

CFTC Proposes Guidance on the Cross-Border Impact of Dodd-Frank's Swap Regulations

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For nearly two years, swap market participants have wanted to know how the Commodity Futures Trading Commission (CFTC) would interpret the extraterritorial reach of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). The CFTC recently provided a partial answer to this question, through Proposed Guidance on the cross-border application of some Dodd-Frank swap provisions and a Proposed Order that would delay some Dodd-Frank regulation of swap dealers (SDs) and major swap participants.¹ The CFTC's actions leave many questions unanswered, however, even as compliance with many core Dodd-Frank swap rules is ostensibly set to begin this fall.² Given that short time frame, we wanted to provide our clients and friends with the key points from the Proposed Guidance and Proposed Order. Note that the CFTC has asked for public comments on the Proposed Guidance by August 27, 2012, and on the Proposed Order by August 13, 2012.

Proposed Cross-Border Application of Swap Rules

Congress provided that Dodd-Frank “shall not apply to activities outside the United States unless those activities — (1) have a direct and significant connection with activities in, or effect on, commerce of the United States.”³ The CFTC interprets this language very broadly, guided by what one commissioner calls the “‘Intergalactic Commerce Clause’ of the United States Constitution.”⁴

The foundation of the CFTC's Proposed Guidance is its definition of a U.S. person to include, among other things, a foreign business guaranteed by a direct or indirect U.S. owner and a commodity pool whose operator is required to register as a commodity pool operator. This broad definition appears to be narrowed by contradictory language in the Proposed Guidance, leaving market participants to sort through considerable confusion and ambiguity. As a result, more market participants may believe it would be prudent to register as SDs, and more swap transactions, potentially including transactions that occur wholly outside the United States, may be ensnared by Dodd-Frank regulation.

The Proposed Guidance also describes how and when the CFTC's swap rules would apply to foreign persons registered as SDs. The proposal would divide swap rules into two categories — entity-level and transaction-level.

Entity-level requirements relate to the management of risks to the SD as a whole. These requirements would apply to all registered SDs, but the CFTC would allow foreign SDs to satisfy some entity-level requirements through “substituted compliance” — compli-

¹ Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, *77 Fed. Reg. 41214* (July 12, 2012) (“Proposed Guidance”); and Exemptive Order Regarding Compliance with Certain Swap Regulations, *77 Fed. Reg. 41110* (July 12, 2012) (“Proposed Order”). We refer only to SDs for the remainder of this client alert.

² A timeline of estimated compliance dates is available here: <http://www.skadden.com/insights/cftc-sec-final-swap-rules-start-regulatory-compliance-countdown>.

³ Dodd-Frank Act § 722(d). The statute also includes an anti-abuse provision that would make the Dodd-Frank Act applicable to activities designed to evade the CFTC's swaps rules. *Id.*

⁴ See Statement of Commissioner Jill Sommers, *77 Fed. Reg.* at 41239.

ance with comparable home-country law. Exhibit A shows when SDs would be required to comply with the entity-level requirements.

Transaction-level requirements, by contrast, would apply on a transaction-by-transaction basis. Under the Proposed Guidance, an SD generally would need to comply with these requirements only for swaps with another SD, a U.S. counterparty or a foreign counterparty guaranteed by a U.S. entity. Exhibit B shows which transactions would be subject to the transaction-level requirements.

Proposed Order

In conjunction with the Proposed Guidance, the CFTC proposed a limited exemptive order that would delay compliance with some CFTC rules for SDs.

- U.S. SDs would not have to comply with entity-level requirements (except for certain reporting and recordkeeping requirements) until January 1, 2013.
- Foreign SDs would not have to comply with entity-level requirements (except for SDR reporting and large trader reporting) until July 2013.
- Foreign SDs and foreign branches of U.S. SDs would not have to comply with transaction-level requirements for swaps with a non-U.S. counterparty, provided the SD (or branch) complies with transaction-level requirements in the dealer's home jurisdiction.
- There would be no exemptive relief from transaction-level requirements for swaps with a U.S. counterparty.

(continued on the next page)

Exhibit A**Applicability of Entity-Level Requirements**

Entity-level requirements relate to the management of risks to an SD as a whole. These requirements will apply to SDs on a firm-wide basis. The chart below shows when an SD must comply with the CFTC's entity-level requirements and when an SD can meet its obligations through substituted compliance (complying with home-country regulation).

