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Milbank discusses Title VII and the Volcker Rule: Same swap, different rules

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Now that the final rule[1] implementing Section 619 of the Dodd-Frank Act,[2] commonly known as the "Volcker Rule,"[3] has been implemented, banking entities engaged in swaps activities must plan how they will navigate the two different and overlapping regulatory regimes that will apply to the same transactions: the Volcker Rule and Title VII of the Dodd-Frank Act ("Title VII"). This challenge will be made greater by the fact that each regime will be interpreted and applied by different federal regulators, each of which will have a varying supervisory purpose.

The policies behind the two titles of Dodd-Frank that regulate the use of swaps are quite different. Title VII is a comprehensive set of regulatory requirements placed on a previously largely unregulated market. The purpose of Title VII was to bring greater transparency to a market considered opaque in size, pricing and risk. The Volcker Rule, which was adopted as Chapter 13 to the Bank Holding Company Act, is the latest volley in the 65-year struggle between those who feel that banks and the entities that control them should be allowed to engage in a broader array of risk producing financial activities, and those who believe that such entities are akin to public utilities and should be prohibited from accepting risk outside of the traditional banking categories of loans, deposits, custody and trust services.

Below, we identify some of the issues raised by the application of different regulatory regimes to the same product.

1. Definitional Issues

A. Products under the Volcker Rule and Title VII

The proprietary trading prohibition in the Volcker Rule (the "Proprietary Trading Prohibition")[4] applies to most products regulated by Title VII, including, subject to certain exceptions, any "swap" (as defined in the Commodity Exchange Act, the "CEA"), "security-based swap" (as defined in the Securities Exchange Act), physical commodity forward, "foreign exchange forward" (as defined in the CEA), and "foreign exchange swap" (as defined in the CEA). Foreign exchange forwards and foreign exchange swaps have been exempted from the definition of "swap" pursuant to a written determination of the Secretary of Treasury (per sections 1a(47)(E) and 1b of the CEA) and are not considered swaps for most purposes under Title VII. As discussed in more detail below, this means that banking entities must monitor carefully instruments that may be swaps for purposes of the Volcker Rule, while not being swaps for purposes of Title VII. This may have implications in areas such as the exception for permitted trading outside the U.S.[5] (the "TOTUS Exemption") where the fact that central clearing of foreign exchange swaps and forwards has not been mandated may require such transactions to be treated differently from other swaps.

The Proprietary Trading Prohibition contains two exemptions for trading in U.S. obligations and foreign government obligations, provided the banking entity is organized under the laws of the issuing foreign sovereign.[6] These exceptions will apply to swaps with or guaranteed by the U.S., the relevant foreign governments and their respective political subdivisions and agencies.[7] However, credit default swaps on sovereign obligations are not captured by these exceptions and will need to fall under another exception to the Proprietary Trading Prohibition to be permissible under the Volcker Rule.

B. Trading Account

Banking entities that are Swap Dealers[8] or that engage in swap dealing activities under the de minimis threshold (together with Swap Dealers, "Swaps Entities") must determine whether the swaps they enter into fall into any of the three prongs of the Trading Account definition. As the Preamble notes, the vast majority of proprietary trading is captured by the first prong, known as the "Short Term Trading Prong."[9] The remaining two prongs—the "Market Risk Capital Prong"[10] and the "Dealer Prong"[11]—"apply to types of entities that engage in trading activities" and the activities captured in these prongs may overlap with and "mutually reinforce" the activities captured by the Short Term Trading Prong.[12]

What is complex for Swaps Entities, however, is the interaction between the Dealer Prong and the Commodity Futures Trading Commission's ("CFTC's") registration rules. The Dealer Prong distinguishes between registered and unregistered entities to determine whether the swap activities of an entity are covered by the Volcker Rule. Specifically, the types of instruments that are deemed to fall within the Dealer Prong depend on whether a particular entity is:

(i) organized under U.S. law and registered as a Swap Dealer;

(ii) organized outside of the U.S. and registered as a Swap Dealer;

(iii) organized under U.S. law and not required to register as a Swap Dealer; or

(iv) organized outside of the U.S. and not required to register as a Swap Dealer.

