

CFTC Addresses Cross-Border Application of Dodd-Frank Swaps Requirements

On July 12, the CFTC held an open meeting to consider final interpretive guidance regarding compliance with its swap regulations (the “Final Guidance”) and a related exemptive order (the “Exemptive Order”).¹ These pronouncements are the latest development in the continuing debate about the reach of the CFTC’s swaps requirements outside the United States. Before July 12, market participants were operating under interim guidance that provided a somewhat narrower definition of U.S. person and granted temporary relief from certain requirements to non-U.S. registered swap dealers and foreign branches of U.S.-based swap dealers. During that time, market participants were left to evaluate how to move forward under earlier proposed guidance that, when adopted, would replace the interim relief.

As explained in this alert, the Exemptive Order provides limited relief to non-U.S. swap dealers and foreign branches of U.S. swap dealers; that relief will expire in stages over the next several months before ultimately terminating on December 21, 2013. The Final Guidance will also begin to take effect as certain aspects of the Exemptive Order expire and as the CFTC begins to determine that “substituted compliance” with applicable non-U.S. swap requirements is permissible. It will be critical for asset managers and other end-users of swaps to understand where they and their trading relationships fit under this framework, so that they can conform their activities to applicable CFTC requirements within the established timeframes.

This alert briefly recaps the CFTC’s earlier proposed guidance and interim relief. It then focuses on the Exemptive Order and the Final Guidance, with a particular emphasis on how the Exemptive Order will affect swap trading relationships over the coming months.²

Background

Section 2(i) of the Commodity Exchange Act. The CFTC’s cross-border efforts are intended to put in place the regulatory framework required by Section 2(i) of the Commodity Exchange Act, which Congress added to the statute when it enacted Dodd-

¹ The CFTC had not made available the Final Guidance by the time this alert was completed. The discussion of the Final Guidance is therefore based on the related CFTC fact sheet, earlier CFTC pronouncements, and discussion of the Final Guidance that occurred during the CFTC’s open meeting on July 12.

² The Exemptive Order and Final Guidance also apply to major swap participants (“MSPs”). 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 or relief that may apply both to those entities and to swap dealers.

Frank. Section 2(i) provides that the swap provisions of the Commodity Exchange Act will not apply to activities outside the United States unless those activities either:

- Have a direct and significant connection with activities in, or effect on, commerce of the United States; or
- Contravene rules adopted by the CFTC for the purpose of preventing evasion of the swaps provisions.

The July 2012 Proposal. In July 2012, the CFTC proposed guidance on the cross-border application of its swaps rules.³ The guidance generally analyzed this issue by dividing those rules into two types – Entity Level Requirements, which apply to swap dealers and major swap participants, and Transaction Level Requirements, which apply at the level of individual trades.

The Entity Level Requirements are:

- Capital adequacy
- Appointment of chief compliance officer
- Risk management procedures
- Swap data recordkeeping
- Swap data repository reporting
- Large trader reporting

The Transaction Level Requirements are:

- 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
 - External business conduct standards
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- Category A
- Category B

How these requirements would apply to a particular transaction would depend on whether the parties to such transactions would be U.S. persons. The proposed guidance defined the term U.S. person as follows, although as indicated in bold below, the CFTC amended the proposed definition somewhat in December 2012:⁴

³ 77 Fed. Reg. 41214 (July 12, 2012).

⁴ 78 Fed. Reg. 909 (Jan. 7, 2013). The CFTC issued the proposal on December 21, 2012, but it was not officially published until the following month.

- (i) Any natural person who is a resident of the United States;
- (ii) **A 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, in each case that is either (A) 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 or (B) directly or indirectly majority-owned by one or more persons described in prong (i) or (ii)(A) and in which such person(s) bears unlimited responsibility for the obligations and liabilities of the legal entity (other than a limited liability company or limited liability partnership where partners have limited liability);**
- (iii) Any individual account (discretionary or not) where the beneficial owner is a U.S. person;
- (iv) **A commodity pool, pooled account, investment fund, or other collective investment vehicle that is not described in prong (ii) and that is directly or indirectly majority-owned by one or more persons described in prong (i) or (ii), except any commodity pool, pooled account, investment fund, or other collective investment vehicle that is publicly-traded but not offered, directly or indirectly, to U.S. persons; (Note that, for this purpose, the CFTC indicated that “majority-owned” would mean beneficial ownership of 50 percent or more of the equity or voting interests in a collective investment vehicle.)**
- (v) Any commodity pool, pooled account, or collective investment vehicle the operator of which would be required to register as a commodity pool operator under the Commodity Exchange Act;
- (vi) A pension plan for the employees, officers, or principals of a legal entity with its principal place of business inside the United States; or
- (vii) An estate or trust, the income of which is subject to U.S. income tax regardless of source.

