

August 16, 2013

CFTC Issues Final Guidance on Cross-Border Application of Swap Regulations

On July 12, 2013, the Commodity Futures Trading Commission (“CFTC”) approved final guidance addressing the extent to which the swap provisions of the Commodity Exchange Act (“CEA”) added by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) apply to persons and entities located outside the United States. This cross-border guidance takes the form of documents entitled “Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations” (the “Final Guidance”) and an “Exemptive Order Regarding Compliance with Certain Swap Regulations” (the “Exemptive Order”).¹

Although Section 2(i) of the CEA contains an express territorial limit on the reach of its swap provisions, the Final Guidance reflects the CFTC’s expansive view of the exception to that limit that permits regulation of any swap activity outside the United States that has “a direct and significant connection with activities in, or effect on, commerce of the United States.” Other jurisdictions were critical of perceived overreaching in the CFTC’s proposed guidance issued last year (the “Proposed Guidance”), but regulators in a number of G20 countries have now apparently accepted the CFTC view that the availability of compliance with non-US law as a substitute for compliance with CFTC swap rules will depend on comparability determinations made by the CFTC applying an “outcomes-based approach.” The Final Guidance will be helpful to many non-US persons, but its complexity will pose challenges for those seeking to comply with its terms and some inconsistencies between the Final Guidance and the cross-border rules proposed by the Securities Exchange Commission (“SEC”) for security-based swaps will have to be addressed over time.

I. Executive Summary

The Final Guidance, which generally follows the Proposed Guidance, will significantly affect the swap activities of US and non-US persons in three ways. First, it broadens the scope of the term “US person” for purposes of the swap rules. Second, it makes important changes to the way swaps are counted for the purposes of determining when a person is required to register as either a swap dealer (“SD”) or major swap participant (“MSP”). Third, it tells swap dealers and major swap participants when and how they must apply particular entity-level and transaction-level requirements in the swap rules when swap transactions involve at least one non-US person.

The Exemptive Order generally postpones the effective date of the Final Guidance to October 9, 2013, to provide time for the swap market participants to implement the Final

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¹ The Final Guidance was published in the *Federal Register* July 26, 2013, at 45292 and is available [here](#). The Exemptive Order was published in the *Federal Register* July 22, 2013, at 43785 and is available [here](#).

Guidance. The Exemptive Order also provides extended relief to the earlier of December 21, 2013, or 30 days after the issuance of a relevant substituted compliance determination for non-US swap dealers and MSPs in Australia, Canada, the European Union, Hong Kong, Japan and Switzerland (the “Six Jurisdictions”), jurisdictions that have already approached the CFTC about substituted compliance.

II. Key Guidance Points

A. “US Person” Interpretation

1. US Person Test

The categorization of swap counterparties as US or non-US persons is an essential element of the new swap regulatory regime since the extent of US person involvement in a swap determines the degree to which the CFTC’s rules will apply. The Final Guidance interprets the term “US person” generally to include, but not be limited to:

- (i) any natural person who is a resident of the United States;
- (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 prongs (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;
- (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-US persons and not offered to US 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 “interpretation” is not an explicit definition, since it includes “but is not limited to” the elements identified (referred to as “prongs” in the Final Guidance). This means that the CFTC has the ability to expand the coverage of the US person test. The Final Guidance also states that the term “non-US person” refers to a person that is not within the CFTC’s interpretation of the term “US person.”

2. Interpretation with Respect to Collective Investment Vehicles

- a. For the purposes of prong (vi) of the interpretation, “majority-owned” means the beneficial ownership of more than 50 percent of the equity or voting interests in the collective investment vehicle. The CFTC expects that a collective investment vehicle will take the following steps to verify if this prong applies: (1) determine whether its direct beneficial owners are US persons described in prong (i), (ii), (iii), (iv) or (v) of the term “US person,” and (2) “look-through” the beneficial ownership of any other legal entity invested in the collective investment vehicle that is controlled by or under common control with the collective investment vehicle in determining whether the collective vehicle is majority-owned by US persons. Accordingly, a collective investment vehicle does not need to look through to indirect owners except in the case where there is a control relationship between an investor in the vehicle and the vehicle itself (e.g., a master and feeder fund relationship).