The Dealer Prong encompasses any account used by a banking entity to purchase or sell one or more financial instruments for any purpose if the banking entity:

> (A) is licensed or registered, or is required to be licensed or registered, to engage in the business of a dealer, swap dealer or security-based swap dealer, to the extent the instrument is purchased or sold in connection with dealing activities that require the banking entity to register as such; or
>
> (B) is engaged in the business of a dealer, swap dealer, or security-based swap dealer outside of the United States, to the extent the instrument is purchased or sold in connection with the activities of such business.[13]

The Preamble makes clear that sub-prong (A) of the Dealer Prong[14] applies "[i]n the case of both domestic and foreign entities … only to financial instruments purchased or sold in connection with the activities that require the banking entity to be licensed or registered to engage in the business of dealing, which is not necessarily all the activities of that banking entity."[15] This language references the fact that not all swaps activity will be the type of activity that would require an entity to register as a Swap Dealer either because (i) the entity is a non-U.S. entity and does not have to count a particular type of "dealing" activity towards its de minimis threshold or (ii) the swaps activity is not considered "dealing activity."

Swap Dealers organized under U.S. law, for example, must include in their Trading Accounts all financial instruments purchased or sold in connection with dealing activities that require such banking entity to register as a Swap Dealer. Pursuant to the CFTC's cross-border guidance (the "Cross-Border Guidance")[16] a banking entity organized under U.S. law should count towards its de minimis threshold all dealing swaps with all counterparties. Non-U.S. Swap Dealers that are affiliates of and guaranteed by U.S. persons or that are conduit affiliates[17] must also count all dealing swaps with all counterparties towards their de minimis thresholds. In each case these types of Swap Dealers would include all dealing swaps in their Trading Accounts.

However, a Non-U.S. Swap Dealer that is neither a guaranteed nor a conduit affiliate need only count its swap dealing transactions with U.S. persons and with guaranteed affiliates of U.S. persons (other than foreign branches of Swap Dealers and guaranteed affiliates of Swap Dealers) towards its de minimis threshold. Non-U.S. Swap Dealers are also not required to count swaps executed anonymously on a Swap Execution Facility ("SEF"), Designated Contract Market or Foreign Board of Trade and cleared towards their de minimis threshold. Therefore, such swaps would not be captured under sub-prong (A) of the Dealer Prong.[18]

With respect to both U.S and non-U.S. Swap Dealers, sub-prong (B) of the Dealer Prong[19] captures dealing swaps purchased or sold in connection with the banking entity's swap dealing business outside of the U.S. Here, the Agencies' intent appears to be to even the playing field between U.S. Swap Dealers who must count all dealing swaps toward their de minimis threshold and non-U.S. Swap Dealers who need only count certain swaps for registration purposes. It is unclear, however, to what extent swaps executed anonymously on a U.S. SEF and then cleared would be captured by sub prong (B) of the Dealer Prong as such activity arguably occurs within the U.S.[20] Further, as the CFTC notes in explaining its rationale for excluding such swaps from a non-U.S. entity's de minimis threshold calculation, there are "practical difficulties involved in determining whether the non-U.S. person should include such swap in the [de minimis] calculation, given that the non-U.S. person would have no information regarding its swap counterparty prior to the execution of the swap."[21] Thus, such swaps may not be captured by either sub-prong (A) or (B) of the Dealer Prong.

The interaction of sub-prongs (A) and (B) of the Dealer Prong leads to similarly odd results with respect to dealing transactions entered into by unregistered entities. In that case, no U.S. swaps activity would be covered, as sub-prong (A) would not apply, and sub-prong (B) would only apply to dealing activity that occurs outside of the U.S. It seems unlikely that the Agencies would have intended to regulate activity occurring outside of the U.S. while not capturing activity within the U.S., but that is what the rule provides.

In either case, the practical result may be that activity that falls outside of the Dealer Prong is picked up by the Short Term Trading Prong. However, in order to comply with the Volcker Rule, Swaps Entities will have to analyze their activities under all three prongs of the Trading Account definition, meaning that a close parsing of the rules respecting registration and the definition of "dealing" activity will continue to be central, even to entities that have already registered as Swap Dealers.

2. Swaps Market Infrastructure: Clearing and Trade Execution

Central clearing is arguably the cornerstone of derivatives regulatory reform both globally and under Title VII. In the U.S., mandatory clearing is currently required for certain classes of interest rate and credit default swaps, and the CFTC expects to issue additional clearing determinations for other products in the future. Margin requirements for uncleared swaps have been proposed in part to equalize the cost of entering into OTC swaps and cleared swaps and to further incentivize market participants to move towards clearing. Mandatory trade execution, though not currently required for any transactions, will also shape the swaps market considerably.

