹⁵

2. History of Swap Regulation

The first major swap deal occurred in 1981 between IBM and the World Bank.¹⁶ Since then, the swaps market has grown substantially in size.¹⁷ In 2013, the swaps market in the United States approached a staggering \$400 trillion.¹⁸ One of the major problems associated with an unregulated OTC swaps market was the lack of a middleman to mitigate risk of default.¹⁹ In the heavily regulated stock and bond markets, clearing agencies typically take on this role.²⁰ Yet historically, swap trades did not pass through a clearinghouse.²¹

C. The Dodd-Frank Act

1. Key Provisions

Title VII of the Dodd-Frank Act regulates OTC derivatives—including swaps.²² Under Title VII, Congress sought to “reduce and contain systemic risk and to increase transparency in the OTC derivatives market.”²³ Since OTC derivatives are not traded on

¹⁵ James, *Introduction to Swaps*, *supra* note 6.

¹⁶ Darwin Bondgraham, *The Swap Crisis*, DOLLARS & SENSE (2012), <http://dollarsandsense.org/archives/2012/0512bondgraham.html>.

¹⁷ *See id.* (“On a global level the total notional amount of interest rate swaps was most recently estimated by \$441 trillion by the International Swaps and Derivatives Association.”).

¹⁸ Andrew Ackerman, *CFTC Misreporting Size of Swaps Market*, *Agency Says*, WALL ST. J. (Dec. 18, 2013), <http://online.wsj.com/news/articles/SB10001424052702304866904579266851056302512>.

¹⁹ *Newsroom Fact Sheet*, SEC, <https://sec.gov/News/Article/Detail/Article/1365171586143#.UwbQUWJUsw> (last visited Apr. 16, 2014).

²⁰ *Id.*

²¹ *See Evolution of the OTC Swaps Market*, *supra* note 13 (discussing the novel “mandat[ed] centralized clearing” of recent swaps regulation).

²² Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 701, 124 Stat. 1376, 1641 (2010) (codified in scattered sections of 15 U.S.C.).

²³ *The End-User Guides to Derivatives Regulation Overview of Title VII of the Dodd-Frank Act*, CHATHAM FIN. 1 (2011), <http://chathamfinancial>.

a national exchange, information about these trades was not always readily available.²⁴ However, the Dodd-Frank Act now mandates that the “vast majority of trades will need to be executed on electronic venues, also known as swap execution facilities.”²⁵

There are four key participants identified under Title VII that are subject to the various new regulatory requirements.²⁶ “Swaps Dealers” are large broker-dealers and firms on Wall Street that engage in dealing and market making.²⁷ A “Major Swap Participant” is any firm “with derivatives exposures large enough to put” the entire financial system at risk.²⁸ The final two participants include “Financial Entities” and “Nonfinancial End Users,” which are both individual swaps traders.²⁹

Title VII imposes a number of regulations on the OTC derivatives market.³⁰ End-of-day reporting of swaps to swap data repositories, and public dissemination of price and volume information, both serve to increase transparency in the swaps market.³¹ A central clearing agency for certain swaps reduces counterparty credit risk exposure.³² The majority of swaps must follow a streamlined process that utilizes “regulated platforms known as swap execution facilities (‘SEFs’).”³³ Finally, registration and oversight of Swaps Dealers and Major Swaps Participants enhances the overall protection of the swaps market.³⁴ Congress

com/wp-content/uploads/2012/08/Chatham-Financial-Overview-of-Title-VII-of-the-Dodd-Frank-Act.pdf.

²⁴ Kesavan Balasubramaniam, *How Do I Buy An Over-The-Counter Stock?*, INVESTOPEDIA (Apr. 18, 2012) (“These companies offer very little information, which may be difficult to find, and they are extremely illiquid which can make it hard to find a buyer.”).

²⁵ *Evolution of the OTC Swaps Market*, *supra* note 13.

²⁶ Dodd-Frank Act § 721.

²⁷ *The End-User Guides to Derivatives Regulation*, *supra* note 23.

²⁸ *Id.* This definition is not expected to capture many firms. *Id.* (“CFTC Chairman Gary Gensler has said that . . . the exposure thresholds proposed by the regulators seem to be set at levels that would not capture many firms.”).

²⁹ *Id.*

³⁰ *See* Dodd-Frank Act § 721.

³¹ *Id.*

³² *The End-User Guides to Derivatives Regulation*, *supra* note 23.