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- b. The CFTC has declined to establish a “bright-line test” for when the principal place of business of a collective investment vehicle would or would not be within the United States. Nonetheless, the CFTC advised that it will generally consider the principal place of business of a collective investment vehicle to be in the United States if the senior personnel responsible for either (1) the formation and promotion of the collective investment vehicle or (2) the implementation of the vehicle’s investment strategy are located in the United States, depending on the facts and circumstances that are relevant to determining the center of direction, control and coordination of the vehicle.
 - c. The CFTC generally believes that a person would not come within the “US person” interpretation solely because it retains an asset management firm located in the United States to manage its assets or provide other financial service.

3. *Guaranteed and Conduit Affiliates*

Although they are not explicitly included in the US person interpretation, the CFTC has identified two types of entities that are treated as US persons for some but not all purposes because they create risks for US persons. The first type is non-US affiliates of US persons that are guaranteed by a US person (“guaranteed affiliates”). The CFTC states that it has the right to regulate swaps with such entities because the ultimate risk of the swap rests with the US guarantor. The Final Guidance does not provide guidance as to the status of a non-US person if only some of its swaps are guaranteed while others are not.

The second type of entity is a non-US person (a “conduit affiliate”) that meets the following criteria:

- (i) the non-US person is a majority-owned affiliate of a US person;
- (ii) the non-US person is controlling, controlled by or under common control with the US person;
- (iii) the financial results of the non-US person are included in the consolidated financial statements of the US person; and
- (iv) the non-US person, in the regular course of business, engages in swaps with non-US third-parties for the purpose of hedging or mitigating risks faced by, or to take positions on behalf of, its US affiliates, and enters into offsetting swaps or other arrangements with its US affiliates in order to transfer the risks and benefits of such swaps with third parties to its US affiliates.

These criteria are not exclusive (“other facts and circumstances also may be relevant”), but the CFTC has stated that the term “conduit affiliate” is not intended to include affiliates of swap dealers.

4. *Foreign Branches of US Persons*

The CFTC views a foreign branch of a US person as a US person itself, but allows it to be treated as a non-US person for certain purposes. The CFTC has increased the complexity of dealing with foreign branches by creating detailed criteria for determining when a branch of a US person qualifies as a foreign branch for the purposes of the Final Guidance. It has also identified the factors that determine when a swap should be considered to be with the foreign branch of a US bank:

- (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 such foreign branch or in another foreign branch of the US bank;
- (ii) the foreign branch or another foreign branch is the office through which the US 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 US bank is such foreign branch;
- (iii) the swap is entered into by such 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.

These new criteria will make it necessary for a counterparty to a foreign branch of a US bank to obtain enhanced representations that confirm that the branch, and each swap with the branch, falls within the Final Guidance.

5. Due Diligence

In response to practical concerns raised by commenters with respect to application of the US person test, the CFTC confirms in the Final Guidance that a party to a swap is generally permitted to rely on a written representation from its counterparty as to the counterparty's US person status if such reliance is "reasonable." The Final Guidance contains a cross-reference to the similar standard in the external business conduct rules which indicates that reliance is reasonable unless a party has information that would cause a reasonable person to question the representation. Industry groups are exploring ways to assist the market participants with the efficient certification and exchange of information about a person's status under the interpretation.

B. Counting Swaps for Determination of Swap Dealer and MSP Status

1. For Potential Swap Dealers

A person must generally aggregate all its dealing swaps with those of its US and non-US affiliates under common control to determine whether it is engaged in a sufficient amount of swap dealing to trigger the need to register as a swap dealer, except that swaps of an affiliate that is a registered swap dealer are excluded. However, this counting exercise is subject to some exclusions if the potential swap dealer making the calculation is a non-US person. This aggregation rule, combined with the changes to the US person test and the refinement of the guaranteed and conduit affiliate concepts, introduce significant complexity into the swap counting process. [Exhibit 1](#) to this advisory is a chart showing the swap counting that must be done by a non-US person to determine if it could be a swap dealer. [Exhibit 2](#) covers the same ground for a possible swap dealer that is a US person with non-US affiliates. In some cases, there are discrepancies between the CFTC positions expressed in the summary sections of the Final Guidance and the views expressed elsewhere.

