

CFTC Issues Final Guidance on the Cross-Border Application of Dodd-Frank Swaps Requirements

Financial Services + Derivatives + Investment Management + Private Investment Funds + Structured Transactions + Asia Funds

On July 12, 2013, the CFTC adopted final guidance (the “Final Guidance”) concerning the regulation of cross-border swap transactions mandated by the Dodd-Frank Act. Under Section 2(i) of the Commodity Exchange Act, as amended by Dodd-Frank, the CFTC may apply the swaps provisions to activities outside the United States that have a direct and significant connection with activities in, or effect on, commerce of the United States, or that contravene CFTC regulations adopted for the purpose of preventing evasion of the swaps provisions.

The Final Guidance was accompanied by a CFTC exemptive order that provides time-limited relief to non-U.S. swap dealers and foreign branches of U.S. swap dealers from certain Dodd-Frank swaps requirements (the “Exemptive Order”). The Exemptive Order is set to terminate no later than December 21, 2013, although certain portions are scheduled to expire earlier in the year. (Please see our [earlier Alert](#) for a more detailed discussion of the Exemptive Order.) Thus, before the end of the year market participants will be subject to the Final Guidance in all respects and must consider their cross-border swap activities within the CFTC’s rule framework.

This Alert briefly discusses the U.S. person definition adopted in the Final Guidance, and then addresses how that definition will bear on determining whether and how the Dodd-Frank swaps provisions will apply to transactions and swap trading relationships. In this regard, it focuses on issues that will be important to asset managers and other buy-side market participants in their dealings with swap dealers.¹

I. Definition of U.S. Person

As explained in the Final Guidance, the CFTC will interpret the term “U.S. person” to include the following categories of persons when determining whether and how the Dodd-Frank swaps provisions will apply to a particular entity or transaction:

- (i) Any natural person who is a resident of the United States;

¹ The Final Guidance also covers major swap participants. Only two major swap participants are currently registered with the CFTC. Thus, this Alert does not separately refer to major swap participants when discussing requirements that may apply both to those entities and to swap dealers. It should also be noted that, in addition to the issues discussed in this Alert, the Final Guidance addresses matters relating to registration as a swap dealer or a major swap participant.

- (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 prong (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 prong (i), (ii), (iii), (iv), or (v), except any commodity pool, pooled account, investment fund, or other collective investment vehicle that is publicly offered only to non-U.S. persons and not offered to U.S. 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 prong (i), (ii), (iii), (iv), (v), (vi), or (vii).

This definition captures natural persons that are physically located in the United States and entities that are either incorporated or have their principal place of business in the United States. An investment vehicle may also be considered a U.S. person if it is majority-owned by one or more U.S. persons. For this purpose, the CFTC defines “majority-owned” to mean the beneficial ownership of more than 50 percent of the equity or voting interests in the investment vehicle.

The definition also includes foreign branches of U.S. swap dealers. In this regard, the Final Guidance provides that the foreign office of a U.S. bank will be considered a “foreign branch” if it is:

- (i) subject to Regulation K of the Federal Reserve Board, the FDIC International Banking Regulation, or otherwise designated as a “foreign branch” by the U.S. bank’s primary regulator;
- (ii) maintains accounts independently of the home office and of the accounts of other foreign branches with the profit or loss accrued at each branch determined as a separate item for each foreign branch; and
- (iii) subject to substantive regulation in banking or financing in the jurisdiction where it is located.

For these purposes, the Final Guidance also provides that an affiliate of a U.S. bank that is incorporated or organized as a separate legal entity would not be considered a foreign branch.

Special Considerations for Investment Vehicles

Principal Place of Business Test. Under the Final Guidance, it is possible that an investment vehicle could be considered a U.S. person if its principal place of business is in the United States, even if it is organized under the laws of a non-U.S. jurisdiction and is not majority-owned by U.S. persons. The CFTC deferred consideration of the principal place of business test under the exemptive order that expired on July 12, and the test does not apply under the U.S. person definition set forth in the Exemptive Order, which definition is scheduled to expire 75 days after publication of the Final Guidance in the Federal Register.

In general, an entity’s principal place of business refers to the place where its high level officers direct, control, and coordinate its activities. Under the Final Guidance, the principal place of business of a collective investment vehicle will generally be the place where the senior personnel who implement the trading strategy operate or where the fund’s promoters are located. The location of the promoters of an investment vehicle is not a relevant consideration, however, if they serve purely ministerial functions. The location where the investment vehicle is registered or holds board meetings also does not matter for this purpose.

