

CFTC Expands Interest Rate Swap Clearing Requirements

Wednesday, October 26, 2016

Introduction

One of the major goals of the Dodd-Frank Act, enacted in the wake of the financial crisis of 2008, was to bring the swaps market under regulation generally and to require that standardized swaps be cleared by a central counterparty (a derivatives clearing organization (“DCO”) under the U.S. Commodity Exchange Act (“CEA”)). On September 28, 2016, the U.S. Commodity Futures Trading Commission (“CFTC”) announced that it had added several classes of interest rate swaps (“IRS”) subject to its jurisdiction to the list of instruments subject to a clearing mandate. These additional swaps are denominated in nine different currencies, and most of them already are subject to a clearing compliance date in a non-U.S. jurisdiction. By this action, the CFTC has taken another step toward fulfilling the Dodd-Frank Act’s goal of centralized clearing and sought to increase the international harmonization of the regulation of swaps.



Article By [K&L Gates](#)
[Lawrence B. Patent](#) [K&L Gates HUB](#)

[Securities & SEC](#)
[Financial Institutions & Banking](#)
[All Federal](#)

Clearing Mandate in General

The intention of clearing requirements is to reduce systemic risk to the global financial system. After parties enter into a swap that is subject to a CFTC clearing mandate, they must submit the swap to a DCO for clearing, a process whereby the original swap is novated into two new swaps, with the DCO becoming the counterparty of each new swap to one of the parties that was a party to the original swap. Thus, each original party is no longer dependent upon the creditworthiness of the original counterparty for fulfillment of the obligations of the swap. Instead, the DCO—which maintains a balanced portfolio, has substantial financial resources, and is subject to government regulation—stands behind each swap. If one of the original parties defaults on its obligations, the DCO will step in to make sure that the other party receives what is due. This is intended to prevent a domino effect based upon a single default and, thus, protect the financial system as a whole.

IRS Clearing Mandates

According to statistics published by the Bank for International Settlements (“BIS”), the notional amount of outstanding IRS as of year-end 2015 exceeded \$384 trillion, almost 78% of the total outstanding in the global over-the-counter derivatives market.^[1]

The CFTC’s original IRS clearing mandates applied to four different classes (fixed-to-floating, basis, forward rate agreement (“FRA”), and overnight index (“OIS”)) for four different currencies (U.S. dollar (“USD”), euro (“EUR”), British pound (“GBP”), and (except for the overnight index), Japanese yen).^[2] The new requirements apply to nine additional currencies for fixed-to-floating swaps, and various subsets of those nine currencies in the other classes.^[3] The new mandates are as follows:

- Fixed-to-floating IRS denominated in 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.

- FRAs denominated in NOK, PLN, and SEK.^[4]
- OIS denominated in AUD and CAD, as well as U.S. dollar-, euro-, and sterling-denominated OIS with termination dates up to three years.

As is the case for the IRS previously required to be cleared, the new swaps subject to a clearing mandate have no optionality or conditional notional amounts and do not involve dual currencies. However, the reference floating rate indexes for the new currencies are different, as are some of the termination date ranges, compared to the swaps originally mandated for clearing.

Implementation Schedule

The CFTC stated when it proposed the new clearing mandates that they would be consistent with those proposed or finalized in 2015 or 2016 by the CFTC’s counterparts in Australia, Canada, the European Union, Hong Kong, Mexico, and Singapore. In light of that and because a number of market participants clear these products already and/or are familiar with clearing other IRS, the CFTC is not providing an implementation schedule for these new products (as permitted under its regulations) that is based upon the type of market participant.^[5] Instead, for those products already subject to a clearing mandate in a non-U.S. jurisdiction (fixed-to-floating AUD and MNX, AUD basis swaps, and all of the OIS except the CAD), the CFTC mandate requires implementation 60 days after publication of the amended regulations in the *Federal Register*; thus, the implementation date is December 13, 2016. Most of the other new IRS mandates apply to instruments where the non-U.S. jurisdiction will first require clearing sometime next year, and the CFTC requirement must be implemented 60 days thereafter. Thus, the NOK, PLN and SEK fixed-to-floating and FRAs must be implemented by April 10, 2017, the CAD fixed-to-floating and OIS by July 10, 2017, and the HKD fixed-to-floating by August 30, 2017. For the other two new mandates (CHF and SGD fixed-to-floating), there is as yet no clearing compliance date in a non-U.S. jurisdiction. Accordingly, the CFTC mandate for those two products becomes effective the earlier of (1) 60 days after the effective date of a clearing requirement in a non-U.S. jurisdiction, or (2) two years after publication of the amended CFTC regulations in the *Federal Register* (i.e., October 15, 2018). The chart below sets forth the new mandates:

