Client Update

CFTC Proposes Rules on Cross-Border Application of Registration Thresholds and External Business Conduct Standards

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On October 11, 2016, the Commodity Futures Trading Commission ("CFTC") issued proposed rules and interpretations (the "Proposed Rules")[1] addressing the cross-border application of the registration thresholds and external business conduct standards for swap dealers ("SDs") and major swap participants ("MSPs").

The Proposed Rules modify the approach in the CFTC's 2013 cross-border guidance (the "2013 Guidance")[2] by adopting various aspects of the CFTC's cross-border margin rules for non-cleared swaps (the "Cross-Border Margin Rules")[3] for the purpose of the cross-border application of the SD and MSP registration thresholds and external business conduct standards. They include proposed definitions of the terms "U.S. person" and "Foreign Consolidated Subsidiary" that are based on the corresponding definitions provided in the Cross-Border Margin Rules.

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1 The text of the Proposed Rules is available at: http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2016-24905a.pdf.

2 For additional information on the 2013 Guidance, see our client memorandum, "CFTC Cross-Border Guidance, Temporary Exemptive Order and No-Action Letters," (July 24, 2013), available at: http://www.debevoise.com/insights/publications/2013/07/cftc-crossborder-guidance-temporary-exemptive-or__.

3 For additional information on the CFTC cross-border margin rules for non-cleared swaps, see our client memorandum, "CFTC Adopts Final Cross-Border Margin Rules for Non-Cleared Swaps" (June 30, 2016), available at: http://www.debevoise.com/insights/publications/2016/06/cftc-adopts-final-cross-border-margin.

The Proposed Rules also address the application of the SD and MSP registration thresholds and external business conduct standards to swap transactions that are arranged, negotiated, or executed using personnel located in the United States ("ANE transactions"), as well as the types of activities that fall within the scope of ANE transactions.

The CFTC expects to address the cross-border application of other applicable rules, including their application to ANE transactions, in future rulemakings.

Comments on the Proposed Rules are due by December 19, 2016.

DEFINITIONS OF U.S. PERSON AND FOREIGN CONSOLIDATED SUBSIDIARY

The Proposed Rules define the terms "U.S. person" and "Foreign Consolidated Subsidiary" in a manner consistent with the corresponding definitions in the Cross-Border Margin Rules. If adopted, the CFTC indicated that these definitions would also be used for future rulemakings addressing the cross-border application of other CFTC requirements under Title VII of the Dodd-Frank Act.

U.S. Person Definition

The Proposed Rules define "U.S. person" as follows:

- A natural person who is a U.S. resident and any estate of a decedent who was a U.S. resident at the time of death;
- A corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund or any similar form of entity (other than a U.S. Pension Plan or a U.S. Trust, as defined below) (a "Legal Entity"), in each case that is organized or incorporated under U.S. law or has its principal place of business in the United States,[4] including any branch of such legal entity (a "U.S. Legal Entity");
- A pension plan for the employees, officers or principals of a U.S. Legal Entity that is not primarily for foreign employees of such entity (a "U.S. Pension Plan");
- 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) (a "U.S. Trust");

[4] The Proposed Rules interpret the phrase "principal place of business" in a manner consistent with the Cross-Border Margin Rules, including with respect to its application to funds.

- A 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) owned by one or more of the persons listed above who bear(s) unlimited responsibility for the obligations and liabilities of the Legal Entity, including any branch of the Legal Entity; and
- Any individual account or joint account (discretionary or not) where the beneficial owner (or one of the beneficial owners, for a joint account) is a person described above.

This definition is the same as the "U.S. person" definition in the Cross-Border Margin Rules. It is also generally consistent with the "U.S. person" definition in the 2013 Guidance, with two notable exceptions:

- The definition in the Proposed Rules does not include collective investment vehicles that are not organized under U.S. laws or located in the United States but that are majority-owned by U.S. persons; and
- The definition in the Proposed Rules is framed as an exhaustive list of the types of individuals and entities that are U.S. persons, whereas the list in the 2013 Guidance is framed as non-exhaustive.