The Final Guidance offers some examples of how the CFTC intends to apply this interpretation. Notably among them is the situation in which a fund would not be considered a U.S. person where U.S. personnel implement the investment objectives of the fund but do so only under the direction of senior personnel who are located outside the United States. The examples are not exhaustive, and the overall discussion of these matters in the Final Guidance will not necessarily address in a

specific way whether a given fund has a U.S. principal place of business. This assessment will be of considerable significance to funds and their swap counterparties in seeking to ascertain the extent to which Dodd-Frank swaps requirements will apply under the Final Guidance.

The Final Guidance also provides some clarity for non-U.S. institutional investors, such as pension plans, that retain the services of U.S. asset management firms. The CFTC has explained that those institutional investors will not be considered U.S. persons solely because they retain a U.S. firm to provide advisory services.

Majority Ownership Test. The Final Guidance also addresses the extent to which a fund must look through a legal entity investor for purposes of determining its status as a U.S. person. If the legal entity is controlled by the fund, or if the fund and the legal entity are under common control, the fund will have to consider the U.S. person status of the legal entity's investors for purposes of its own analysis – i.e., whether the fund is a U.S. person because it is indirectly majority-owned by U.S. persons. The Final Guidance indicates that where such a control relationship cannot be readily determined the fund may rely (absent indications to the contrary) upon a written, bona fide representation from a legal entity investor concerning its status as a U.S. person.

Guaranteed and Conduit Affiliates

The Final Guidance also provides important clarifications on the application of the U.S. person definition to entities that are organized or domiciled outside the United States but whose swap obligations are guaranteed by a U.S. person. Such entities are not considered U.S. persons simply because they are the beneficiary of a guarantee by a U.S. person. Similarly, a conduit affiliate of a U.S. person will not itself be a U.S. person solely because of that affiliation.² Whether a non-U.S. person is guaranteed by or is a conduit affiliate of a U.S. person will have implications for the application of firm-wide and transaction-specific requirements to swaps between non-U.S. swap dealers or major swap participants and non-U.S. counterparties, as more fully discussed below.

In addition, under the Final Guidance foreign entities that are majority-owned by U.S. persons who bear unlimited liability for the entity's obligations and liabilities will be considered U.S. persons. Such an entity will be considered a U.S. person even

² Whether a non-U.S. person is a conduit affiliate will depend on such factors as whether: (i) the non-U.S. person is a majority-owned affiliate of a U.S. person; (ii) the non-U.S. person is controlling, controlled by or under common control with the U.S. person; (iii) the financial results of the non-U.S. person are included in the consolidated financial statements of the U.S. person; and (iv) the non-U.S. person, in the regular course of business, engages in swaps with non-U.S. third-party(ies) for the purpose of hedging or mitigating risks faced by, or to take positions on behalf of, its U.S. affiliate(s), and enters into offsetting swaps or other arrangements with its U.S. affiliate(s) in order to transfer the risks and benefits of such swaps with third-party(ies) to its U.S. affiliates. The term does not include affiliates of swap dealers.

if only some of the U.S. majority owners bear unlimited liability and even where unlimited liability exists only with respect to some of the entity's obligations.

II. Application of the Dodd-Frank Swaps Requirements to Non-U.S. Swap Dealers and Foreign Branches of U.S. Swap Dealers

The Final Guidance distinguishes between Entity Level Requirements, which apply firm-wide to swap dealers and major swap participants, and Transaction Level Requirements, which apply at the level of individual trades. As further discussed below, the Entity Level Requirements and Transaction Level Requirements are applied differently, in certain circumstances, depending on whether the counterparty is a U.S. person. The CFTC may also permit substituted compliance with comparable and comprehensive foreign regulatory requirements in the case of transactions and relationships involving non-U.S. persons and foreign branches of U.S. swap dealers.

Application of the Entity Level Requirements

The Final Guidance divides the Entity Level Requirements into the following two categories:

Entity Level Requirements – First Category:

- Capital adequacy
- Appointment of chief compliance officer
- Risk management procedures
- Swap data recordkeeping (excluding requirements as to complaints and sales material)

Entity Level Requirements – Second Category:

- Swap data repository reporting (SDR reporting)
- Swap data recordkeeping as to complaints and sales material
- Large trader reporting

U.S. swap dealers, along with U.S. subsidiaries and affiliates of non-U.S. swap dealers, must comply with all of the Entity Level Requirements. Non-U.S. swap dealers may be able to substitute compliance with local requirements for compliance with the Entity Level Requirements, except with respect to large trader reporting.³ Whether substituted compliance is available for an Entity Level Requirement in the Second Category (other than large trader reporting) will depend on whether the counterparty is a U.S. person or a non-U.S. person.

