

# Client Alert

## Capital Markets/Derivatives

July 2012

### CFTC Publishes Proposed Interpretative Guidance With Respect to the Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act

On June 28, 2012, the Commodity Futures Trading Commission (the "CFTC") proposed interpretative guidance<sup>1</sup> (the "Interpretive Guidance") regarding the cross-border application of certain swap provisions of the Commodity Exchange Act (the "CEA") and requested comments in relation to the Interpretive Guidance. The comment period is open for 45 days following publication of the Interpretive Guidance in the Federal Register<sup>2</sup>.

Section 722(d) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") amends Section 2 of the CEA by inserting new paragraph (i) entitled "Applicability" which consists of two subsections. Section 2(i) provides that the provisions added to the CEA by Title VII of the Dodd-Frank Act 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; or (2) contravene such rules or regulations as the CFTC may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of the CEA that was enacted by the Dodd-Frank Act. Section 2(i) therefore gives the CFTC express authority over activities outside the United States that have a direct and significant connection with activities in, or effect on, commerce of the United States.

The Interpretive Guidance addresses (i) the nature of the connections to the United States that would require a non-US person to register as a swap dealer ("SD") or major swap participant ("MSP"); (ii) which Dodd-Frank Act requirements apply to the swap activities of non-US persons, US persons and their branches, agencies, subsidiaries and affiliates outside the United States; and (iii) to the extent that Title VII of the Dodd-Frank Act requirements apply, the circumstances under which the CFTC will consider permitting a non-US person to comply with the regulatory regime of its home jurisdiction instead of complying with the requirements under the Dodd-Frank Act.

We note that there are a number of inconsistencies and conflicts within the interpretative guidance, both with respect to published rules and other sections of the Interpretive Guidance itself. We have highlighted only a few of these inconsistencies in relation to various sections of this memorandum to the extent that we thought it beneficial with respect to the discussion. Given the inconsistencies, this memorandum is a summary of our best understanding of the Interpretive Guidance to date.



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<sup>1</sup> 77 FR 41213 July 12, 2012

<sup>2</sup> The proposed interpretive guidance was published in the Federal Register on July 12, 2012

### Definition of US Person

The CFTC proposes to interpret the term "US person" by reference to the extent to which swap activities or transactions involving one or more such persons have the relevant effect on US commerce.

As proposed, the term "US person" would include, but not be limited to:

- i. Any natural person who is a resident of the United States.
- ii. 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, in each case that is either (A) organized or incorporated under the laws of the United States or having its principal place of business in the United States or (B) in which the direct or indirect owners thereof are responsible for the liabilities of such entity and one or more of such owners is a US person.
- iii. Any individual account (discretionary or not) where the beneficial owner is a US person.
- iv. Any commodity pool, pooled account or collective investment vehicle (whether or not it is organized or incorporated in the United States) of which a majority ownership is held, directly or indirectly, by a US person(s).
- 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 CEA.
- vi. A pension plan for the employees, officers, or principals of a legal entity with its principal place of business inside the United States.
- vii. An estate or trust, the income of which is subject to United States income tax regardless of source.

According to the Interpretive Guidance, the term "US person" generally would cover a foreign branch or agency of a US person by virtue of the fact that a branch/agency is a part of a US person. A foreign affiliate or subsidiary of a US person would, however, be considered a non-US person, even where such an affiliate or subsidiary has certain or all of its swap-related obligations guaranteed by the US person.

The CFTC has requested comment on whether:

- The term "US person" should be interpreted to include a foreign affiliate or subsidiary guaranteed by a US person.
- The CFTC should interpret the term "US person" in line with Regulation S, notwithstanding that Regulation S has a different focus.
- As an alternative approach, the term "US person" should include a concept of control under which a non-US person who is controlled by or under common control with a US person would also be considered a US person and, if so, how the CFTC should define the term "controlled by or under common control".
- There are other persons or interests that should be specifically identified as a "US person".