New Mandates

IRS Product (Currency Denomination and Class)	First Clearing Requirement Compliance Date in a Non-U.S. Jurisdiction, if Any	CFTC Clearing Requirement Compliance Date
AUD fixed-to-floating	April 4, 2016	December 13, 2016
CAD fixed-to-floating	May 9, 2017	July 10, 2017
CHF fixed-to-floating	None to date	No later than October 15, 2018
HKD fixed-to-floating	July 1, 2017	August 30, 2017
MXN fixed-to-floating	April 1, 2016	December 13, 2016
NOK fixed-to-floating	February 9, 2017	April 10, 2017
PLN fixed-to-floating	February 9, 2017	April 10, 2017
SEK fixed-to-floating	February 9, 2017	April 10, 2017
SGD fixed-to-floating	None to date	No later than October 15, 2018
AUD basis	April 4, 2016	December 13, 2016

NOK FRA	February 9, 2017	April 10, 2017
PLN FRA	February 9, 2017	April 10, 2017
SEK FRA	February 9, 2017	April 10, 2017
EUR OIS (2-3 year term)	June 21, 2016	December 13, 2016
GBP OIS (2-3 year term)	June 21, 2016	December 13, 2016
USD OIS (2-3 year term)	June 21, 2016	December 13, 2016
AUD OIS	October 3, 2016	December 13, 2016
CAD OIS	May 9, 2017	July 10, 2017

The CFTC’s clearing requirement is based upon the first date that any person in the non-U.S. jurisdiction is initially subject to a clearing mandate for new trades (i.e., if any front-loading or back-loading requirements of the non-U.S. jurisdiction take effect earlier, they would not be relevant for purposes of the CFTC’s implementation schedule).

In the event that Singapore and Switzerland do not finalize their clearing mandates and set compliance dates within the two-year time limit for fixed-to-floating IRS, the CFTC indicated that it would be open to considering changing its compliance deadline for these products. In addition, if a non-U.S. jurisdiction modifies any existing initial clearing requirement compliance date, or adopts a clearing requirement for either the CHF-denominated or the SGD-denominated fixed-to-floating IRS that would require a CFTC compliance date for a market participant earlier than October 15, 2018, the CFTC will publish a press release on the CFTC’s website setting forth the CFTC’s clearing requirement compliance date for the relevant IRS in advance of the date upon which compliance will be required.

DCOs Involved

Various registered DCOs made submissions to the CFTC regarding their willingness and ability to clear the IRS in question, which the CFTC has now approved. As of the end of 2016, Chicago Mercantile Exchange, Inc. and LCH.Clearnet Ltd. will clear all of the additional IRS now subject to a clearing mandate. Eurex Clearing AG will clear the CHF fixed-to-floating and the EUR, GBP, and USD two- to three-year OIS, and the Singapore Exchange Derivatives Clearing Ltd. will clear the SGD fixed-to-floating.^[6]

Market Participants Not Subject to Clearing Mandates

Certain market participants are not required to clear an IRS subject to the expanded clearing mandate by electing the exception for nonfinancial entities under CFTC Regulation 50.50 (commonly referred to as the “end-user” exception), the exemption for cooperatives under CFTC Regulation 50.51, or the exemption for swaps between affiliated counterparties under CFTC Regulation 50.52, provided that the market participant is eligible and complies with the various applicable conditions.

A market participant may also rely upon an applicable no-action or interpretative letter issued by CFTC staff in connection with the expanded IRS clearing requirement, just as with the existing clearing requirements.^[7]

However, despite the suggestions of certain commenters that the CFTC consider excluding from its clearing mandates those entities not subject to clearing requirements in the relevant non-U.S. jurisdiction, the CFTC determined not to provide further exemptions beyond those discussed above.

