

# Client Update

## Recent Notable CFTC and SEC Actions Relating to Swaps and Security-Based Swaps

### NEW YORK

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The following are some recent actions regarding the regulation of swaps and security-based swaps taken by the Commodity Futures Trading Commission (the “CFTC”) and the Securities and Exchange Commission (the “SEC”).

On September 28, 2016, the CFTC adopted a final rule expanding the existing clearing requirement for interest rate swaps (the “New CFTC Clearing Determination”).<sup>1</sup> This New CFTC Clearing Determination amends CFTC Regulation 50.4(a) by adding new currencies to the categories of interest rate swaps required to be cleared under the CFTC’s original clearing determination<sup>2</sup> issued in 2012 (the “2012 CFTC Clearing Determination”). The clearing requirement for these additional swaps will be phased in from December 13, 2016 through October 15, 2018.

On October 13, 2016, the CFTC issued an order (the “CFTC SD Order”) establishing December 31, 2018 as the new phase-in termination date for the swap dealer (“SD”) registration *de minimis* threshold.<sup>3</sup>

On November 4, 2016, the CFTC issued a supplemental proposal (the “Supplemental CFTC Proposed Regulation AT”)<sup>4</sup> to its existing proposed

<sup>1</sup> The text of the New CFTC Clearing Determination is available at: <https://www.gpo.gov/fdsys/pkg/FR-2016-10-14/pdf/2016-23983.pdf>.

<sup>2</sup> The text of the CFTC’s 2012 clearing determination is available at: <http://www.cftc.gov/PressRoom/PressReleases/pr6429-12>.

<sup>3</sup> The text of the CFTC Order is available at: <http://www.cftc.gov/PressRoom/PressReleases/pr7471-16>. For additional information on the SD *de minimis* threshold and the CFTC’s report on the threshold, see our client update, “Final Report on Swap Dealer *De Minimis* Exception” (Aug. 19, 2016), available at: <http://www.debevoise.com/insights/publications/2016/08/final-report-on-swap-dealer-de-minimis-exception>.

Regulation Automated Trading (the “2015 CFTC Proposed Regulation AT”),<sup>5</sup> amending and streamlining some of the requirements from the 2015 CFTC Proposed Regulation AT. Comments on the Supplemental CFTC Proposed Regulation AT must be submitted on or before January 24, 2017.

On September 28, 2016, the SEC adopted final rules (the “SEC CCP Final Rules”) establishing enhanced standards for the operation and governance of SEC-registered securities clearing agencies (“registered clearing agencies”) that are either designated as systemically important or are involved in complex activities, such as clearing security-based swaps.<sup>6</sup> On the same day, the SEC issued proposed rules (the “SEC Clearing Agency Proposed Rules”) to apply these enhanced standards to other categories of registered clearing agencies.<sup>7</sup>

On October 13, 2016, the SEC issued an order (the “SEC Forcerank Order”) instituting cease-and-desist proceedings against Forcerank LLC (“Forcerank”), a New York-based company, for failure to file a registration statement for its offering to retail investors of mobile phone games described as “fantasy sports for stocks.” The SEC determined that such offering was in violation of the Securities Act and the Securities Exchange Act, as the games constituted security-based swaps offered and sold to players without a registration statement.<sup>8</sup> The SEC Forcerank Order announced that the SEC has accepted a settlement offer from Forcerank, under which Forcerank has agreed to pay a civil money penalty in the amount of \$50,000.

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<sup>4</sup> The text of the Supplemental CFTC Proposed Regulation AT is available at: [http://www.cftc.gov/PressRoom/Events/opaevent\\_cftcstaff110416](http://www.cftc.gov/PressRoom/Events/opaevent_cftcstaff110416).

<sup>5</sup> The text of the 2015 CFTC Proposed Regulation AT is available at: <http://www.cftc.gov/PressRoom/PressReleases/pr7283-15>. For additional information on the 2015 CFTC Proposed Regulation AT, see our client update, “CFTC Proposes Rules Regulating Automated Trading” (Dec. 16, 2015), available at: <http://www.debevoise.com/insights/publications/2015/12/cftc-proposes-rules-regulating-automated-trading>.

<sup>6</sup> The text of the SEC CCP Final Rules is available at: <https://www.gpo.gov/fdsys/pkg/FR-2016-10-13/pdf/2016-23891.pdf>.