### Registration as a Swap Dealer or Major Swap Participant

SDs and MSPs must register with the CFTC. The CFTC (jointly with the Securities and Exchange Commission) recently published final rules<sup>3</sup> (the "Entity Definitions") further defining, among others, the terms "swap dealer" and "major swap participant" together with interpretative guidance with respect to such terms. The Entity Definitions and the related guidance describe activities that would cause a person to be a swap dealer or major swap participant and exceptions thereto.

In relation to SDs, the CFTC has specified a *de minimis* threshold of swap dealing whereby if a person engages in swap dealing transactions having an aggregate notional amount above the specified threshold during any 12-month look-back period, such person is a swap dealer and must register with the CFTC. Initially the threshold is set at US\$8 billion for CFTC-regulated swaps and credit default swaps.

In relation to MSPs, the CFTC has specified swap position thresholds for determining whether registration as an MSP is required. When a person holds swap positions above the thresholds, such person meets the definition of an MSP and must register with the CFTC.

In addition to the registration requirement, SDs and MSPs are required to comply with various prudential, business conduct, reporting, clearing and trading requirements. Unless an SD or MSP is granted a limited designation, all of its swap dealing activities are subject to such requirements, not only those dealing activities that trigger the registration requirement.

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<sup>3</sup> 77 FR 30596, May 23, 2012

### Non-US Persons as SDs

The CFTC proposes to require that a non-US person engaging in more than the *de minimis* level of swap dealing (i) **with US persons** or (ii) **with non-US persons where the dealing entity's obligations are guaranteed by a US person**, would be required to register as a swap dealer, regardless of the location of any particular swap or activity.

In determining whether its swap dealing activities exceed the *de minimis* threshold, swaps between majority-owned affiliates are excluded<sup>4</sup>. In the case of an affiliated group of non-US persons under common control, the CFTC has stated that it believes that all of the affiliated non-US persons should aggregate the notional value of their swap dealing transactions with (i) US persons and (ii) non-US persons to the extent that the dealing entity's obligations are guaranteed by US persons, in order to determine the level of swap dealing activities conducted by the affiliated group of non-US persons in the aggregate. Swap dealing transactions of affiliated US persons are not to be included. Neither swap dealing transactions between the non-US person and foreign branches of registered US SDs nor swap dealing transactions by the non-US person's US affiliates would be included in the aggregation.

This means that, in determining whether a non-US person is engaged in more than a *de minimis* level of swap dealing, the non-US person should include in its calculation the aggregate notional value of:

- i. Swap dealing transactions between itself or any of its non-US affiliates under common control and a US person (other than foreign branches of US persons that are registered swap dealers).
- ii. Any other swap dealing transactions<sup>5</sup> where its obligations, or the obligations of its non-US affiliates under common control are guaranteed by US persons.

In respect of non-US persons that are foreign branches and agencies of US persons that are SDs, the Interpretive Guidance states that only the US person would be required to register with the CFTC. The registration would apply on an entity-wide basis and the branch or agency would not be required to register separately.

### Regular Business

The Entity Definitions provide that a person must apply the *de minimis* test only if it determines that it is engaged in swap dealing activity as part of a regular business. A non-US person without a guaranty from a US person must first determine if it enters into swap dealing activities as part of a regular business before applying the *de minimis* test. The same "facts and circumstances" approach outlined by the CFTC in the Entity Definitions would apply equally to the non-US person.

### Central Booking Model—US Person as Booking Entity

In the Interpretive Guidance, the CFTC acknowledges that many financial institutions operate a central booking model whereby various branches, affiliates, agencies and subsidiaries enter into trades that are ultimately, directly or indirectly, booked in a single entity (usually the parent). In circumstances where a US person is the central booking entity either because its non-US affiliates or subsidiaries have transferred a swap to it by way of a back-to-back arrangement or because they acted in an agency capacity (and the US person is the true counterparty to the transaction), the CFTC proposes to attribute these "centrally booked" swaps to the US person. The Interpretative Guidance does not specifically state whether or not the swaps will also be attributed to the non-US affiliate or subsidiary. Note however that a non-US affiliate or subsidiary of a US person may also be required to register as an SD if it otherwise independently meets the definition of swap dealer.