The December 2012 Order. In December 2012, the CFTC adopted a final order that addressed how Entity Level Requirements and Transaction Level Requirements would apply to swap dealers located outside the United States and to foreign branches of U.S. swap dealers.⁵ For this purpose, the CFTC set forth a narrower definition of U.S. person that included, for instance, a U.S. resident individual, any entity that is organized or incorporated in the United States, and any entity other than a fund or collective

⁵ 78 Fed. Reg. 858 (Jan. 7, 2013). The CFTC issued the order on December 21, 2012, but it was not officially published until the following month.

investment vehicle that has its principal place of business in the United States. The final order expired on July 12, 2013 and, as explained below, has been replaced by the Exemptive Order.

Summary of Final Guidance

Definition of U.S. Person

The definition of U.S. person to be set forth in the Final Guidance will be territorial-based and will encompass, for instance:

- Natural persons that are U.S. residents;
- Corporations, other business entities, and funds that either are organized in the United States or have their principal place of business in the United States; and
- Any commodity pool, pooled account, investment fund, or other collective investment vehicle that is either (i) organized in the United States, (ii) directly or indirectly majority-owned by U.S. persons, or (iii) has its principal place of business in the United States. *(For a collective investment vehicle the analysis relating to its principal place of business is principally focused on the location of the investment manager, fund sponsor/promoter, and the sales and trading desk used by the fund.)*

The CFTC has indicated that the definition of U.S. person will not include a non-U.S. affiliate of a U.S. person that is guaranteed by that U.S. person. In addition, a commodity pool, pooled account, investment fund, or other collective investment vehicle will not be considered a U.S. person if it is publicly-traded but not offered, directly or indirectly, to U.S. persons.⁶

Application of Transaction Level Requirements to trades with non-U.S. swap dealers and the foreign branches and affiliates of U.S.-based swap dealers

The Final Guidance will classify Transaction Level Requirements into the two categories noted above. Application of the Transaction Level Requirements and eligibility for substituted compliance (discussed below) will depend on the jurisdiction and status of the parties to a particular swap.

Application of the Entity Level Requirements

Unlike Transaction Level Requirements, the CFTC's Entity Level Requirements will apply to all non-U.S. swap dealers and foreign branches and affiliates of U.S. swap dealers. Substituted compliance may be available to non-U.S. swap dealers and certain foreign affiliates of U.S. swap dealers, at least as to certain Entity Level Requirements.

⁶ The Final Guidance provides further details on the U.S. person definition.

The Final Guidance further divides Entity Level Requirements into 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
- Swap data recordkeeping as to complaints and sales material
- Large trader reporting

Substituted Compliance and Agreed “Path Forward” with the European Commission

The CFTC has indicated that it will permit “substituted compliance” for swap requirements applicable under non-U.S. law in lieu of the corresponding requirement under the Commodity Exchange Act and CFTC’s rules. 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.

The CFTC is expected to make comparability determinations, and thus permit substituted compliance, for Entity Level Requirements and Transaction Level Requirements (a “Substituted Compliance Determination”). The CFTC has yet to make any Substituted Compliance Determination with respect to the laws and regulations of any non-U.S. jurisdiction.

On July 11, 2013, the CFTC and the European Commission announced that they had reached a common understanding on coordinating implementation of their respective swaps requirements.⁷ The CFTC also issued four no-action letters on July 11 granting relief to EU-based derivatives clearing organizations and swap dealers from certain requirements and permitting direct access by U.S. customers to foreign boards of trade that list swaps for trading.⁸

⁷ The release addressing these matters is available at: http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/jointdiscussionscftc_europeanu.pdf.

⁸ See CFTC Letter Nos. 13-43, 13-44, 13-45, and 13-46 (July 11, 2013).

Application of Swap Rules to Persons other than Swap Dealers and 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 swap 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 both parties are guaranteed by or a conduit affiliate of a U.S. person. Substituted compliance may be available in certain circumstances, however.