No Backloading Required

The CFTC’s new clearing mandates only apply to swaps executed on or after the applicable compliance date, so there is no requirement to backload uncleared swaps executed prior to those dates. Accordingly, IRS in the classes subject to the new mandates that are currently in existence or that are entered into prior to December

13, 2016, are not required to be cleared, even if they remain open on that date. Furthermore, for those swaps with a CFTC clearing requirement compliance date in 2017 or beyond, any swaps that are entered into prior to the relevant compliance date are not required to be cleared, even if they remain open on that date.^[8]

Exchange Trading

Pursuant to CEA Section 2(h)(8), once a swap is subject to a CFTC clearing mandate, a market participant must execute the swap on a swap execution facility (“SEF”) or a designated contract market (“DCM”), if a SEF or DCM makes the swap available to trade (“made-available-to-trade”). The CFTC has issued Regulations 37.10 and 38.12 to implement the trade execution requirement.

Conclusion

The CFTC’s new clearing mandates represent another step toward the Dodd-Frank Act’s goal of requiring the clearing of standardized swaps by a central counterparty. The IRS market, the largest swap category in the world, is increasingly subject to clearing mandates, not only in the United States but globally as well. The more bespoke nature and lesser liquidity for other swap categories will likely make clearing mandates for those instruments a long time in coming, if ever.

[1] BIS statistics for 2014 and 2015, https://www.bis.org/statistics/d5_1.pdf.

[2] 77 Fed. Reg. 74283 (December 13, 2012).

[3] The CFTC published its new clearing mandates at 81 Fed. Reg. 71202 (October 14, 2016), which is available here. They will be codified in CFTC Regulation 50.4.

[4] While AUD-denominated FRAs were included in the CFTC’s proposed additional clearing mandates announced in June (81 Fed. Reg. 39505 (June 16, 2016)), the CFTC decided not to require clearing this class of swap at this time. The CFTC noted that the Australian authorities have postponed required clearing of AUD-denominated FRAs until July 2018. The Australian clearing organization, ASX Clear (Futures) Pty Limited (“ASX”), commented that it would not be prudent for the CFTC to finalize a clearing requirement for this product in light of the delay in the Australian clearing requirement for this product. ASX also stated that it has observed a general trend in the Australian domestic market away from FRAs and toward single-period swaps instead, which may partly be a result of the fact that AUD FRAs present clearinghouses with an operational challenge insofar as AUD-denominated FRAs settle and fix on the same day, creating problems for clearinghouses because their end-of-day process will not complete until the start of the next Asia-Pacific trading day. 81 Fed. Reg. 71202, at 71213 n.102.

[5] See CFTC Regulation 50.25, 17 C.F.R. § 50.25, which permits, but does not require, the CFTC to implement any clearing mandate based upon whether an entity is classified under the regulation as an “active fund,” a commodity pool, a private fund other than an active fund, a third-party sub-account, or a person predominantly engaged in banking activities or activities that are financial in nature. The permissible clearing mandate schedule establishes three phases of implementation based upon the nature of the parties. For example, the clearing mandate for a swap between a swap dealer and an active fund would take effect within 90 days; between an active fund and a commodity pool, 180 days; and between a third-party sub-account or a pension plan and a swap dealer, 270 days. Despite the pleas of several commenters that this should always be the implementation schedule, the CFTC gives itself discretion in this regard. 77 Fed. Reg. 44441, 44446 (July 30, 2012).

[6] Two DCOs that the CFTC has exempted from registration, ASX and OTC Clearing Hong Kong Ltd., clear some of the swaps subject to the new IRS clearing mandates (AUD- and HKD-denominated IRS, respectively). The CFTC exemption orders permit these two DCOs to clear for U.S. proprietary accounts but not for U.S. customers. The CFTC has indicated that, should either of these two exempt DCOs decide that they wish to offer clearing to U.S. customers, they would be eligible to apply for registration as full DCOs under the CEA.

[7] See, e.g., CFTC Staff Letters 16-01 (bank holding company or savings and loan holding company with consolidated assets of \$10 billion or less), 16-02 (community development financial institutions), 13-01 (swaps resulting from multilateral portfolio compression exercises), and 13-02 (partially novated or terminated swaps). These letters may be accessed through the CFTC website, www.cftc.gov.

[8] This is true even though the amendments to CFTC Regulation 50.4, setting forth the classes of swaps required to be cleared,

technically become “effective” as of December 13, 2016.

Copyright 2019 K & L Gates

Source URL: <https://www.natlawreview.com/article/cftc-expands-interest-rate-swap-clearing-requirements>