### Central Booking Model—non-US Person as Booking Entity

Where a non-US person is the booking entity and even if the US branch, agency, affiliate or subsidiary of a non-US person engages in solicitation or negotiation in connection with the swap entered into by the non-US person, the CFTC proposes to interpret section 2(i) of the CEA such that the Dodd-Frank Act requirements, including the registration requirement, applicable to swap dealers also apply to the non-US person.

<sup>4</sup> Note that this seems to conflict with the concept of the "central booking" model discussed below.

<sup>5</sup> We have assumed that the CFTC means this to apply only to dealings with non-US persons, however, the Interpretive Guidance does not state this explicitly.

<sup>6</sup> It is unclear from the Interpretive Guidance which swap, in relation to a back-to-back arrangement, will be attributed to the US person—i.e., whether the original swap between its affiliate and the counterparty will be attributed or whether the back-to-back swap (or portion thereof) will be attributed. The Interpretive Guidance also does not state that the transferring affiliate need not count the swap in its own calculations.

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The CFTC's guidance regarding the central booking model seems to be inconsistent with its other statements within the Interpretive Guidance that inter-affiliate swaps are excluded when an entity is calculating whether its dealing activity exceeds the *de minimis* threshold.

### Summary of Dealing Determination

The following Table A summarizes which swaps a non-US person or US person as a dealing party must include in determining whether it is a swap dealer.

Table A

Counterparty	US Person	Non-US Person
<b>Party making the dealing determination</b>		
<b>Non-US Person</b>	Yes, count any swap dealing transactions where a US person is the counterparty. <ul style="list-style-type: none"><li>■ Exclude, however, swaps with foreign branches of US persons that are registered swap dealers.</li></ul>	Yes, but only count swap dealing transactions where dealing party's obligations are guaranteed by a US person.
<b>Aggregation</b>	Include any swap dealing transactions by non-US person's affiliates under common control.	Include any swap dealing transactions by non-US person's affiliates under common control where such affiliates obligations are guaranteed by a US person.
<b>A non-US person who is a foreign affiliate or subsidiary of US person under "central booking" model</b>		
	<ul style="list-style-type: none"><li>■ Swap dealing transactions with either a US person or a non-US person counterparty are counted by the US person regardless of whether the swaps were booked directly by the US person (i.e., direct party to the swap) or indirectly (i.e., by way of back-to-back or other arrangement) under the "central booking" model.</li></ul>	
<b>US branches, agencies, affiliates and subsidiaries of a non-US person under "central booking" model (i.e., where the non-US person books the transactions)</b>		
	<ul style="list-style-type: none"><li>■ Similar analysis to the above applies, but in reverse.</li><li>■ Swap dealing transaction by US branch or agency would be treated as having been directly entered into by the non-US person.</li><li>■ Swap dealing transaction by US affiliate or subsidiary of a non-US person under "central booking" model would be counted by non-US person, regardless of whether booked directly or indirectly (i.e., in a back-to-back transaction).</li></ul>	
<b>US Persons</b>	Yes, count any swap dealing transactions even if the swap dealing is conducted by foreign branch or agency.	Yes, count any swap dealing transactions even if the swap dealing is conducted by foreign branch or agency.
	Swap dealing conducted by foreign affiliate or subsidiary of the US person under a "central booking" model are counted by US person.	

