

CLIENT UPDATE

FURTHER GUIDANCE AND ORDER WITH RESPECT TO CROSS-BORDER APPLICATION OF CFTC SWAP REGULATION

NEW YORK

Byungkwon Lim
blim@debevoise.com

Emilie T. Hsu
ehsu@debevoise.com

Aaron J. Levy
ajlevy@debevoise.com

On December 21, 2012, the Commodity Futures Trading Commission (“CFTC”) issued a time-limited final exemptive order (the “Exemptive Order”) and some additional proposed guidance (the “Further Cross-Border Guidance”) regarding the cross-border application of certain swap regulations mandated by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”).

The Exemptive Order was issued by the CFTC to finalize on a time-limited basis, with some modifications and clarifications, the proposed exemptive order previously published on July 12, 2012 (the “Proposed Order”), and the Further Cross-Border Guidance supplements the proposed interpretative guidance and policy statement published on July 12, 2012 (the “Proposed Guidance”).

The Exemptive Order became effective on its issue date and will expire on July 12, 2013. Comments on the Further Cross-Border Guidance were published in the Federal Register on January 7, 2013, and must be received on or before February 6, 2013.

DEFINITION OF U.S. PERSON

For purposes of the Exemptive Order, the CFTC defines a “U.S. Person” as any person that is:

- (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) effective as of April 1, 2013 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.

The definition of U.S. Person in the Exemptive Order is different from the definition provided in the CFTC no-action letter No. 12-22 dated October 12, 2012 in certain respects. First, the no-action letter did not include a legal entity formed under laws outside the United States with a principal place of business in the United States within the scope of the term U.S. Person. The phrase “principal place of business” is described in the Exemptive Order as a single place where a company’s officers direct, control and coordinate the company’s activities, which is typically where the company maintains its headquarters. However, the CFTC will not treat entities organized outside of the United States with a principal place of business in the United States as a “U.S. Person” until April 1, 2013 to allow such entities a transition period for compliance.

In addition, the Exemptive Order expands the existing exclusion from the scope of the term U.S. person for a “pension plan” of a legal entity treated as a U.S. Person, such that a pension plan primarily for foreign employees is excluded, in addition to pension plans exclusively for foreign employees, which were already excluded under the no-action letter. Last, the Exemptive Order includes the concept of joint accounts where any of the beneficial owners is otherwise a U.S. Person, in addition to individual accounts where the beneficial owner is otherwise a U.S. Person.

To rely upon the exemptive relief provided in the Exemptive Order, a party to a swap can rely on its counterparty’s representations in determining whether such counterparty is a U.S. Person as long as such reliance is reasonable. This definition of “U.S. Person” only applies for the purposes of the Exemptive Order and only with respect to swap regulations (i.e., it does not apply to regulations with respect to the futures markets).

FOREIGN BRANCH OF U.S. PERSON

The Exemptive Order provides that a foreign branch of a U.S. Person is also a U.S. Person because a branch does not have a separate legal identity from that of its principal entity; therefore, the activities of a foreign branch are deemed to be the activities of the principal entity. Accordingly, if a foreign branch were to be a swap dealer (“SD”) or a major swap participant (“MSP”), its U.S. principal entity would be required to register as an SD or MSP, and once registered, such registration would cover the foreign branch.

THRESHOLD CALCULATION FOR REGISTRATION OF SDS AND MSPS

The Exemptive Order provides guidance on the scope of swaps to be included in determining whether a non-U.S. Person meets the applicable registration threshold as an SD (the *de minimis* threshold determination under section 1.3(ggg)(4) of the CFTC regulations) or MSP (the swap position determination under section 1.3(jjj) and (lll) for the MSP definition under section 1.3(hhh) of the CFTC regulations). It also provides guidance on aggregation of certain swaps for purposes of the *de minimis* threshold determination with respect to SD registration.

Exclusion of Swaps with Non-U.S. Persons

In determining its SD or MSP status, a non-U.S. Person (regardless of whether its swaps are guaranteed by a U.S. Person) is not required to include any swap with a counterparty that is a non-U.S. Person.

Exclusion for Swaps with Foreign Branches of U.S. SDs

In determining its SD or MSP status, a non-U.S. Person is not required to include swaps with a foreign branch of a U.S. Person that (i) is a registered SD or (ii) is not yet registered as an SD but represents that it intends to register as such by March 31, 2013.