Summary of the Exemptive Order

The Exemptive Order extends certain conditional relief that the CFTC afforded to non-U.S. swap dealers and to foreign branches of U.S. swap dealers in its December 2012 order. The Exemptive Order applies to swap dealers in Australia, Canada, the European Union, Hong Kong, Japan and Switzerland (the “Six Enumerated Jurisdictions”) and to foreign branches of U.S. swap dealers located in those same Jurisdictions. The relief is applicable only to dealers and branches in the Six Enumerated Jurisdictions because, as of July 12, 2013, those are the only non-U.S. jurisdictions in which a person has registered with the CFTC as a swap dealer.⁹

The Exemptive Order will terminate no later than December 21, 2013. As explained below, however, portions of this relief will begin to expire earlier in the year:

- **Interim Definition of U.S. Person – Expires 75 days after Final Guidance is Officially Published.**
 - Firms must begin applying Entity Level Requirements and Transaction Level Requirements in accordance with the U.S. person definition contained in the Final Guidance and any Substituted Compliance Determination applicable to such a Requirement. The 75-day period is estimated to expire in early October 2013.
 - The U.S. person definition is set out in Annex A to this alert.

⁹ The CFTC has indicated that it may defer compliance with Entity Level Requirements and Transaction Level Requirements as to another non-U.S. jurisdiction if a person in that jurisdiction files an application for registration with the CFTC before December 21, 2013 and accompanies its application with a request for a Substituted Compliance Determination.

- **Swaps with Guaranteed Affiliates and Conduit Affiliates – Transaction-Level Requirements – Expires 75 days after Final Guidance is Officially Published.**
 - For purposes of the Exemptive Order, the term “guaranteed affiliate” refers to a non U.S. person that is affiliated with a U.S. person and guaranteed by a U.S. person. A “guarantee” would include not only traditional guarantees of payment or performance of the related swaps, but also other formal arrangements that, in view of all the facts and circumstances, support the non-U.S. person’s ability to pay or perform its swap obligations with respect to its swaps.
 - A “conduit affiliate” is an entity that functions as a vehicle for U.S. persons to conduct swaps transactions with others – i.e., an entity majority-owned by a U.S. person, the financial results of which are included in the consolidated financial statements of the U.S. person, and that regularly engages in swaps with non-U.S. third parties and offsetting swaps with its U.S. affiliates.
- **Non-U.S. Swap Dealers – Entity Level Requirements – Earlier of December 21, 2013 or 30 days following a Substituted Compliance Determination.**
 - Until this date, a non-U.S. swap dealer established in one of the Six Enumerated Jurisdictions need not comply with relevant Entity Level Requirements as to which Substituted Compliance is possible under the Final Guidance.¹⁰
 - Non-U.S. swap dealers in the Six Enumerated Jurisdictions that are not part of an affiliated group in which the ultimate parent entity is a U.S. swap dealer, U.S. major swap participant, U.S. bank, or U.S. bank holding or financial holding company may delay compliance with the CFTC’s swap data reporting requirements with respect to swaps with non-U.S. counterparties, provided that they comply with local reporting and recordkeeping requirements. If no such requirements have been implemented, then those swap dealers must comply with CFTC recordkeeping requirements enumerated in the Exemptive Order.
 - Large trader reporting requirements under Part 20 of the CFTC’s regulations are not considered part of the Entity Level Requirements for purposes of the Exemptive Order.

¹⁰ For this purpose, the CFTC does not include its proposed requirements on capital adequacy or margin and segregation for uncleared swaps. If the CFTC adopts final regulations before December 21, 2013, the non-U.S. swap dealers would comply with such requirements in accordance with any compliance date provided in the relevant rulemaking.

- **Non-U.S. Swap Dealers – Transaction Level Requirements Generally – Earlier of December 21, 2013 or 30 days following a Substituted Compliance Determination.**
 - Until this date, a non-U.S. swap dealer established in one of the Six Enumerated Jurisdictions may comply with any law and regulations of the jurisdiction in which it is established (to the extent that requirement applies) instead of complying with any Transaction Level Requirement for which substituted compliance would be possible under the Final Guidance.
 - This relief applies to “Category A” Transaction Level Requirements only. The CFTC has noted that “Category B” Transaction Level Requirements do not apply under the Final Guidance unless the swap counterparty is a U.S. person other than a foreign branch of a bank that that is U.S. swap dealer (or a U.S. major swap participant).
- **Non-U.S. Swap Dealers – Swaps Subject to Clearing Determination – Clearing Required 75 days after Final Guidance is Officially Published.¹¹**
 - The clearing requirement will apply if a swap dealer would have been required to comply with the clearing determination but for the December 2012 order.
 - To date, the CFTC has issued mandatory clearing requirements for major classes of interest rate swaps and index credit default swaps. (Please see our [earlier alert](#) for a list of those classes.) The compliance date for swap dealers under that clearing determination was March 11, 2013.
- **Non-U.S. Swap Dealers in the Six Enumerated Jurisdictions – Swaps with Guaranteed Affiliates of U.S. Persons – Real-Time Reporting – September 30, 2013.¹²**
 - Until this date, a swap dealer established in one of the Six Enumerated Jurisdictions may comply with any real-time swap reporting related requirement under the laws and regulations of the jurisdiction in which it is established, to the extent that requirement applies.