³³ *Id.*

³⁴ *Id.*

delegated the implementation of the details and specifics for these requirements, including registration processes, to the CFTC.³⁵

2. Key Questions

Congress anticipated that cross-border activities could have a substantial impact on swaps activity within the United States.³⁶ However, it remains difficult to determine when such activities fall under the Dodd-Frank Act. Section 722(d) of the Dodd-Frank Act provides that swaps provisions apply to cross-border activities when such activities have a “direct and significant connection with activities in, or effect on, commerce of the United States.”³⁷ This language, while helpful, remains imprecise as to which activities will be subject to regulation.

Since the enactment of the Dodd-Frank Act, banks, financial participants, and regulatory agencies have grappled with how to apply the statute to swaps in foreign jurisdictions.³⁸ Some CFTC regulators advocate subjecting all overseas swaps trades to strict regulation and rules promulgated by the CFTC.³⁹ Swaps had widespread systemic effects on U.S. markets in 2008 and regulators consider strict oversight to be essential in preventing another financial crisis.⁴⁰ However, many swaps participants, including large financial institutions, have pushed back against the regulators.⁴¹ Some of the large banks and funds argue that overseas swaps should receive limited, if any, regulation under U.S. laws.⁴² They worry that excessive regulation, including reporting requirements, will increase

³⁵ See Dodd-Frank Act § 712.

³⁶ Interpretative Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45,292, 45,295 (July 26, 2013) (to be codified at 17 C.F.R. pt. 1) [hereinafter Interpretive Guidance].

³⁷ Dodd-Frank Act § 722(d).

³⁸ Interpretive Guidance, *supra* note 36, at 45,292.

³⁹ Schmidt & Brush, *supra* note 1.

⁴⁰ See Interpretive Guidance, *supra* note 36, at 45,293 (“The potential for cross-border activities to have a substantial impact on the U.S. financial system was apparent in the fall of 2008, when a series of large financial institutional failures threatened to freeze foreign and domestic credit markets.”).

⁴¹ See, e.g., Schmidt & Brush, *supra* note 1 (“The largest banks told swap brokers in late September that the language means certain swaps still don’t fall under the agency’s new trading rules . . .”).

⁴² *Id.*

transaction costs and place an unnecessary burden on the swaps market.⁴³

D. CFTC Agency Releases

On July 26, 2013, the CFTC released an Interpretive Guidance and Policy Statement regarding compliance with various swap regulations.⁴⁴ The release states that any trader or swaps participant who arranges, negotiates, or executes a swap deal in the United States must comply with Dodd-Frank regulations.⁴⁵ Gary Gensler, Chairman of the CFTC, said that many large banks have two swaps departments in the United States: one department to engage in United States swaps deals and another to engage in foreign-based swaps deals.⁴⁶ The foreign-based swap dealer formerly sought to avoid regulation.⁴⁷ However, the CFTC has mandated that all swaps dealers who arrange, negotiate, or execute a swap in the United States must follow the same set of rules, regardless of the underlying nature of the swap.⁴⁸

In the CFTC's release, the staff proposed to elaborate upon the definition of a "U.S. person" as used by the Dodd-Frank Act to describe the scope of the regulation.⁴⁹ According to the CFTC, a U.S.

⁴³ See, e.g., *CME Swap Data Repository Fee Schedule*, *supra* note 5 (charging swaps counterparties fees "on a per transaction basis" for the reporting to the swap data repository, as mandated under Dodd-Frank).

⁴⁴ Interpretive Guidance, *supra* note 36, at 45,292.

⁴⁵ *Id.* ("Specifically, the Proposed Guidance addressed the general manner in which the Commission proposed to consider: (1) When a non-U.S. person's swap dealing activities would justify registration as a 'swap dealer,' as further defined in a joint release adopted by the Commission and the Securities and Exchange Commission ('SEC'); (2) when a non-U.S. person's swaps positions would justify registration as a 'major swap participant,' as further defined in the Final Entities Rules; and (3) how foreign branches, agencies, affiliates, and subsidiaries of U.S. swap dealers generally should be treated.").

⁴⁶ Robert Schmidt, *Wall Street Pushes Back on CFTC's Advisory for Overseas Swaps*, BLOOMBERG (Nov. 19, 2013, 12:01 AM), <http://bloomberg.com/news/2013-11-18/wall-street-pushes-back-on-cftc-s-advisory-for-overseas-swaps.html>.