## Non-US Persons as MSPs

A non-US person who holds swap positions above the specified MSP thresholds **where its counterparty is a US person** would be required to register as an MSP, subject to certain exceptions regarding guaranteed swaps discussed below. The relevant thresholds for non-US persons are the same as those set forth with respect to US persons in the Entity Definitions. In determining whether it is an MSP, a non-US person would include all swap positions with a counterparty that is a US person, but would **not include** any swap position where the counterparty is a non-US person. In addition, swap positions between a non-US person where the obligations of such non-US person thereunder are guaranteed by a US person, should be attributed to the US person acting as guarantor and **not** to the non-US person in determining whether either person is an MSP. This means that a non-US person would be required to register as an MSP if its swaps with US persons exceed a relevant MSP threshold **not including** any swap positions where such non-US person's obligations are guaranteed by US persons. Those guaranteed positions would instead be attributable to the US person in determining whether the US person has swap positions that exceed the relevant MSP threshold.

With respect to the aggregating of swap positions in determining whether the relevant MSP thresholds have been exceeded, the non-US person ("X") should consider the aggregate notional value of:

- i. Any swap position between X and a US person.
- ii. Any swap between another non-US person and a US person, where X guarantees the obligations of the non-US person thereunder.

## Summary of MSP determination

Table B below summarizes which swaps a non-US person and US person must include in determining whether it is a major swap participant.

## Compliance With Title VII Requirements

Registered SDs and MSPs must comply with risk management requirements, internal and external business conduct rules, and reporting and recordkeeping requirements. In the Interpretive Guidance, the CFTC has divided these requirements into "entity level" and "transaction-level" requirements. In certain circumstances, the CFTC would permit a non-US SD/MSP to comply with comparable requirements promulgated by its home jurisdiction in lieu of complying with the entity-level requirements and transaction-level requirements.

Substituted compliance would be permitted if the CFTC determines that such foreign requirements are comparable to the corresponding requirements under the CEA and the CFTC's regulations. This means that a non-US SD/MSP may be permitted to comply, for certain requirements, with regulations in its home jurisdiction to the extent that the comparability standard is met but also may be required to comply with certain of the Dodd-Frank Act requirements where comparable home regulations are lacking.

## Comparability Determination

According to the Interpretive Guidance, a non-US person would be required to request permission from the CFTC to avail itself of substituted compliance and would do so in connection with its application to register as a SD/MSP. Alternatively, a group of non-US persons or a foreign regulator may submit an application for substituted compliance on behalf of a group of non-US persons that are subject to a foreign supervisory regime. An applicant, at a minimum, is expected to state with specificity the factual basis for requesting the comparability recognition and should include all

Table B

Counterparty	US Person	Non-US Person
<b>Party making the dealing determination</b>		
<b>US Person</b>	Yes, include in computation.	Yes, include in computation.
<b>Non-US Person</b>	Yes, include swaps in computation but not the swap obligations of the determining party that are guaranteed by a US person. Also, a non-US person making the determination includes any swaps of another non-US person with a US person where the non-US person's obligations are guaranteed by the determining party.	No, do not include in computation.

applicable legislation, rules and policies. The CFTC, if it deems it appropriate, may conduct an onsite examination of the applicant as well as the applicant's home regulator. The applicant is expected to state that it is licensed and in good standing with the regulators in its home country<sup>7</sup>. Following registration, the non-US SD or MSP must inform the CFTC of any material changes to information submitted. Categories of what needs to be notified will be made public by the CFTC in due course. The CFTC has noted that comparable does not necessarily mean identical.

The CFTC has stated that it will use its experience in making comparability determinations under Rule 30.10 in developing its approach for swaps and that it will use an "outcomes-based approach" to determine whether requirements of a given foreign jurisdiction are designed to meet the same regulatory objectives of the Dodd-Frank Act. The CFTC proposes that comparability and comprehensiveness would be determined by reviewing the laws and regulations of the foreign jurisdiction and that it will retain broad discretion to make its determination.