<sup>7</sup> The text of the SEC Clearing Agency Proposed Rules is available at: <https://www.gpo.gov/fdsys/pkg/FR-2016-10-13/pdf/2016-23892.pdf>.

<sup>8</sup> The text of the SEC Forcerank Order is available at: <https://www.sec.gov/news/pressrelease/2016-216.html>.

## NEW CFTC CLEARING DETERMINATION

The New CFTC Clearing Determination expands the mandatory clearing requirement to include:

- Fixed-to-floating interest rate swaps denominated in the following currencies: Australian dollar (“AUD”), Canadian dollar (“CAD”), Hong Kong dollar (“HKD”), Mexican peso (“MXN”), Norwegian krone (“NOK”), Polish zloty (“PLN”), Singapore dollar (“SGD”), Swedish krona (“SEK”), and Swiss franc (“CHF”);
- Basis swaps denominated in AUD;
- Forward rate agreements (“FRA”) denominated in NOK, SEK and PLN;
- Overnight index swaps (“OIS”) denominated in AUD and CAD.

In addition, the CFTC changed the maximum termination date for USD, GBP and EUR-denominated OIS to three years, rather than two years (as specified in the 2012 CFTC Clearing Determination).

As with fixed-to-floating interest rate swaps, basis swaps, FRA and OIS that were covered by the 2012 CFTC Clearing Determination (*i.e.*, those denominated in USD, EUR, GBP and JPY), these additional classes of interest rate swaps will be subject to mandatory clearing only if they are based on specified floating rate indices (*i.e.*, the applicable interbank rate, or the applicable overnight rate for OIS), the stated termination date falls within a specified range and certain other conditions apply.

The charts in CFTC Regulation 50.4(a), listing the swaps subject to mandatory clearing, have been amended to reflect these additions and changes. (See Appendix A to this client update for the updated charts.)

Unless an exception or exemption from clearing applies,<sup>9</sup> any such swap entered into after the applicable compliance date (set forth below) will need to be cleared at one of the four registered derivatives clearing organizations (“DCOs”) (Chicago Mercantile Exchange, Inc., LCH.Clearnet Ltd., Eurex Clearing AG or Singapore Exchange Derivatives Clearing Ltd.), except that if the swap is being cleared for a U.S. proprietary account, it may be cleared at one of the other four

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<sup>9</sup> The same exceptions and exemptions from clearing that are available for swaps that are already subject to mandatory clearing (*e.g.*, the end-user exception, the inter-affiliate swap exemption) will also be available for these additional classes of interest rate swaps. Parties may also rely on applicable no-action or interpretive relief to the same extent as they may do so for swaps that are already required to be cleared.

DCOs that the CFTC has exempted from registration (ASX Clear (Futures) Pty Ltd., Japan Securities Clearing Corp., Korea Exchange Inc. and OTC Clearing Hong Kong Ltd.).

The New CFTC Clearing Determination generally covers swaps that are either already subject to a clearing requirement in another jurisdiction or are considered likely to be in the future, reflecting the CFTC's intention to harmonize the scope of its own clearing requirement with that of regulators in other jurisdictions.

Compliance with the expanded clearing requirement will be phased in from December 13, 2016 through October 15, 2018, based on when analogous clearing requirements have taken, or will take, effect in foreign jurisdictions (in each case, generally at least two months after the corresponding foreign compliance date). Appendix B to this client update sets forth the implementation schedule, listing the applicable CFTC compliance date for each newly added class of interest rate swaps, as well as the first compliance date for clearing that same type of swap in a foreign jurisdiction. Only swaps executed after the relevant compliance date will be required to be cleared.

### **CFTC ORDER ON SWAP DEALER REGISTRATION**

The CFTC SD Order establishes December 31, 2018 as the new phase-in termination date for the SD registration *de minimis* threshold, rather than the original termination date of December 31, 2017. If the CFTC does not take action to modify or maintain the current \$8 billion threshold or to further modify the termination date for the phase-in period, the *de minimis* threshold will automatically drop to \$3 billion on December 31, 2018.

The one-year extension of the phase-in period is intended to provide additional time for more information to become available to possibly reassess the *de minimis* exception, while providing clarity to market participants regarding when they will need to begin preparing for a change to the threshold.