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ Interpretive Guidance, *supra* note 36, at 45,301 ("Under the Proposed Guidance, the term 'U.S. person' identifies those persons who, under the Commission's interpretation, could be expected to satisfy the jurisdictional

person is someone who is expected to satisfy the jurisdictional nexus “based on their swap activities either individually or in the aggregate.”⁵⁰ The definition of “U.S. person” includes residents of the United States; companies organized in the United States or having their principal place of business there; companies that have at least one owner that is a U.S. person; individual accounts owned by a U.S. person; pooled accounts, or investment vehicles with majority ownership held by a U.S. person; investment vehicles required to be registered with the CFTC; pension plans for employees of a company with its principal place of business inside the United States; and trusts or estates subject to U.S. income tax.⁵¹

A U.S. person, as defined by the CFTC, also includes any foreign branch of a U.S. person.⁵² According to the CFTC, “this approach is appropriate because a foreign branch of a U.S. swap dealer is an integral part of a U.S. swap dealer and not a separate legal entity.”⁵³ This definition greatly expands the number of swaps dealers that must comply with swaps requirements.⁵⁴ If a foreign branch of a U.S. swap dealer engages in a swap with a non-U.S. person, the foreign branch is still expected to comply with the swaps requirements.⁵⁵ Most banks engaging in these types of transactions argue that the swap would be so far removed from the United States that it should not be subject to U.S. regulation.⁵⁶

E. Extent of Regulation

The CFTC has released a number of policy statements in order to assist major U.S. banks with correctly interpreting the new swaps regulations.⁵⁷ The swaps rules established by the CFTC now

nexus . . . based on their swap activities either individually or in the aggregate.”).

⁵⁰ *Id.*

⁵¹ *Id.* at 45,302.

⁵² *Id.*

⁵³ *Id.* at 45,327.

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ Schmidt & Brush, *supra* note 1 (“The largest banks told swap brokers in late September that the language means certain swaps still don’t fall under the agency’s new trading rules . . .”).

⁵⁷ See, e.g., *Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations*, CFTC, <http://cftc.gov/ucm/>

apply to all overseas firms that employ personnel in the United States, arrange swaps transactions in the United States, or do business with U.S. counterparties.⁵⁸ The interpretation will have drastic effects on overseas firms, who will now be subject to swap recordkeeping, risk-management policies, and chief compliance officer requirements.⁵⁹ Thus, the CFTC interpretations have garnered much criticism from overseas firms.⁶⁰ The cost of doing business in the swaps market will undoubtedly increase over the next few years as swaps participants begin to comply with regulation promulgated by the CFTC.⁶¹ The CFTC has waited to make decisions as to capital requirements for those foreign companies engaged in swaps that fall under U.S. regulation.⁶² The agency expects to finalize such rules in the near future.⁶³

F. Response from Major Banks

Prior to the release of the CFTC's Interpretive Guidance and Policy Statement, swaps traders and banks were taking advantage of a major loophole.⁶⁴ In order to avoid swaps regulation, a U.S. bank would assign its foreign affiliate to arrange swaps with foreign

groups/public/@newsroom/documents/file/crossborder_factsheet_final.pdf (last visited Apr. 16, 2014).

⁵⁸ Andrew Ackerman, *CFTC Extends Some Swaps Rules to Overseas Firms*, WALL ST. J. (Dec. 21, 2013, 2:24 PM), <http://online.wsj.com/news/articles/SB10001424052702304866904579272510388548966> (“In a move likely to renew criticism the U.S. is bidding to become the de facto global financial regulator, the CFTC voted 3-1 to apply many of its key swaps rules to overseas firms that will also fall under their home country regulations.”).

⁵⁹ *Id.*

⁶⁰ *Id.* (“The prospect of U.S. rules being applied across borders has prompted a blowback from overseas policy makers, particularly in Europe, who have criticized the U.S. for flouting an international agreement to coordinate international rule-making through the Financial Stability Board.”).

⁶¹ *CME Swap Data Repository Fee Schedule*, *supra* note 5.

⁶² Ackerman, *supra* note 58.

⁶³ *Id.*

⁶⁴ Carla Main, *CFTC Closes Loophole, Treasuries Rule, Tech REITs: Compliance*, BLOOMBERG (Nov. 18, 2013, 12:00 AM), <http://bloomberg.com/news/2013-11-18/cftc-closes-loophole-treasuries-rule-tech-reits-compliance.html>.

participants.⁶⁵ Lawyers for the banks predicted that such an arrangement would not subject the bank to CFTC rules because the bank's affiliate would not be considered a "U.S. person."⁶⁶ Ultimately, the banks sought to handle swaps privately, instead of on the mandated electronic platform.⁶⁷ Privately handling the swaps would offer an abundance of cost savings.⁶⁸ However, the policy statement released by the CFTC shifted the regulatory environment and closed this major loophole.⁶⁹

The banks have offered much administrative criticism on the CFTC's Interpretive Guidance and Policy Statement.⁷⁰ Three Wall Street trade groups recently filed a lawsuit alleging, "that the Commodity Futures Trading Commission illegally issued a series of informal guidelines and staff advisories . . . to govern how U.S. rules should apply to overseas trading."⁷¹ The trade groups request that the CFTC utilize a more rigorous formal rulemaking procedure when the

⁶⁵ Douwe Miedema, *CFTC Urges Closing 'Tropical Island' Loophole*, REUTERS (June 6, 2013, 10:49 AM) <http://reuters.com/article/2013/06/06/us-derivatives-regulation-idUSBRE9550UM20130606> (explaining that "offshore hedge funds, such as those based in the Cayman Islands, can avoid the requirement, at least temporarily").