The Volcker Rule preferences central clearing and anonymous execution to a certain extent by allowing foreign banking organizations ("FBOs") more flexibility in relying on the TOTUS Exemption either (i) where a swap is entered into with an unaffiliated market intermediary (such as a Swap Dealer) and cleared or (ii) where the swap is executed anonymously on an exchange and then cleared (together, the "U.S. Market Infrastructure Exceptions").[22] As we noted in our earlier alert,[23] however, the fact that a large range of products covered by the Volcker Rule are not yet centrally cleared means that most non-U.S. Swap Dealers will be unable to use the TOTUS Exemption without cutting themselves off from the liquidity of the U.S. markets, and will, therefore, end up having to implement the proprietary trading compliance regime globally. For example, security-based swaps are not currently subject to a clearing mandate, though a few such products are clearable voluntarily, and foreign exchange swaps and forwards will never be subject to a clearing mandate, as such products are not considered "swaps" for purposes of Title VII.

Furthermore, the portion of the TOTUS Exemption intended to permit access to anonymous trading venues in the U.S. ((v)(C))[24] appears not to take account of the way SEF market architecture is developing. Most Swap Dealers have signed up to SEFs as direct access participants in anticipation of the mandatory SEF execution requirement so that they may continue to make markets in swaps subject to a "made available to trade determination" (such determination, a "MAT Determination," and such swaps, "Required Transactions"). Sub-prong (v)(C) of the TOTUS Exemption,[25] however, requires FBOs to trade through an unaffiliated market intermediary to access a SEF.[26] Although sub-prong (v)(B) of the TOTUS Exemption[27] allows FBOs to trade with unaffiliated market intermediaries as principal, this prong cannot be applied to anonymous SEF execution.[28] Because SEFs must offer impartial access to all eligible contract participants and may not use enablement mechanisms to limit the types of market participants with which another market participant can interact,[29] an FBO accessing a SEF to execute a trade anonymously has no way of ensuring that the entity with which it trades is an unaffiliated market intermediary (which must be a registered swap dealer, broker-dealer or futures commission merchant).[30] In fact, the Preamble suggests that sub-prong (v)(B) of the TOTUS Exemption is intended to apply only to transactions that are not conducted on an exchange.[31] Together, then, these two elements of the TOTUS Exemption seem to require an FBO to route its own SEF trades through an unaffiliated entity – clearly an unworkable business proposition for the largest swap dealers.

Because the U.S. Market Infrastructure Exceptions may not be workable in all cases, an FBO wishing to rely on the TOTUS Exemption and trade with or through a U.S. entity will have to enter into uncleared swaps through that entity's non-U.S. operations. However, no personnel of the U.S. entity that arrange, execute or negotiate such swaps may be located in the U.S. Although moving personnel out of the U.S. may be problematic for certain U.S. entities, ultimately the structure of the TOTUS Exemption appears to preference trading through non-U.S. branches and subsidiaries of U.S. banking entities. If a banking entity fails to satisfy the conditions of the TOTUS Exemption, however, it may continue to engage in certain permitted activities, provided that it complies with the conditions set forth in one of the exceptions to the Proprietary Trading Prohibition, such as the market-making[32] or hedging exceptions.[33]

3. Arrange, Negotiate and Execute (and Decide): ANED v ANE

Both the Volcker Rule and Title VII swaps regulations place some emphasis on the location of personnel involved in a particular swap. An FBO may only rely on the TOTUS Exemption if none of its (or its affiliate's) personnel that arrange, negotiate, execute or make the decision to enter into the swap are located in the U.S. The Preamble explains that this prohibition applies to personnel who solicit or sell or arrange for trades as well as to those who serve as decision makers in transactions.[34] The prohibition does not apply to personnel engaged in back-office functions, such as clearing or settlement.[35] The brief explanation provided in the Preamble leaves open many questions regarding the breadth of the prohibition. For example, it is unclear how robustly the Agencies intend to interpret the term "decision maker" and whether the term applies only to personnel who make the ultimate decision to enter into a particular swap or whether it also covers all personnel who are empowered to be decision makers with respect to a particular issue (e.g. credit and risk personnel who agree to accept particular terms).