### **CFTC SUPPLEMENT TO PROPOSED REGULATION AT**

The 2015 CFTC Proposed Regulation AT proposed a comprehensive regulatory framework for algorithmic (or automated) trading on designated contract markets ("DCMs"), including a number of pre-trade risk controls, transparency measures, and other safeguards, with the goal of reducing risk (including the risk of another flash crash) and increasing transparency in algorithmic trading on U.S. futures exchanges.

The Supplemental CFTC Proposed Regulation AT amends and streamlines certain of these requirements. The supplemental proposal replaces the 2015 proposal's three-level risk control structure (consisting of the AT Person (as defined in the proposal), the futures commission merchant ("FCM") and the DCM) with a two-level structure, with the first level of risk controls at the AT Person or the FCM (but not both) and the second level at the DCM. The first level of risk controls would be imposed at the AT Person level for their algorithmic (and electronic)<sup>10</sup> trading, and at the FCM level for all electronic trading originating with any market participant other than AT Persons. An AT Person would have the option of delegating compliance with risk control requirements to its FCM(s) (rather than implementing its own controls), where (1) it is technologically feasible for the FCM to do this monitoring and (2) the FCM agrees in writing to do so. The AT Person would ultimately remain legally responsible for all risk control functions (even where it delegates such functions to its FCM).

In addition, the Supplemental CFTC Proposed Regulation AT, among other things:

- Modifies the floor trader registration requirement (for AT Persons) by adding a volume-based threshold below which registration would not be required;
- Replaces the original proposal's annual report requirement<sup>11</sup> with a streamlined annual certification requirement, requiring DCMs to adopt rules requiring AT Persons and executing FCMs to provide the DCM with an annual certification attesting to their compliance with Regulation AT;
- Revises the risk control provisions to provide AT Persons, FCMs and DCMs with additional flexibility as to the level of granularity at which pre-trade risk controls must be set, by permitting the controls to be set at any appropriate level or levels as are "technologically feasible and reasonably effective at preventing and reducing potential risk of Electronic Trading

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<sup>10</sup> The Supplemental CFTC Proposed Regulation AT would expand the scope of the required risk controls under Regulation AT to encompass all "Electronic Trading" (rather than limiting such obligations to "Algorithmic Trading," as originally proposed in 2015). "Algorithmic Trading" refers to a subset of Electronic Trading on a DCM where a computer algorithm or system determines whether to place the order (or makes other determinations with respect to the order). "Electronic Trading" is defined more broadly to include all trading on an electronic trading facility where the order is electronically submitted.

<sup>11</sup> The 2015 CFTC Proposed Regulation AT would have required AT Persons and clearing member FCMs to provide annual reports to the DCMs on which they engage in algorithmic trading on their compliance with risk control requirements.

disruption” (including at the same levels enumerated in the original proposal and certain additional levels); and

- Permits AT Persons that use third-party algorithmic trading systems to rely on certifications from these service providers to comply with certain aspects of Regulation AT, including with respect to the standards for developing and testing their Algorithmic Trading Systems. To rely on these third-party certifications, AT Persons would need to conduct due diligence to reasonably determine the accuracy and sufficiency of the certification for compliance purposes.

Finally, the Supplemental CFTC Proposed Regulation amends the original proposal’s requirements regarding the preservation of and access to algorithmic trading source code. The original proposal would have treated a firm’s source code as part of its “books and records” which must be made available for inspection upon request by CFTC staff in accordance with the general recordkeeping requirements set forth in CFTC Regulation 1.31. The CFTC has attempted to address concerns over the confidentiality and proprietary nature of source code by requiring the CFTC to expressly authorize access to a firm’s source code, either by issuing a special call or a subpoena.

The 2015 CFTC Proposed Regulation AT remains under active consideration by the CFTC unless specifically amended.

### SEC RULES REGARDING CLEARING AGENCIES

The SEC CCP Final Rules amend SEC Regulation 17Ad-22 (on the regulation of registered clearing agencies) to establish requirements for the operation and governance of Covered Clearing Agencies. A “Covered Clearing Agency” includes a registered clearing agency that:

- has been designated as systemically important by the Financial Stability Oversight Council (“FSOC”) and for which the SEC is the supervisory agency under the Clearing Supervision Act; or
- provides central counterparty (“CCP”) services for security-based swaps or is involved in activities the SEC determines to have a more complex risk profile, unless the CFTC is the supervisory agency under the Clearing Supervision Act.