2. For Potential MSPs

In determining whether it holds swap positions sufficient to trigger MSP registration, a US person must consider all its swaps with all its counterparties (both US and non-US). A non-US person, on the other hand, needs to consider only the aggregate notional value of:

- (i) any swap position between it and a US person;
- (ii) any swap position between it and a guaranteed affiliate (but its swap positions where its own obligations thereunder are guaranteed by a US person should be attributed to that US person and not included in the non-US person's determination); and
- (iii) any swap position between another (US or non-US) person and a US person or guaranteed affiliate, where it guarantees the obligations of the other person thereunder.

[Exhibit 3](#) to this advisory is a chart showing how these points apply in practice for a non-US person testing for MSP status.

C. Swap Dealer and MSP Requirements

1. General Principles

The Final Guidance follows the Proposed Guidance and separates the substantive swap compliance obligations imposed on swap dealers and major swap participants under the CEA into two categories: (i) entity-level requirements and (ii) transaction-level requirements. The Final Guidance also establishes a tiered approach to entity-level and transaction-level requirements for swaps entered into on a cross-border basis. The extent of the required compliance with entity- and transaction-level requirements depends on the nature of the counterparties to the swap. At one end of the spectrum, US swap dealers must comply with all entity-level and transaction-level requirements at all times, regardless of counterparty. At the other end of the spectrum, non-US persons that are not required to register as swap dealers and are not guaranteed by US persons are subject to none of the entity-level and transaction-level requirements for swaps entered into with other such non-US persons.

In between these two extremes, the Final Guidance distinguishes among: (i) non-US branches of US swap dealers; (ii) non-US swap dealer affiliates of US swap dealers; (iii) non-US swap dealers; and (iv) guaranteed and conduit affiliates. In general, for

swaps booked outside the United States by non-US swap dealers (whether or not affiliated with a US swap dealer), the Final Guidance permits substituted compliance for entity-level requirements but limits substituted compliance with transaction-level requirements to swaps that are entered into with non-US persons. Non-US branches of US swap dealers are also eligible for substituted compliance with transaction-level requirements for swaps entered into with non-US persons. However, the CFTC views large trader reporting (“Large Trader Reporting”) as essential for carrying out its mission to oversee US commodity markets, so no exceptions are permitted for that requirement.

2. Entity-Level Requirements

Entity-level requirements apply generally to all swap dealers and MSPs across all of their swaps without regard to the counterparty or the location of the swaps. The Final Guidance divides them into two categories:

First Category entity-level requirements are:

- (i) capital adequacy;
- (ii) chief compliance officer;
- (iii) risk management; and
- (iv) swap data recordkeeping except for customer complaints and sales and marketing materials.

Second Category entity-level requirements are:

- (i) swap data reporting (SDR Reporting);
- (ii) swap data recordkeeping for customer complaints and sales and marketing materials; and
- (iii) large trader reporting.

[Exhibit 4](#) to this advisory is a chart showing the extent to which entity-level requirements apply to a non-US person registered as a swap dealer or MSP.

3. Transaction-Level Requirements

Transaction-level requirements apply to specific swap transactions rather than to the swap entity. The Final Guidance divides the transaction-level requirements under the CEA and the CFTC’s regulations into two categories:

Category A transaction-level requirements:

- (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; and
- (viii) daily trading records.

The only Category B transaction-level requirements are the external business conduct standards.

[Exhibit 5](#) to this advisory is a chart showing the extent to which transaction-level requirements apply to a non-US person registered as a swap dealer or MSP. One surprising addition in the Final Guidance that did not appear in the Proposed Guidance is a statement that all transaction-level requirements apply to a swap executed with a US branch of a non-US person (without regard to whether the counterparty is a US or non-US person). In the absence of detailed information about this development from the CFTC, one imagines that the determination of when a swap is made with such a branch involves the same principles applicable to the determination of when a swap is made with the non-US branch of a US person.

4. Swap Requirements for Persons Other than SDs and MSPs

Certain of the CFTC's entity-level and transaction-level requirements can even apply to an end user of derivatives (i.e., an entity that is neither a swap dealer nor a major swap participant and that does not "deal" in swaps (so it does not have to worry about being a swap dealer)). [Exhibit 6](#) to this advisory is a chart showing the extent of these requirements. In addition, the following consequences flow from an end user being found to be a US person:

- The end user cannot enter into over-the-counter swaps (as defined in the CEA) unless it is an "eligible contract participant" (as defined in the CEA).
- Non-US persons entering into swaps with the end user may become subject to Dodd-Frank requirements by virtue of the end user's US person status.
- Dealers and MSPs will require the end user to adhere to International Swaps and Derivatives Association, Inc. protocols and/or sign additional documentation (which in turn will require the end user to adopt certain swap policies and procedures).
- If the end user is a collective investment vehicle, execution of even a single swap will arguably (from the perspective of the CFTC) turn the end user into a commodity pool that must have a commodity pool operator registered with the CFTC or exempt from such registration because swaps are now "commodity interests."
- The end user must obtain a CFTC Interim Compliant Identifier ("CICI") number.