Aggregation for De Minimis Exemption from SD Registration

In determining whether to aggregate swap dealing activities of affiliates for purposes of determining whether a non-U.S. Person that was engaged in swap dealing activities with U.S. Persons as of the Effective Date is eligible for the *de minimis* exemption, such non-U.S. Person is not required to aggregate:

- swaps connected with the swap dealing activity of its U.S. affiliate under common control;
- swaps connected with the swap dealing activity of its non-U.S. affiliate under common control with counterparties that are non-U.S. Persons;¹ or
- swaps connected with the swap dealing activity of its non-U.S. affiliate under common control that either (a) was engaged in swap dealing with U.S. Persons as of the Effective Date or (b) is registered as an SD, but in either case only if the non-U.S. Person at issue is an affiliate under common control with a registered SD.

In other words, if at least one of the entities in the affiliated group registers as an SD, the CFTC does not require the aggregation of the swap dealing activities of the various non-U.S. affiliates, even if the aggregate amount of such swap dealing among all the unregistered non-U.S. affiliates is above the *de minimis* threshold during the transition period covered by the Exemptive Order.

For this purpose, an affiliate of a non-U.S. Person means a person controlling, controlled by or under common control with such non-U.S. Person.

This limited transitional relief with respect to aggregation of swap dealing activities of affiliates of a non-U.S. Person is not applicable to a non-U.S. Person that began to engage in swap dealing activities with U.S. Persons after the Effective Date. Therefore, for example, a non-U.S. Person that commences swap dealing activities with U.S. Persons after the Effective Date may have to take into account swap dealing activities of all affiliates.

¹ The CFTC states that in no situation would swap dealing activities between a non-U.S. Person's non-U.S. affiliates and other non-U.S. counterparties need to be included in the SD determination of such non-U.S. Person.

Central Booking Entity

In case a group operates a “central booking entity” to which swaps are booked whether directly or through back-to-back swaps with affiliates, the Exemptive Order provides that a non-U.S. Person is not required to include in its SD registration *de minimis* calculation any swap to which it is not a party because such swap was entered into by an affiliated central booking entity.

Aggregation for MSP Threshold Determination

The Exemptive Order does not address the aggregation issue for non-U.S. Persons that may be required to register as MSPs. The Exemptive Order only provided that, in calculating the MSP registration threshold, a non-U.S. Person is not required to include swaps with non-U.S. Persons or swaps with foreign branches of U.S. Persons that are registered as SDs or represent that they intend to so register by March 31, 2013. Therefore, some interpretive issues remain unresolved during the limited effective period of the Exemptive Order. For example, there is no particular guidance for a non-U.S. parent company that guarantees swap obligations of its U.S. subsidiary on whether to include or exclude swaps entered into by such subsidiary with non-U.S. counterparties. Similarly, there is no particular guidance for a U.S. parent company that guarantees swap obligations of its non-U.S. subsidiary on whether to include or exclude swaps entered into by such subsidiary with non-U.S. counterparties.

RELIEF FROM ENTITY-LEVEL AND TRANSACTION-LEVEL REQUIREMENTS

The Exemptive Order provides non-U.S. SDs and non-U.S. MSPs with relief until July 12, 2013 from compliance with all of the Entity-Level Requirements² other than swap data repository (“SDR”) and large trader reporting (“LTR”) requirements with respect to swaps with U.S. Persons. However, temporary relief from such SDR reporting and LTR requirements with respect to swaps with non-U.S. Persons is available only if a non-U.S. SD or non-U.S. MSP is not part of an affiliated group, in which the ultimate parent is a U.S. SD or MSP, bank, financial holding company or bank holding company.

² Entity-Level Requirements, which apply to SDs and MSPs across all of their swaps without distinction as to the counterparties or the location of the swaps, are the following: (1) capital adequacy requirement, (2) chief compliance officer, (3) risk management, (4) swap data recordkeeping, (5) SDR reporting and (6) large trader reporting.

Non-U.S. SDs or non-U.S. MSPs are not required to comply with any of the Transaction-Level Requirements³ until July 12, 2013, except to the extent required by applicable local laws.