Foreign Consolidated Subsidiary Definition

The Proposed Rules define a "Foreign Consolidated Subsidiary" ("FCS") as a non-U.S. person whose operating results, financial position and statement of cash flows are consolidated (in accordance with U.S. GAAP) with those of an ultimate parent entity[5] that is a U.S. person. This definition of FCS is consistent with the definition in the Cross-Border Margin Rules.

In the Proposed Rules, the CFTC clarifies that FCSs should include relevant swaps toward their SD or MSP registration calculation in the same way as a U.S. person (or U.S. Guaranteed Entity). However, the CFTC notes that it may not necessarily treat FCSs the same as U.S. persons (or U.S. Guaranteed Entities) in the context of other Title VII requirements, and that it expects to address the application of such other requirements (*e.g.*, trade execution and clearing) to FCSs' cross-border transactions in future rulemakings (including whether, and to what extent, substituted compliance should be available).

[5] The Proposed Rules define "ultimate parent entity" as the parent entity in a consolidated group in which none of the other entities in the consolidated group has a controlling interest (under U.S. GAAP).

CROSS-BORDER APPLICATION OF THE REGISTRATION THRESHOLDS FOR SDs AND MSPs

Swap Dealer Registration

The Proposed Rules address when an entity's cross-border swap dealing activities should be counted towards the *de minimis* threshold for SD registration purposes:

- A U.S. person or a FCS must include all of its swap dealing transactions toward the *de minimis* threshold for SD registration.
- A non-U.S. person must include all of its swap dealing transactions that are guaranteed by a U.S. person (when such non-U.S. person's swaps are guaranteed by a U.S. person, a "U.S. Guaranteed Entity")[6] toward the *de minimis* threshold for SD registration.

A non-U.S. person that is not a FCS or a U.S. Guaranteed Entity (an "Other Non-U.S. Person") must include in its *de minimis* calculation its swap dealing transactions with U.S. persons, U.S. Guaranteed Entities, and FCSs, but may exclude its swap dealing transactions with Other Non-U.S. Persons (even where they constitute ANE transactions).

Additionally, Other Non-U.S. Persons need not include any swap that is executed anonymously on a registered designated contract market ("DCM"), swap execution facility ("SEF") or foreign board of trade ("FBOT") and is cleared through a registered or exempt derivatives clearing organization ("DCO").

The Proposed Rules' treatment of non-U.S. persons for purposes of the SD *de minimis* calculation differs from the 2013 Guidance in several respects, including:

- While the Proposed Rules' treatment of U.S. Guaranteed Entities and U.S. persons is generally consistent with the 2013 Guidance, the Proposed Rules

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[6] As is the case under the Cross-Border Margin Rules, whether a non-U.S. person is a U.S. Guaranteed Entity under the Proposed Rules is determined on a swap-by-swap basis, based on whether the non-U.S. person's obligations under the particular swap transaction are guaranteed by a U.S. person. The definition of "guarantee" is consistent with the corresponding definition in the Cross-Border Margin Rules (*i.e.*, an arrangement (whether written or not) pursuant to which a party to a swap has legally enforceable rights of recourse against a guarantor with respect to its counterparty's obligations under the swap (even where the guarantor is not affiliated with the guaranteed non-U.S. person counterparty and whether or not the rights of recourse are contingent upon such counterparty's insolvency or failure to meet its obligations under the swap or upon the guaranteed party having first made a demand for payment or performance from the non-U.S. counterparty before proceeding against the guarantor)).

add the category of FCSs, which are also required to count all of their swap dealing activity toward the *de minimis* threshold (regardless of counterparty).

- The Proposed Rules do not include a separate category for "affiliate conduits" as in the 2013 Guidance.[7]
- While the Proposed Rules' treatment of Other Non-U.S. Persons is generally consistent with the 2013 Guidance (with respect to non-U.S. persons that are not guaranteed affiliates or affiliate conduits), the Proposed Rules do not allow such non-U.S. persons to exclude transactions with foreign branches of U.S. SDs from the calculation.