¹¹ The Exemptive Order also includes an exception to the trade execution requirement – i.e., that swaps determined to be made “available to trade” on an organized facility be traded on the facility rather than bilaterally. However, the Exemptive Order notes that no swaps are subject to this requirement yet.

¹² As used in the Exemptive Order, the term “guaranteed affiliate” refers to a non-U.S. person that is affiliated with a U.S. person and guaranteed by a U.S. person.

- **Non-U.S. Swap Dealers not in the Six Enumerated Jurisdictions – Swaps with Guaranteed Affiliates of U.S. Persons – Transaction Level Requirements – Expires 75 days after Final Guidance is Officially Published.**
 - For swaps with guaranteed affiliates of U.S. Persons, a non-U.S. swap dealer not established in one of the Six Enumerated Jurisdictions may comply with any law and regulations of the jurisdiction in which it is established (to the extent that requirement applies) instead of complying with any Transaction Level Requirement for which substituted compliance would be possible under the Final Guidance.
- **Foreign Branches of U.S. Swap Dealers in the Six Enumerated Jurisdictions – Transaction Level Requirements – Same Timeframes as Applicable to Non-U.S. Swap Dealers in the Six Enumerated Jurisdictions.**
 - Relief from Transaction Level Requirements is available to foreign branches located in the Six Enumerated Jurisdictions to the extent that substituted compliance would be available under the Final Guidance.
 - The limitation on the relief with respect to clearing, and the application of real-time reporting for swaps with guaranteed affiliates of U.S. persons, also apply to the relief for foreign branches.¹³
 - The Exemptive Order does not provide relief from Entity Level Requirements applicable to U.S. swap dealers with foreign branches.
- **Foreign Branches of U.S. Swap Dealers not located in the Six Enumerated Jurisdictions – Transaction Level Requirements – Expires 75 days after Final Guidance is Officially Published.**
 - A foreign branch of a U.S. swap dealer not located in one of the Six Enumerated Jurisdictions may comply with any law and regulations of the jurisdiction in which it is located (to the extent that requirement applies) instead of complying with any Transaction Level Requirement for which substituted compliance would be possible under the Final Guidance.
- **Swaps between Guaranteed Affiliates of U.S. Persons – Transaction Level Requirements – Expires 75 days after Final Guidance is Officially Published.**
 - Non-U.S. guaranteed affiliates of U.S. persons that are not swap dealers may comply with any law and regulations of the jurisdiction in which

¹³ The Exemptive Order includes the same exception to the trade execution requirement for foreign branches as it does for non-U.S. swap dealers.

they are established (to the extent that requirement applies) instead of complying with any Transaction Level Requirement for which substituted compliance would be possible under the Final Guidance.

The Exemptive Order specifies that it does not affect the requirement of a person relying on the inter-affiliate exemption from mandatory clearing to comply with the conditions of that exemption.¹⁴ The Exemptive Order also provides relief to a non-U.S. person with respect to determining whether it is required to register with the CFTC as a swap dealer or a major swap participant.

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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, Investment Management, and Broker-Dealer Groups set forth above.

¹⁴ See 17 C.F.R. § 50.52.

Annex A: U.S. Person as Defined in the Exemptive Order

From July 13, 2013 until 75 days after the Final Guidance is officially published in the *Federal Register*, all market participants, including a prospective or registered swap dealer or major swap participant, must apply for purposes of the Exemptive Order the term “U.S. person” as:

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

(ii) A 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, in each case that is –

(A) organized or incorporated under the laws of a state or other jurisdiction in the United States, or

(B) for all such entities other than funds or collective investment vehicles, having its principal place of business in the United States;

(iii) A pension plan for the employees, officers or principals of a legal entity described in (ii) above, unless the pension plan is primarily for foreign employees of such entity;

(iv) An estate of a decedent who was a resident of the United States at the time of death, or a 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;

or

(v) An 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 (i) through (iv) above.