<p>Entity-level requirements are:</p> <ul style="list-style-type: none"> - capital - chief compliance officer - risk management - swap data recordkeeping - SDR reporting - large trader reporting 	<table border="1"> <thead> <tr> <th data-bbox="691 491 1068 579">Type of SD</th> <th data-bbox="1068 491 1442 579">Entity-level requirements apply?</th> </tr> </thead> <tbody> <tr> <td data-bbox="691 579 1068 632">U.S.-Based SD</td> <td data-bbox="1068 579 1442 632">Yes</td> </tr> <tr> <td data-bbox="691 632 1068 709">Foreign Branches/Agencies of U.S.-Based SD</td> <td data-bbox="1068 632 1442 709">Yes (to the U.S.-Based SD)</td> </tr> <tr> <td data-bbox="691 709 1068 825">Foreign Affiliates of U.S. Persons (Swaps Booked in the U.S.)</td> <td data-bbox="1068 709 1442 825">Yes⁵</td> </tr> <tr> <td data-bbox="691 825 1068 1041">Non-U.S.-Based SDs and Foreign Affiliates of U.S. Persons (Swaps Not Booked in U.S. or Guaranteed by a U.S. Person⁶)</td> <td data-bbox="1068 825 1442 1041">Substituted Compliance Is Permitted</td> </tr> </tbody> </table>	Type of SD	Entity-level requirements apply?	U.S.-Based SD	Yes	Foreign Branches/Agencies of U.S.-Based SD	Yes (to the U.S.-Based SD)	Foreign Affiliates of U.S. Persons (Swaps Booked in the U.S.)	Yes ⁵	Non-U.S.-Based SDs and Foreign Affiliates of U.S. Persons (Swaps Not Booked in U.S. or Guaranteed by a U.S. Person ⁶)	Substituted Compliance Is Permitted
Type of SD	Entity-level requirements apply?										
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Foreign Affiliates of U.S. Persons (Swaps Booked in the U.S.)	Yes ⁵										
Non-U.S.-Based SDs and Foreign Affiliates of U.S. Persons (Swaps Not Booked in U.S. or Guaranteed by a U.S. Person ⁶)	Substituted Compliance Is Permitted										

⁵ If the swaps are booked in a U.S. person, the U.S. person must comply with all of the SD duties and obligations related to the swaps.

⁶ For swaps involving foreign affiliates, if the affiliate is the legal counterparty to the swap, but the swap is guaranteed by a U.S. person, substituted compliance will be permitted with respect to SDR reporting only if the CFTC has direct access to the swap data.

Exhibit B**Applicability of Transaction-Level Requirements**

Unlike entity-level requirements, transaction-level requirements apply on a transaction-by-transaction basis, depending on whether counterparty to the SD is a U.S. person or guaranteed by a U.S. person. The chart below shows the circumstances in which transaction-level requirements will apply to swaps.

<p>The proposed guidance divides transaction-level requirements into two categories:</p> <p><u>Risk mitigation and transparency:</u></p> <ul style="list-style-type: none"> - clearing and swap processing - margin (and segregation) for uncleared swaps - trade execution mandate - swap trading relationship documentation - portfolio reconciliation and compression - real-time public reporting - trade confirmation - daily trading records <p><u>Sales practices:</u></p> <ul style="list-style-type: none"> - external business conduct standards 	U.S. Person	Non-U.S. Person Guaranteed by a U.S. Person⁷	Non-U.S. Person Not Guaranteed by a U.S. Person	
	U.S.-Based SD	Apply	Apply	Apply
	Foreign Affiliate of a U.S.-Person, Swaps Booked in the U.S.	Apply	Apply (Except Business Conduct Standards)	Apply (Except Business Conduct Standards)
	Foreign Branches/ Agencies of U.S.-Based SD	Apply	Substituted Compliance (Business Conduct Standards Do Not Apply)	Substituted Compliance (Business Conduct Standards Do Not Apply)
	Non-U.S.-Based SDs and Foreign Affiliates of U.S. Persons (Swaps not Booked in the U.S.)	Apply	Substituted Compliance (Business Conduct Standards Do Not Apply)	Do Not Apply

⁷ The CFTC states that transaction-level requirements would apply to swaps in which: i) a non-U.S. counterparty is majority-owned, directly or indirectly, by a U.S. person; ii) the non-U.S. counterparty regularly enters into swaps with one or more U.S. affiliates or subsidiaries of the U.S. person; and iii) the financials of such non-U.S. counterparty are included in the consolidated financial statements of the U.S. person.