The Proposed Rules, like the 2013 Guidance, apply the aggregation principles to all affiliates in a corporate group, whether they are U.S. or non-U.S. persons. Therefore, all potential SDs, whether U.S. or non-U.S. persons, must aggregate their swap dealing transactions with those of their affiliates under common control with the potential SD, unless such affiliates are themselves registered SDs. When an affiliated group's swap dealing activities exceed the *de minimis* threshold in the aggregate, one or more affiliates (whether a U.S. or non-U.S. person) would need to register as an SD so that the relevant dealing activity of the unregistered affiliates remains below the threshold.

Major Swap Participant Registration

The Proposed Rules use the same cross-border framework for MSP threshold calculations as described above for SD threshold calculations, requiring potential MSPs to count swap positions toward the MSP threshold to the same extent as the swap dealing entities are required to count dealing transactions toward the SD threshold.

For purpose of the MSP threshold calculation, the swap positions of an entity (whether a U.S. or non-U.S. person) should be attributed to the parent, affiliate or guarantor only to the extent the counterparties to those positions have recourse to the parent, affiliate or guarantor, and even in the presence of such recourse, attribution should not be required if the entity that entered into the swap is subject to capital regulation by the CFTC, the SEC or a U.S. prudential regulator. However, where such an entity is not subject to such capital regulation, swap positions that are subject to recourse are attributed to a guarantor unless

[7] The 2013 Guidance treated "affiliate conduits" (*i.e.*, entities that function as a conduit or vehicle for U.S. persons conducting swaps with third parties) the same as U.S. persons and guaranteed affiliates for this purpose, requiring such entities to count all of their dealing activity toward the SD *de minimis* threshold.

the guarantor, the guaranteed entity and its counterparty are Other Non-U.S. Persons.

CROSS-BORDER APPLICATION OF EXTERNAL BUSINESS CONDUCT STANDARDS

The Proposed Rules require a U.S. SD or MSP ("U.S. SD/MSP") to comply with the external business conduct standards in Part 23 of the CFTC Regulations for all swaps, without substituted compliance, except with respect to swaps conducted through its foreign branches.

A Non-U.S. SD/MSP (including a FCS and a Guaranteed Entity) and foreign branches of U.S. SD/MSP must comply with the external business conduct standards for swaps with U.S. person counterparties (other than a counterparty that is the foreign branch of a U.S. SD/MSP), without substituted compliance.

A Non-U.S. SD/MSP (including a FCS and a Guaranteed Entity) and foreign branches of U.S. SD/MSP generally do not need to comply with the external business conduct standards with respect to swaps with non-U.S. SDs/MSPs (including FCSs and Guaranteed Entities) and foreign branches of U.S. SDs/MSPs. The sole exception to this is that foreign branches of a U.S. SD and a non-U.S. SD that use personnel located in the United States to arrange, negotiate, or execute a swap (or a swap that is offered but not entered into) must comply with CFTC Regulations 23.410 (Prohibition on Fraud, Manipulation, and other Abusive Practices) and 23.433 (Fair Dealing).

TRANSACTIONS THAT ARE "ARRANGED, NEGOTIATED, OR EXECUTED" IN THE UNITED STATES

DSIO Advisory

In 2013, the Division of Swap Dealer and Intermediary Oversight (the "DSIO") of the CFTC issued an advisory (the "DSIO Advisory")[8] regarding the applicability of the CFTC's "transaction-level requirements"[9] (including the external business conduct standards) to ANE transactions.

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[8] CFTC Staff Advisory 13-69 (Nov. 14, 2013), available at: http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/13-69.pdf.

[9] "Transaction-level requirements" include (1) clearing and swap processing, (2) margin (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.

The DSIO Advisory states that a non-U.S. SD "regularly using personnel or agents located in the United States to arrange, negotiate or execute a swap with a non-U.S. person" generally would be required to comply with the CFTC's transaction-level requirements (including with respect to its transactions with non-U.S. persons) because such activities are "core, front-office activities" of the non-U.S. SD's dealing business.