³ Non-U.S. persons must comply with the large trader reporting requirement in the same manner that U.S. persons comply.

ENTITY LEVEL REQUIREMENTS - FIRST CATEGORY

U.S. Swap Dealer (Including Foreign Branches)	Apply
Non-U.S. Swap Dealer (including a non-U.S. affiliate of a U.S. Person whether guaranteed by or a conduit affiliate of the U.S. Person)	Substituted Compliance may be available*

*The CFTC may provide relief that would permit guaranteed affiliates in a corporate group under common control that do not enter into swaps with U.S. persons to comply with these requirements on a consolidated or group basis.

ENTITY LEVEL REQUIREMENTS - SECOND CATEGORY (EXCLUDES LARGE TRADER REPORTING)

	U.S. Person	Non-U.S. Person guaranteed by or a conduit affiliate of a U.S. Person	Non-U.S. Person <u>not</u> guaranteed by or a conduit affiliate of a U.S. Person
U.S. Swap Dealer (including Foreign Branches)	Apply	Apply	Apply
Non-U.S. Swap Dealer (including a non-U.S. affiliate of a U.S. person whether guaranteed by or a conduit affiliate of the U.S. Person)	Apply	Apply (Except that Substituted Compliance may be available for swap data recordkeeping)	Substituted Compliance may be available

Application of the Transaction Level Requirements

For purposes of the Final Guidance, the Transaction Level Requirements are categorized as follows:

Transaction Level Requirements - Category A

- Clearing and swap processing
- Margining and segregation for uncleared swaps
- Trade execution
- Swap trading relationship documentation
- Portfolio reconciliation and compression
- Real-time public reporting
- Trade confirmation
- Daily trading records

Transaction Level Requirements - Category B

- External business conduct standards

Similar to the Entity Level Requirements, U.S. swap dealers must comply in full with all Transaction Level Requirements regardless of whether the other counterparty is a U.S. person or a non-U.S. person and without substituted compliance available. However, as shown in the charts below, application of the Transaction Level Requirements to non-U.S. swap dealers depends on the status of the counterparty to the swap, and substituted compliance may be available for Category A Transaction Level Requirements in certain circumstances. Where a swap is with a foreign branch of a U.S. swap dealer, that foreign branch may also be able to substitute compliance with local requirements for compliance with Category A Transaction Level Requirements, if the counterparty is a non-U.S. person or a foreign branch of another U.S. swap dealer.

A swap is generally considered to be “with a foreign branch” and not the U.S. swap dealer itself for purposes of the Transaction Level Requirements if all of the following factors are present:

- (i) 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 the foreign branch or in another foreign branch;
- (ii) the foreign branch or another foreign branch is the office through which the U.S. 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 U.S. bank is that foreign branch;
- (iii) the swap is entered into by the foreign branch in its normal course of business;
- (iv) the swap is treated as a swap of the foreign branch for tax purposes; and
- (v) the swap is reflected in the local accounts of the foreign branch.

If a swap is executed anonymously between a non-U.S. swap dealer and a U.S. person (other than a foreign branch of a U.S. swap dealer) on a registered designated contract market, swap execution facility or foreign board of trade and cleared, the non-U.S. swap dealer will be deemed to have complied with the Category A Transaction-Level Requirements. Nonetheless, the non-U.S. swap dealer must still comply with certain daily trading record requirements applicable before the execution of the swaps.

CATEGORY A TRANSACTION LEVEL REQUIREMENTS

	U.S. Person (other than a Foreign Branch of a U.S. Swap Dealer)	Foreign Branch of a U.S. Swap Dealer	Non-U.S. Person guaranteed by or a conduit affiliate of U.S. Person	Non-U.S. Person not guaranteed by or a conduit affiliate of a U.S. Person
U.S. Swap Dealer	Apply	Apply	Apply	Apply
Foreign Branch of a U.S. Swap Dealer	Apply	Substituted Compliance may be available	Substituted Compliance may be available	Substituted Compliance may be available*
Non-U.S. Swap Dealer (including a non-U.S. affiliate of a U.S. Person whether guaranteed by or a conduit affiliate of the U.S. Person)	Apply	Substituted Compliance may be available	Substituted Compliance may be available	Do Not Apply

* Applies generally where a swap between a branch and its counterparty is located in Australia, Canada, the European Union, Hong Kong, Japan, or Switzerland, pending applicable determination of substituted compliance. In any other foreign jurisdiction, counterparties may substitute compliance with the requirements of the foreign jurisdiction where the foreign branch is located, provided the aggregate notional value of the swaps of the U.S. swap dealer's branches in the foreign jurisdiction does not exceed five percent of the aggregate notional value of all the swaps of the U.S. swap dealer (calculated in U.S. dollars on a quarterly basis) and certain recordkeeping requirements are met.