⁶⁶ See Evan Weinberger, *CFTC Closes Loophole On Cross-Border Swaps Trading*, LAW360 (Nov. 15, 2013, 2:55 PM), <http://law360.com/articles/488970/cftc-closes-loophole-on-cross-border-swaps-trading> ("Some banks interpreted [the guidance] to mean that trades arranged by U.S.-based brokers or banks for foreign clients that were then processed by a foreign affiliate of the bank could avoid being completed through an electronic clearinghouse or exchange.").

⁶⁷ *Id.*

⁶⁸ *CME Swap Data Repository Fee Schedule*, *supra* note 5.

⁶⁹ See Weinberger, *supra* note 66 ("The U.S. Commodity Futures Trading Commission on Thursday cleared up confusion on a potential loophole in its cross-border swaps trading guidelines by saying that trades prepared by U.S. firms for overseas clients should be processed through electronic platforms.").

⁷⁰ See, e.g., Sarah N. Lynch, *U.S. Regulators Temper Overseas Swaps Guidance As Lawsuit Looms*, REUTERS (Jan. 3, 2014, 2:08 PM), <http://reuters.com/article/2014/01/03/cftc-swaps-crossborder-idUSL2N0KD0XV20140103> ("Doing so, they said, let the CFTC bypass a more rigorous formal rulemaking procedure and seize control of a broader swath of trading activities.").

⁷¹ *Id.* The trade groups are the Securities Industry and Financial Markets Association, International Swaps and Derivatives Association, and the Institute of International Bankers. *Id.*

commission enacts its rules.⁷² This procedure allows for an extensive comment and review period, which was not offered prior to the release of the Interpretive Guidance and Policy Statement.⁷³ Moreover, the trade groups have argued that issuing the guidance statement in lieu of a formal rule violates the Administrative Procedures Act, which “requires agencies to seek public comments and properly weigh those comments before adopting any new regulation.”⁷⁴ Additionally, the trade groups were frustrated that no final date was issued in the policy statement as to when the policy will actually take effect.⁷⁵ However, the CFTC has since opened up a sixty-day comment period.⁷⁶

G. Conclusion

The Dodd-Frank Act contained a set of congressional statutes to govern derivatives and swaps.⁷⁷ The CFTC, in accordance with Dodd-Frank has adopted its own set of rules governing international swaps trading.⁷⁸ The extent of these rules’ application is currently under dispute. The CFTC has sought to expand its reach to all affiliates of U.S. swaps participants.⁷⁹ Large banks have pushed back on the additional regulation, and sought to avoid costly reporting requirements.⁸⁰ The swaps market, previously unregulated,

⁷² *Id.*

⁷³ *Id.* (“The groups argue that issuing guidance and advisories in lieu of formal rules violates a federal law that governs the process that many U.S. agencies must follow before they can adopt new regulations.”).

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 701, 124 Stat. 1376, 1641 (2010) (codified in scattered sections of 15 U.S.C.).

⁷⁸ Dodd-Frank Act § 712 (“Notwithstanding any other provision of this title, the Commodity Futures Trading Commission and the Securities and Exchange Commission, in consultation with the Board of Governors, shall jointly adopt such other rules regarding such definitions as the Commodity Futures Trading Commission and the Securities and Exchange Commission determine are necessary and appropriate, in the public interest, and for the protection of investors.”).

⁷⁹ Schmidt & Brush, *supra* note 1.

⁸⁰ See, e.g., *id.* (“The largest banks told swap brokers in late September that the language means certain swaps still don’t fall under the agency’s new trading rules . . .”).

drastically affected the financial crisis of 2008.⁸¹ Thus, the CFTC's disclosure requirements aim to create a sense of transparency.⁸² Such requirements should ultimately enhance the safety and efficiency of swaps markets.

Jake Saifman⁸³

⁸¹ See Interpretive Guidance, *supra* note 36, at 45,293 (“The potential for cross-border activities to have a substantial impact on the U.S. financial system was apparent in the fall of 2008, when a series of large financial institutional failures threatened to freeze foreign and domestic credit markets.”).

⁸² *Transparency*, CFTC, <http://cftc.gov/Transparency/index.htm> (last visited Apr. 16, 2014) (“The CFTC is committed to transparency in the rulemaking process.”).

⁸³ Student, Boston University School of Law (J.D. 2015).