Similarly, CFTC Staff Advisory 13-69 on the Applicability of Transaction-Level Requirements to Activity in the United States ("Staff Advisory 13-69″)[36] provides that a "non-U.S. [Swap Dealer] regularly using personnel or agents located in the U.S. to arrange, negotiate, or execute a swap with a non-U.S. person generally would be required to comply with the Transaction-Level Requirements."[37] Staff Advisory 13-69 contains no explanation of how the CFTC intends to interpret or apply this language and the CFTC has sought comment on various aspects of the Advisory.[38]

As currently drafted there are some important differences between the language in the TOTUS Exemption and Staff Advisory 13-69. To begin, the TOTUS Exemption applies more broadly and captures a wider array of entities than Staff Advisory 13- 69, which only applies to Non-U.S. Swap Dealers. Further, the TOTUS Exemption clearly applies on a swap-by-swap basis. Staff Advisory 13-69, however, appears to apply to the non-U.S. Swap Dealer's U.S. operations generally if the Non-U.S. Swap Dealer "regularly" uses personnel located in the U.S. Staff Advisory 13-69 does not rule out the possibility that the U.S. transaction level requirements might be applied only on a swap-by-swap basis or business line-by-business line basis, but neither does it explicitly allow for that. The advisory also states that a non-U.S. Swap Dealer whose personnel were engaging in swaps activities in the U.S. would "generally" be required to comply with the transaction-level requirements. It is unclear whether the CFTC envisions situations in which a non-U.S. Swap Dealer might use U.S. personnel to perform swaps activities while not requiring application of the transaction-level requirements. Finally, of course, the most important difference is that a swap not in compliance with the TOTUS Exemption would not be permitted **at all**, unless another exemption can be found and proven pursuant to the application of the detailed compliance regime of the Volcker Rule. A swap not in compliance with Staff Advisory 13-69 would be permitted, albeit with the application of burdensome and potentially duplicative transaction-level requirements.

Market participants should take careful note of the interaction of the Volcker Rule with these Title VII concepts when responding to the CFTC's requests for comment on Staff Advisory 13-69.

4. Compliance Burdens under Title VII and the Volcker Rule

Swaps that fall within the hedging or market making exceptions from the Proprietary Trading Prohibition will be subject to the Volcker Rule's detailed compliance framework. For Swap Dealers, this will mean reconciling the risk management requirements of the Volcker Rule with risk management requirements under Part 23 of the CFTC regulations. Swap Dealers will need to develop risk management reports for their swaps business that will support the requirements of both rules.

Part 23 of the CFTC regulations[39] details the elements of the risk management program for Swap Dealers, which includes, at a minimum: (1) identification of risks and risk tolerance limits, (2) periodic risk exposure reports, (3) policies designed to identify risks with new products, (4) specific risk management considerations (i.e., policies and procedures to monitor and manage market risk, credit risk, liquidity risk, foreign currency risk, legal risk, operational risk and settlement risk), (5) policies on the use of central counterparties, (6) compliance with margin and capital requirements, and (7) monitoring of compliance with risk management program. On the other hand, Section III of Appendix A to Subpart D of the Volcker Rule outlines seven metrics banking entities that are required to calculate daily and report, which include: (1) risk and position limits and usage, (2) risk factor sensitivities, (3) value-at-risk and stress VaR, (4) comprehensive profit and loss attribution, (5) inventory turnover, (6) inventory aging, and (7) customer-facing trade ratio. In many cases, the same data will be used to feed both sets of reports. Aligning the presentation of this data across the varying purposes of the different regulators overseeing Title VII and the Volcker Rule will not be a trivial undertaking.

Finally, for FBOs, the extra-territoriality of the Volcker Rule will amplify these compliance headaches. Although non-U.S. Swap Dealers won a battle for rational cross-border regulation in the CFTC's recent substituted compliance determinations,[40] they may well have lost the war in the Volcker Rule, where the cramped nature of the TOTUS Exemption effectively forces an export of the entire Volcker Rule compliance regime worldwide. As a result, Non-U.S. Swap Dealers will still have to implement a compliance reporting regime designed and interpreted by U.S. regulators for a large segment of their swap dealing businesses outside the U.S. and reconcile such regulations with potentially duplicative or even conflicting home country prudential regulations.

ENDNOTES:

1. ”Proprietary Trading and Certain Interests in and Relationships with Covered Funds,” http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210a1.pdf.

2. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, July 21, 2010.

3. See http://www.milbank.com/images/content/1/5/15022/Milbank-Volcker-Rule-and- Foreign-Banks-Client-Alert.pdf.

4. §_.3.

5. §_.6(e).

6. §_.6(a)-(b).

7. With respect to domestic government obligations, the exception more specifically applies to: “(1) An obligation of, or issued or guaranteed by, the United States; (2) An obligation, participation, or other instrument of, or issued or guaranteed by, an agency of the United States, the Government National Mortgage Association, the Federal National Mortgage As- sociation, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation or a Farm Credit System institution chartered under and subject to the provisions of the Farm Credit Act of 1971 (12 U.S.C. 2001 et seq.); (3) An obligation of any State or any political subdivision thereof, including any municipal security; or (4) An obligation of the FDIC, or any entity formed by or on behalf of the FDIC for purpose of facilitating the disposal of assets acquired or held by the FDIC in its corporate capacity or as conservator or receiver under the Federal Deposit Insurance Act or Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act.” §_.6(a).

8. An entity must register with the CFTC as a Swap Dealer if it enters into more than a de minimis level of swap dealing activity over the preceding twelve-month period. 17 C.F.R. 1.3(ggg)(4).

9. §_.3(b)(1)(i).

10. §_.3(b)(1)(ii).

11. §_.3(b)(1)(iii).

12. Preamble at 39-40.

13. §_.3(b)(1)(iii)(A)-(B).

14. §_.3(b)(1)(iii)(A).

15. Preamble at 41-42, emphasis added.

16. Interpretative Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45292, 45318 (July 26, 2013) available at http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013- 17958a.pdf.

17. “Conduit affiliate” means an entity that serves as swap conduit for a U.S.-based corporate group (other than a group that includes a registered SD);”Guaranteed affiliate” means an entity organized outside the U.S. whose swap obligations are guaranteed by a U.S. Person.

18. §_.3(b)(1)(iii)(A).

19. §_.3(b)(1)(iii)(B).

20. Further, pursuant to CFTC’s Interpretive Letter 13-69, swaps between two non-U.S. persons where U.S. personnel are engaged in negotiating, executing or arranging the swap are also “located in the United States” and therefore arguably outside of the United States and beyond the scope of sub-prong (B) of the Dealer Prong.

21. Cross-Border Guidance at 45325.

22. Section_.3(d) of the Volcker Rule also takes account of clearing market infrastructure by excluding certain trades done by derivatives clearing organizations and their members related to clearing and settlement from the definition of proprietary trading.

23. See footnote 3, supra.

24. §_.6(e)(v)(C).

25. Id.

26. Preamble at 428.

27. §_.6(e)(v)(C).

28. Id.

29. 17 C.F.R. 37.202(a).

30. "Unaffiliated market intermediary" means an unaffiliated entity, acting as an intermediary that is a registered broker-dealer, swap dealer, security-based swap dealer or an FCM. §_.6(e)(6).

31. Preamble at 430.

32. §_.4(b).

33. §_.5.

34. Preamble at 421 n. 1521.

35. Preamble at 421 n. 1521.

36. Division of Swap Dealer and Intermediary Oversight, CFTC Staff Advisory 13-69, DIVISION OF SWAP DEALER AND INTERMEDIARY OVERSIGHT ADVISORY: Applicability of Transaction- Level Requirements to Activity in the United States (November 14, 2013) available at http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/13-69.pdf.

37. Staff Advisory 13-69 at 2.

38. Request for Comment on Application of Commission Regulations to Swaps Between Non- U.S. Swap Dealers and Non-U.S. Counterparties Involving Personnel or Agents of the Non- U.S. Swap Dealers Located in the United States, 79 Fed. Reg. 1347 (Jan. 8, 2014) available at http://www.cftc.gov/LawRegulation/FederalRegister/ProposedRules/2014-00080.

39. 17 C.F.R. 23.600(c).

40. CFTC Approves Comparability Determinations for Six Jurisdictions for Substituted Compliance Purposes, (Dec. 20, 2013) *available at* http://www.cftc.gov/PressRoom/PressReleases/pr6802-13.

The original memo was published by Milbank, Tweed, Hadley & McCloy LLP on January 13, 2014 and is available here. Its content should not be construed as legal advice, and readers should not act upon the information in this memo without consulting counsel.

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