CATEGORY B TRANSACTION LEVEL REQUIREMENTS

	U.S. Person (other than a Foreign Branch of a U.S. Swap Dealer)	Foreign Branch of a U.S. Swap Dealer	Non-U.S. Person guaranteed by or a conduit affiliate of U.S. Person	Non-U.S. Person <u>not</u> guaranteed by or a conduit affiliate of a U.S. Person
U.S. Swap Dealer	Apply	Apply	Apply	Apply
U.S. Swap Dealer (swaps solicited and negotiated through foreign subsidiary or affiliate)	Apply	Do Not Apply	Do Not Apply	Do Not Apply
Foreign Branch of a U.S. Swap Dealer	Apply	Do Not Apply	Do Not Apply	Do Not Apply
Non-U.S. Swap Dealer (including a non-U.S. affiliate of a U.S. Person whether guaranteed by or a conduit affiliate of the U.S. Person)	Apply	Do Not Apply	Do Not Apply	Do Not Apply

III. Application of the Dodd-Frank Swaps Requirements to Non-Swap Dealers and Non-Major Swap Participants

Swap transactions between persons other than registered swap dealers or major swap participants will be subject to clearing, trade execution, real-time reporting, large trader reporting, swap data repository reporting, and swap data recordkeeping. Where one (or both) of these counterparties to a swap is a U.S. person (including a U.S. affiliate of a non-U.S. person), the parties must comply with these swaps requirements as they apply to the transaction in question.

These requirements will not apply where both non-registrant counterparties are also non-U.S. persons, unless each party is guaranteed by or a conduit affiliate of a U.S. person. Substituted compliance may be available in that circumstance, however. The Final Guidance does not affect the requirement for a person relying on the inter-affiliate exemption from mandatory clearing to comply with the conditions of that exemption.⁴

⁴ See 17 C.F.R. § 50.52.

IV. Substituted Compliance

Under the Final Guidance, the CFTC will permit “substituted compliance” for swaps requirements applicable under non-U.S. law in lieu of the corresponding requirement under the Commodity Exchange Act and the CFTC’s regulations. In order to permit substituted compliance, the CFTC first must determine that a non-U.S. jurisdiction’s requirement is comparable to and as comprehensive as the corresponding U.S. requirement. In doing so, the CFTC will focus on whether non-U.S. laws and regulations achieve the same outcomes as U.S. laws and regulations. Rather than making a determination with respect to the regulatory regime of a non-U.S. jurisdiction as a whole, the CFTC will make a comparability determination as to each of the Entity Level and Transaction Level Requirements (each a “Substituted Compliance Determination”).

Any eligible person may make a request for a Substituted Compliance Determination, either individually or as a group, as may foreign regulators. The CFTC has yet to make any Substituted Compliance Determination with respect to the laws and regulations of any non-U.S. jurisdiction. The CFTC has received, or expects to receive, requests for Substituted Compliance Determinations for swap transactions from persons in the six non-U.S. jurisdictions – Australia, Canada, the European Union, Hong Kong, Japan, and Switzerland – in which persons have registered with the CFTC as swap dealers. Once a Substituted Compliance Determination is made for a jurisdiction, it will apply to all affected entities in that jurisdiction. A Substituted Compliance Determination will be reevaluated every four years and reissued as necessary to account for any changes in the CFTC’s original findings.

As noted in our earlier Alert, the CFTC and the European Commission recently announced that they had reached a common understanding on coordinating implementation of their respective swaps requirements.⁵ In addition, the CFTC staff has issued four no-action letters that provide relief to EU-based derivatives clearing organizations and swap dealers from certain requirements and that permit direct access by U.S. customers to foreign boards of trade that list swaps for trading.⁶

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Please feel free to reach out to your regular contacts at the Firm if you have any questions about the matters addressed in this Alert. In addition, you are welcome to contact the members of the Derivatives/CFTC, Investment Management, and Broker-Dealer Groups set forth above.

⁵ See

http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/jointdiscussionscftc_europeanu.pdf.

⁶ See CFTC Letter Nos. 13-43, 13-44, 13-45, and 13-46 (July 11, 2013).