Under the SEC CCP Final Rules, Covered Clearing Agencies must adopt policies and procedures that:

- establish qualifications for their directors and senior management, specify clear and direct lines of responsibility and consider the interests of relevant stakeholders;
- address recovery and wind-down planning, including by providing that the Covered Clearing Agency will hold liquid net assets funded by equity equal to at least six months of current operating expenses (so that operations can continue during a recovery or wind-down), and adopting a viable plan (approved by the board and updated at least annually) for raising additional equity should it fall close to or below the required amount;
- address holding “qualifying liquid resources” sufficient to withstand the default of the participant family that would generate the largest aggregate payment obligation in extreme but plausible market conditions, and that address the sufficiency of its liquidity providers;
- ensure that risk management and internal audit personnel have sufficient authority, resources, independence from management and access to the board to fulfill their functions;
- address daily stress testing, monthly review and annual validation of credit risk models;
- address the establishment and enforcement of appropriate haircuts and concentration limits, subject to review on at least an annual basis; and
- address the process for marking positions to market, collecting margin at least daily and conducting daily back-testing, monthly sensitivity analyses and annual model validation.

The SEC CCP Final Rules also include a new Rule 17Ab2-2, establishing procedures for the SEC to make determinations as to certain financial resource requirements a Covered Clearing Agency must satisfy depending on certain factors.

The SEC CCP Final Rules will become effective December 12, 2016, and Covered Clearing Agencies will be required to comply with the requirements beginning on April 11, 2017.

In addition, the SEC Clearing Agency Proposed Rules, if adopted, would expand the definition of “Covered Clearing Agency” to include any registered clearing agency that provides the services of a CCP, central securities depository or securities settlement system.

## SEC FORCERANK ORDER ON SECURITY-BASED SWAP OFFERING

The SEC Forcerank Order is based on its findings that Forcerank violated securities regulations through the offering of its mobile phone games to public players. The SEC determined that the Forcerank games constitute security-based swaps, which were offered and sold without a registration statement. Further, these security-based swaps were not effected on any national securities exchange and were entered into with persons whom Forcerank did not determine to be eligible contract participants.

According to the SEC Forcerank Order, Forcerank ran mobile phone games where players predicted the order in which 10 securities would perform relative to each other. In each week-long game, players won points based on the accuracy of their prediction, and players with the most aggregate number of points received cash prizes at the end of the competition. Forcerank kept 10% of the entry fees and obtained a data set about market expectations that it hoped to sell to hedge funds and other investors.

The SEC Forcerank Order explains that Forcerank's contracts with players were security-based swaps because:

- the contracts provided for a payment that was dependent on the occurrence, or the extent of the occurrence, of an event or contingency (*i.e.*, each player's predictions compared to the actual performance of the securities, and each player's aggregate points compared to other players);
- the event or contingency was "associated with" a potential financial, economic or commercial consequence (*i.e.*, the change in the price of each security relative to the change in the price of other securities); and
- the contracts were "based on" the value of individual securities.

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Please do not hesitate to contact us with any questions.

**Appendix A**  
**Interest Rate Swaps Subject to Mandatory Clearing**

<b>Specification</b>	<b>Fixed-to-Floating Swap Class</b>					
1. Currency	AUD	CAD	EUR	HKD	MXN	NOK
2. Floating Rate Index	BBSW	CDOR	EURIBOR	HIBOR	TIEE-BANXICO	NIBOR
3. Stated Termination Date Range	28 days to 30 yrs	28 days to 30 yrs	28 days to 50 yrs	28 days to 10 yrs	28 days to 21 yrs	28 days to 10 yrs
4. Optionality	No	No	No	No	No	No
5. Dual Currencies	No	No	No	No	No	No
6. Conditional Notional Amounts	No	No	No	No	No	No