## Entity-Level Requirements

The entity-level requirements are as follows:

- i. Capital adequacy
- ii. Appointment of chief compliance officer
- iii. Risk management
- iv. Swap data recordkeeping
- v. Swap data reporting
- vi. Physical commodity swaps reporting

The entity-level requirements apply to all registered SDs and MSPs across all their swaps without distinctions as to the counterparty or the location of the swap. The CFTC proposes to subdivide the entity-level requirements into two subcategories. In one subcategory are the requirements related to capital adequacy, chief compliance officer, risk management and swap data recordkeeping which can be distinguished as the "risk control" category. In the other subcategory are the requirements related to swap data reporting and large position reporting i.e., the "reporting" category.

The CFTC proposes to require all non-US SDs/MSPs to comply with all the "risk control" requirements. However, the CFTC will allow substituted compliance for any "risk control" requirements where the non-US SD/MSP is subject to comparable regulation in its home jurisdiction.

In respect of the "reporting" category, the CFTC proposes to require all non-US SDs/MSPs to report all swaps to a registered swap data repository and to report their reportable positions. Substituted compliance will be permitted to the extent that a comparable regime exists provided that, with respect to swap data repository reporting, the CFTC has direct access to such data.

Foreign branches and agencies of US SDs/MSPs are part of the US SD/MSP and therefore the US SD/MSP is responsible for compliance with the entity-level requirements. With respect to non-US affiliates and subsidiaries of US SDs/MSPs where the affiliate or subsidiary independently meets the SD/MSP definition, both the US SD/MSP and the non-US SD/MSP would be required to comply.

## Transaction-Level Requirements

The transaction-level requirements are as follows:

- i. Clearing and swap processing
- ii. Margining and segregation for uncleared swaps
- iii. Trade execution
- iv. Swap trading relationship documentation
- v. Portfolio reconciliation and compression
- vi. Real-time public reporting
- vii. Trade confirmation
- viii. Daily trading records
- ix. External business conduct standards

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<sup>7</sup> We query how this would work in circumstances where a foreign regulator made an application.

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#### Non-US SDs/MSPs

The CFTC proposes to require all non-US SDs/MSPs to comply with all transaction-level requirements in relation to all swaps with (a) US persons and (b) non-US persons to the extent such non-US person's obligations are guaranteed by a US person. Substituted compliance would **not** be permitted when a non-US SD/MSP faces a US person, however, substituted compliance would be permitted when the non-US SD/MSP faces non-US persons who are guaranteed by a US person. Substituted compliance would also be permitted for swaps between a foreign branch of a US person and a non-US person (whether or not the non-US person is guaranteed by a US person).

The external business conduct rules apply only when a non-US SD/MSP faces a US person. Such requirements will not apply to non-US SDs/MSPs facing a non-US person even if the obligations of the non-US SD/MSP are guaranteed by a US person.

#### US SDs/MSPs

The Interpretive Guidance provides that, in limited circumstances, substituted compliance by foreign branches or agencies of a US person with transaction-level requirements would be permitted where there are no comparable foreign regulations. To be eligible for the exception, the aggregate notional value the swaps of all foreign branches and agencies of the US person in the relevant jurisdictions may not exceed five percent of the aggregate notional value of all the swaps of the relevant US person. In each case, notional values will be expressed in US dollars and measured quarterly. The US person would be required to maintain records to verify its eligibility for the exception and identify, define and address any significant risk that may arise from the non-application of the transaction-level requirements.

Whether transaction-level requirements apply to swaps entered into by a foreign affiliate or subsidiary of a US person depends on where the swap is booked. If the foreign affiliate/subsidiary independently meets the definition of an SD, it must separately register as an SD and comply with all entity-level and transaction-level requirements, although substituted compliance would be permitted with respect to the obligations of the foreign affiliate/subsidiary.

The Interpretive Guidance sets out in tabular which entity-level and transaction-level requirements the CFTC is proposing would apply and in which circumstances.

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