Foreign Branches of a U.S. SD

The Exemptive Order provides relief until July 12, 2013 from compliance with the Transaction-Level Requirements to a foreign branch of a U.S. SD or U.S. MSP with respect to a swap with a foreign branch of another U.S. SD or U.S. MSP. This relief is provided as the CFTC is working with international regulators regarding the treatment of foreign branches of U.S. SD or MSP. However, this temporary relief is available only if (i) the personnel negotiating and agreeing to the swap terms are located in the jurisdiction of the relevant foreign branch, (ii) the documentation of the relevant swap specifies that the counterparty (or the “office” of the U.S. counterparty) is a foreign branch and (iii) the swap is entered into by the foreign branch in the normal course of business.

Privacy and Confidentiality Laws

The CFTC notes that it has recently granted time-limited no-action relief to parties from the provisions of Parts 20, 45 and 46 when such regulations require the reporting of certain information revealing the identity of a counterparty or affiliated group where the reporting would violate the privacy laws of a relevant non-U.S. jurisdiction. In light of the no-action relief, the CFTC stated that it will not grant further relief in the Exemptive Order.

CFTC Declines to Broaden Exemptions for Transaction-Level Requirements

The CFTC stated in the release adopting the Exemptive Order that:

- U.S. SDs and U.S. MSPs will be fully subject to the Entity-Level and Transaction-Level Requirements (other than limited relief available to foreign branches of U.S. SDs and U.S. MSPs described above); and
- All swap-related requirements (such as reporting, recordkeeping and clearing requirements) applicable to non-SDs and non-MSPs will apply to non-U.S. Persons that are not SDs or MSPs (so that, for example, a swap between a non-U.S. Person that is not

³ Transaction-Level Requirements apply on a transaction-by-transaction basis and are the following: (1) clearing and swap processing, (2) margining and segregation for uncleared swaps, (3) trade execution, (4) swap trading relationship documentation, (5) portfolio reconciliation and compression, (6) real-time public reporting, (7) trade confirmation, (8) daily trading records and (9) external business conduct standards.

an SD or MSP and a foreign branch of a U.S. Person that is not an SD or MSP will be fully subject to such requirements).

COMPLIANCE PLANS AND GOOD FAITH COMPLIANCE

The CFTC had previously proposed that a person seeking relief should submit to the National Futures Association a compliance plan that addresses how it plans to comply with the applicable requirements. However, the CFTC has determined that the submission of the compliance plan is not required in connection with the phasing in of compliance during the limited timeframe of the effectiveness of the Exemptive Order.

The CFTC also clarifies that it does not intend to bring enforcement actions against an SD or MSP for failing to comply with applicable requirements prior to July 12, 2013, as long as there is a practical or technical impediment to compliance that results in a party's inability to comply with the relevant compliance deadlines and such party is acting reasonably and in good faith to fully comply, which includes:

- Material progress toward timely implementation and compliance;
- Identification of any implementation or interpretative issue as soon as reasonably possible;
- Timely elevation of such issues to the SD's or MSP's senior management for consideration and resolution; and
- Timely consultation with other industry participants and the CFTC as necessary to seek resolution of such issue.

FURTHER PROPOSED GUIDANCE AND COMMENTS

Aggregation of Affiliates' Swaps for SD Calculation

In the Further Cross-Border Guidance, the CFTC proposed an alternative interpretation of the swap notional amounts aggregation rule and asked parties to provide comments. Under the alternative interpretation, the CFTC proposes to require a non-U.S. Person to include the aggregate notional amounts of swap dealing entered into by all of its affiliates under common control (both U.S. and non-U.S. affiliates), but to exclude the aggregate notional amounts of swap dealing entered into by any non-U.S. affiliate under common control that is registered as an SD.

Definition of “U.S. Person”

The CFTC proposes two alternative prongs to the definition of “U.S. Person”:⁴

- Prong (ii) of the “U.S. Person” definition would be modified as follows: “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);” and
- Prong (iv) of the “U.S. Person” definition in the Proposed Guidance with respect to commodity pools and collective investment vehicles would be modified as follows: “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.”

The CFTC seeks comments to these two alternative prongs.

* * *

Please do not hesitate to contact us with any questions.

January 16, 2013

⁴ For the proposed definition of “U.S. Person,” see Client Update “CFTC Issues Proposed Guidance on the Cross-border Application of the Commodity Exchange Act to Swap Transactions” <http://www.debevoise.com/clientupdate20120703a/>