<b>Specification</b>	<b>Fixed-to-Floating Swap Class</b>						
1. Currency	PLN	SGD	SEK	CHF	GBP	USD	JPY
2. Floating Rate Index	WIBOR	SOR-VWAP	STIBOR	LIBOR	LIBOR	LIBOR	LIBOR
3. Stated Termination Date Range	28 days to 10 yrs	28 days to 10 yrs	28 days to 15 yrs	28 days to 30 yrs	28 days to 50 yrs	28 days to 50 yrs	28 days to 30 yrs
4. Optionality	No	No	No	No	No	No	No
5. Dual Currencies	No	No	No	No	No	No	No
6. Conditional Notional Amounts	No	No	No	No	No	No	No

<b>Specification</b>	<b>Basis Swap Class</b>				
1. Currency	AUD	EUR	GBP	USD	JPY
2. Floating Rate Index	BBSW	EURIBOR	LIBOR	LIBOR	LIBOR
3. Stated Termination Date Range	28 days to 30 yrs	28 days to 50 yrs	28 days to 50 yrs	28 days to 50 yrs	28 days to 30 yrs
4. Optionality	No	No	No	No	No
5. Dual Currencies	No	No	No	No	No
6. Conditional Notional Amounts	No	No	No	No	No

<b>Specification</b>	<b>Forward Rate Agreement Class</b>						
1. Currency	EUR	PLN	NOK	SEK	GBP	USD	JPY
2. Floating Rate Index	EURIBOR	WIBOR	NIBOR	STIBOR	LIBOR	LIBOR	LIBOR
3. Stated Termination Date Range	3 days to 3 yrs	3 days to 2 yrs	3 days to 2 yrs	3 days to 3 yrs			
4. Optionality	No	No	No	No	No	No	No
5. Dual Currencies	No	No	No	No	No	No	No
6. Conditional Notional Amounts	No	No	No	No	No	No	No

**Appendix B**  
**Implementation Schedule for the New CFTC Clearing Determination**

Product	First Compliance Date in a Foreign Jurisdiction	CFTC Compliance Date <sup>12</sup>
AUD-denominated Fixed-to-floating IRS	April 4, 2016	December 13, 2016 (i.e., 60 days after publication in Fed. Reg.)
CAD-denominated Fixed-to-floating IRS	May 9, 2017	July 10, 2017
CHF-denominated Fixed-to-floating IRS	None to date.	October 15, 2018 <sup>13</sup> (i.e., the first date U.S. markets are open two years after publication in Fed Reg.)
HKD-denominated Fixed-to-floating IRS	July 1, 2017	August 30, 2017
MXN-denominated Fixed-to-floating IRS	April 1, 2016	December 13, 2016
NOK-denominated Fixed-to-floating IRS	February 9, 2017	April 10, 2017
PLN-denominated Fixed-to-floating IRS	February 9, 2017	April 10, 2017
SEK-denominated Fixed-to-floating IRS	February 9, 2017	April 10, 2017
SGD-denominated Fixed-to-floating IRS	None to date.	October 15, 2018
AUD-denominated Basis Swap	April 4, 2016	December 13, 2016
NOK-denominated FRA	February 9, 2017	April 10, 2017
PLN-denominated FRA	February 9, 2017	April 10, 2017

<sup>12</sup> The CFTC notes that if a foreign jurisdiction modifies an existing initial clearing requirement compliance date, or adopts a clearing requirement for either CHF-denominated fixed-to-floating interest rate swaps or SGD-denominated fixed-to-floating interest rate swaps that would require a CFTC compliance date for a market participant earlier than October 15, 2018, then the CFTC staff will publish a press release setting forth the CFTC's clearing requirement compliance date for the relevant interest rate swaps in advance of the date on which compliance will be required.

<sup>13</sup> The CFTC notes that if Singapore and Switzerland do not finalize their clearing mandates and set compliance dates within the two-year time limit, the CFTC may consider options for modifying the compliance deadline as appropriate.

<b>Product</b>	<b>First Compliance Date in a Foreign Jurisdiction</b>	<b>CFTC Compliance Date<sup>12</sup></b>
SEK-denominated FRA	February 9, 2017	April 10, 2017
EUR-denominated OIS (2-3 year term)	June 21, 2016	December 13, 2016
GBP-denominated OIS (2-3 year term)	June 21, 2016	December 13, 2016
USD-denominated OIS (2-3 year term)	June 21, 2016	December 13, 2016
AUD-denominated OIS	October 3, 2016	December 13, 2016
CAD-denominated OIS	May 9, 2017	July 10, 2017