Application of Title VII Requirements to ANE Transactions

In the Proposed Rules, the CFTC clarifies that arranging, negotiating or executing swaps are functions that fall within the scope of the "swap dealer" definition, and that because non-U.S. persons engaged in ANE transactions conduct "a substantial aspect of their swap dealing activity within the United States," ANE transactions may fall within the scope of the Dodd-Frank Act even where counterparty risks reside primarily outside the United States.

In making a determination as to whether a particular Title VII requirement should apply to an ANE transaction, the CFTC will consider the extent to which the underlying regulatory objectives would be advanced in light of other policy considerations, including the potential for undue market distortions and international comity.

Scope of ANE Transactions

For purposes of the Proposed Rules, the terms "arrange" and "negotiate" refer to market-facing activities normally associated with sales and trading, and "execute" refers to the market-facing act of becoming irrevocably bound to the terms of the swap under applicable law.

The Proposed Rules distinguish "arranging" and "negotiating" a swap from internal, back-office activities, such as ministerial or clerical tasks, performed by personnel not involved in the actual sale or trading of the swap. The terms do not encompass swap processing, preparation of the underlying swap documentation (including negotiation of a master agreement and related documentation) or the mere provision of research information to sales and trading personnel located outside the United States.

In applying the Proposed Rules, the CFTC would look to the activities of personnel assigned to (on an ongoing or temporary basis) or regularly working in a U.S. location, whether such U.S. personnel are working directly for the dealing entity itself or for a third-party agent of the dealing entity. The mere fact that such U.S. personnel are not formally designated as sales persons or traders is

irrelevant for this purpose; a transaction would be an ANE transaction if such U.S. personnel are involved in market-facing sales and trading activities.

On the other hand, the swap activities of personnel who are "only incidentally present in the United States" when they arrange, negotiate, or execute the transaction (*e.g.*, an employee of a non-U.S. entity that happens to be attending a conference in the United States) may be disregarded for this purpose.[10]

To prevent evasion, a transaction would be in scope as an ANE transaction if personnel located in the United States direct other personnel located outside the United States to arrange, negotiate or execute the transaction for or on behalf of the dealing entity. In addition, the reason for involving U.S. personnel in arranging, negotiating or executing a transaction is irrelevant for this purpose.

The CFTC notes that the use of algorithmic (or automated) trading to execute a swap will not cause the swap to fall outside the scope of the Title VII requirements. A swap transaction involving algorithmic trading may be an ANE transaction if U.S. personnel specify the trading strategy or techniques carried out through algorithmic trading.

The Proposed Rules' approach to the scope of ANE transaction is consistent with the approach of the Securities and Exchange Commission ("SEC") with respect to security-based swaps.[11] The CFTC, like the SEC, does not limit the scope of ANE transactions to swaps that are "regularly" arranged, negotiated or executed using U.S. personnel. Therefore, a dealing entity may need to establish operational structures to identify swaps for which U.S. personnel are involved in performing market-facing activities. However, the CFTC expects that the burden of this trade-by-trade analysis will be mitigated by the Proposed Rules' focus on personnel assigned to or regularly working in a U.S. location and the exclusion of incidental activity. The CFTC also expects that dealing entities should generally have existing means of identifying personnel involved in market-facing activities (*e.g.*, for purposes of compliance or compensation), and that such entities may adopt policies and procedures requiring dealing activity to be arranged, negotiated or executed solely by non-U.S. personnel.

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[10] As another example, the involvement of a U.S.-based attorney in negotiations regarding the terms of a swap transaction would not, by itself, render the transaction an ANE transaction.

[11] See our client memorandum, "SEC Final Cross-Border Rules on "Arranging, Negotiating, or Executing" Security-Based Swaps and the *De Minimis* Exception," (Feb. 24, 2016), available at: http://www.debevoise.com/insights/publications/2016/02/sec-final-cross.

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Please do not hesitate to contact us with any questions.