The Final Guidance contains a reminder from the CFTC that certain swap rules can apply to non-US persons even if they are not registered with the CFTC as swap dealers or MSPs.

5. Substituted Compliance

- a. The Final Guidance would permit non-US registered swap dealers and MSPs to comply with certain of the entity-level and transaction-level requirements in some circumstances through compliance with applicable home country regulation. Such substituted compliance will be permitted only if the CFTC determines, upon application, "that such home jurisdiction's requirements (or in the case of foreign branches of a bank, the foreign location of the branch) are comparable with and as comprehensive as the corollary area(s) of regulatory obligations encompassed by the Entity- and Transaction-Level Requirements."

The CFTC describes this as an "outcomes based" approach, meaning that it "is likely to review the requirements of a foreign jurisdiction for rules that are comparable to and as comprehensive as the requirements of the Dodd-Frank Act, but it will not require that the foreign jurisdiction have identical requirements. . . ."

- b. In the short run, the availability and usefulness of substituted compliance will depend on the speed with which the CFTC actually makes comparability determinations. There are no precise timetables for determinations in the Final Guidance and the CFTC views the process as being one initiated by requests from other governments and/or market participants.
- c. The CFTC intends to take into consideration all relevant factors including, but not limited to, the scope, objectives and comprehensiveness of the jurisdiction's regulatory requirements as well as the relevant regulator's supervisory program and its authority to support and enforce its oversight on the non-US person.
- d. Because many foreign jurisdictions have been implementing over-the-counter derivatives reforms in an incremental manner, the CFTC's comparability determinations may be made on a requirement-by-requirement basis, rather than on the basis of the foreign regime as a whole. Where certain of the home jurisdiction's requirements are determined to be lacking, a non-US person may be required to comply with certain of the Dodd-Frank requirements.

A non-US person swap dealer or MSP subject to the CFTC regulations must request the CFTC's permission to comply with the entity-level and transaction-level requirements through substituted compliance. Alternatively, a group of non-US persons from the same jurisdiction or the regulator from a non-US jurisdiction may submit an application for substituted compliance on behalf of non-US persons subject to its regulatory regime. A request for substituted compliance must be submitted by the non-US swap dealer or MSP at the same time it files its application to register as a swap dealer or MSP.

The non-US swap dealer or MSP will be expected to state with particularity the reasons why the CFTC should recognize comparability with respect to a particular Dodd-Frank Act provision as well as include all applicable legislation, rules and policies. The entity will further have to state that it is licensed and in good standing with the applicable supervisor in its home jurisdiction. The CFTC expects that when substituted compliance is permitted, it will have entered into an appropriate memorandum of understanding (MOU) or a similar arrangement with the relevant regulator in the jurisdiction of the applicant. Although existing information-sharing and/or enforcement arrangements would be indicative of the regulator's ability to cooperate with the CFTC, the CFTC would expect that, going forward, supervisory MOUs will be put in place to establish ongoing coordination between the CFTC and the regulator. Such MOUs would address, but not be limited to, procedures for confirming continuing oversight activities, access to information, on-site visits, and notification and procedures in certain situations.

The Final Guidance also details what the CFTC would expect to view as substituted compliance with regard to swaps covered by a CFTC mandatory clearing requirement. Another jurisdiction's regime would be comparable when: (i) the swap is subject to a mandate by the other jurisdiction that is comparable and comprehensive to the CFTC's mandate; and (ii) the swap is cleared through a derivatives clearing organization ("DCO") that is exempted from registration under the CEA.

- e. The CFTC issued a no action letter (no. 13-45) on July 11 that permits certain non-US swap dealers and major swap participants to satisfy their obligations under certain CFTC documentation rules by complying with similar rules enacted under Article 11 of the European Market Infrastructure Regulation ("EMIR") and the related EMIR Technical Standards. The basis for the relief is a series of determinations that the relevant CFTC and EMIR rules are "essentially identical" for regulatory purposes. This use of a no-action letter to provide relief similar to that provided by a substituted compliance determination has been publicly criticized by CFTC Commissioner O'Malia as an inappropriate delegation of the CFTC's authority.

The specific CFTC rules covered by the relief are as follow:

1. 23.501 (confirmations)
2. 23.502 (other than 23.502(c)) (portfolio reconciliation)
3. 23.503 (portfolio compression)
4. 23.504(b)(2) (incorporation of confirmations into trading relationship documentation)
5. 23.504(b)(4) (Valuations)

The relief described in the letter does not apply to other sections of subpart I of Part 23 of the CFTC Rules. These requirements include § 23.502(c) (requiring reporting to the CFTC of any swap valuation dispute in excess of \$20,000,000 (or its equivalent in any other currency)), § 23.504 (except for (b)(2) and (b)(4))(swap trading relationship documentation), § 23.505 (end-user exception documentation) and § 23.506 (swap processing and clearing).

6. Five Percent Exemption

Under a limited exception, where a swap between the foreign branch of a US swap dealer or US MSP and a non-US person (that is not a guaranteed or conduit affiliate) takes place in a foreign jurisdiction other than the Six Jurisdictions, the counterparties generally may comply only with the transaction-level requirements in the foreign jurisdiction where the foreign branch is located if the aggregate notional value of all the swaps of the US swap dealer's or US MSP's foreign branches in such countries does not exceed five percent of the aggregate notional value of all of the swaps of the US swap dealer, and the US person maintains records with supporting information for the five percent limit to identify, define and address any significant risk that may arise from the non-application of the transaction-level requirements.

D. Exemptive Order

1. Time-Limited Relief

The Exemptive Order generally provides relief from the new elements in the Final Guidance until October 9, 2013 (75 days after publication of the Final Guidance in the *Federal Register*) in order to allow time for an orderly transition to the new status quo.

In addition, it generally extends to that same date the relief from transaction- and entity-level requirements provided to non-US swap dealers and MSPs by prior exemptive orders. The Exemptive Order does not apply to US persons other than foreign branches of US persons. The Exemptive Order in some cases introduces conditions to relief that may make the relief unavailable as a practical matter. For instance, the delay in SDR reporting for non-US swap dealers in the Six Jurisdictions is expressly conditioned on compliance with certain rules of the party's home jurisdiction (which may not yet have been enacted) or similar CFTC rules (which may not be possible for the non-US person as a technical matter).

2. *The Six Jurisdictions*

Because Australia, Canada, the European Union, Hong Kong, Japan and Switzerland have all commenced discussions with the CFTC concerning substituted compliance, swap dealers and MSPs from those jurisdictions do not have to comply with otherwise applicable entity-level requirements (and, to a more limited extent, transaction-level requirements) until the earlier of December 21, 2013, or 30 days after the issuance of a relevant substituted compliance determination. No such relief has been granted for SDs and MSPs in other jurisdictions.

3. *Comment Period*

Although the Exemptive Order was effective on July 13, 2013, the CFTC included an after-the-fact comment period. Since a number of commentators have pointed out potential inconsistencies and ambiguities in the Exemptive Order, it is anticipated that the CFTC will receive comments requesting clarification of these points.

III. Unresolved Issues

A. CFTC-SEC Coordination

The Final Guidance differs in numerous ways from the cross-border guidance proposed by the SEC for security-based swaps. These differences are not necessarily significant, either individually or in the aggregate but, if they are not resolved, they will create a daunting compliance task for swap market participants that use both products.

B. SEFs, DCMs and FBOTs

The Final Guidance provides very little information for operators of non-US multilateral trading facilities ("MTFs"), designated contract markets ("DCMs") and foreign boards of trade ("FBOTs") with respect to their obligations under US law if they permit US persons to use their platforms. The CFTC does state affirmatively that it will extend no-action relief to EU-regulated MTFs in the event that the CFTC's trade execution requirement becomes operative before March 15, 2014, but it does not say anything about the substance of that relief. On a more positive note, the Final Guidance states that where swaps that are executed anonymously between a US person and a non-US person on a swap execution facility ("SEF"), DCM or FBOT and successfully submitted for clearing, the non-US person will generally be viewed as having satisfied all applicable Category A transaction-level requirements and will not have to count the swaps towards its *de minimis* dealing limit.

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