

CFTC Issues Final Exemptive Order on Cross-Border Application of Certain Swap Regulations

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Mark D. Young
Washington, D.C.
202.371.7680
mark.d.young@skadden.com

Maureen A. Donley
Washington, D.C.
202.371.7570
maureen.donley@skadden.com

Theodore M. Kneller
Washington, D.C.
202.371.7264
ted.kneller@skadden.com

Ryan K. Elsey
Washington, D.C.
202.371.7317
ryan.elsey@skadden.com

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1440 New York Avenue, NW,
Washington, D.C. 20005
Telephone: 202.371.7000

Four Times Square, New York, NY 10036
Telephone: 212.735.3000

WWW.SKADDEN.COM

Swaps trade in a global market. Title VII of the Dodd-Frank Act amended the Commodity Exchange Act (CEA) to impose a panoply of regulation on the swaps market mostly through regulations adopted by the Commodity Futures Trading Commission (CFTC). In Dodd-Frank, Congress expressed its intent to have the CFTC's regulations apply to the global swap market, including activity outside of the United States, if that activity has a "direct and significant connection with activities in, or effect on, commerce of the United States."¹

Until recently, however, the CFTC had provided scant guidance as to how the new regulatory requirements would apply to cross-border swaps (*i.e.*, swaps with at least one counterparty that is a non-U.S. person). On December 21, 2012, the CFTC took a major step toward providing clarification through a final exemptive order that provides time-limited relief to certain cross-border market participants.²

The final exemptive order narrows the definition of "U.S. person" for the purposes of the order and provides "non-U.S. persons" with relief from various aspects of compliance. The relief is effective only until July 12, 2013.³ By that time, the CFTC hopefully will have finalized its cross-border guidance, which should provide more enduring certainty about the extraterritorial reach of the CFTC's jurisdiction over swaps.

U.S. Person Definition

The foundation of the final exemptive order is a revised and narrowed definition of "U.S. person" that includes only the following five categories:⁴

- A natural person who is a U.S. resident;
- A corporation, partnership, LLC, trust, association, joint-stock company, fund or other similar enterprise that 1) is incorporated in the U.S. or 2) has its principal place of business in the U.S.;⁵
- A pension plan for the employees of the entities listed above, unless the plan is "primarily for foreign employees" of the entity;
- An estate of someone who was a resident of the U.S. at the time of death, or a trust "governed by the laws of a state or other jurisdiction" in the U.S. if a court within the U.S. can exercise primary supervision over the trust's administration; and
- Individual or joint accounts for which a beneficial owner is a person within the scope of the above categories.

1 7 U.S.C. § 2(i).

2 "Final Exemptive Order Regarding Compliance with Certain Swap Regulations," 78 Fed. Reg. 858 (Jan. 7, 2013).

3 See 78 Fed. Reg. at 859.

4 *Id.* at 863.

5 The principal place of business requirement is effective starting April 1, 2013, and does not apply to funds or collective investment vehicles. *Id.* at 879.

Consistent with the CFTC's proposed cross-border guidance, branches and agencies of a person will have the same U.S. person status as the principal entity. Therefore, foreign branches of U.S. banks will be considered U.S. persons.⁶ Any entity not covered by these five categories is considered a "non-U.S. person" for the purposes of the final order.⁷

The definition of U.S. person — while only temporary — is much narrower than the definition the CFTC initially proposed.⁸ The CFTC had proposed that U.S. persons would include, in addition to the categories in the final order, entities for which the owners are responsible for the entity's liabilities and at least one owner is a U.S. person. The proposed definition also included commodity pools, pooled investment accounts and collective trusts of which 1) the operator is required to register as a commodity pool operator or 2) U.S. persons have direct or indirect majority ownership. Additionally, pension plans for an entity with its principal place of business in the U.S. would have been U.S. persons. Finally, all estates and trusts subject to U.S. income tax fell within the definition.

The CFTC has signaled an intent to expand the U.S. person definition when it adopts the final cross-border guidance. In a companion Federal Register notice to the final exemptive order, the CFTC has proposed to include as U.S. persons some non-U.S. business organizations that are majority-owned by U.S. persons where the owners are responsible for the obligations of the entity as well as certain commodity pools and other collective investment vehicles that are majority-owned by U.S. persons.⁹ Comments on this proposal must be received on or before February 6, 2013.

Effect of Non-U.S. Person Status on Swap Dealer and Major Swap Participant Threshold Calculations

The remainder of the final exemptive order addresses how the swaps provisions of the CEA and the CFTC's regulations will apply to non-U.S. persons that may register as swap dealers (SDs) or major swap participants (MSPs). The final exemptive order does not address compliance obligations of non-SD/MSP market participants. One impact of the final exemptive order relates to the calculations for determining whether an entity meets the thresholds of swaps activity requiring registration as a SD or MSP.¹⁰ To determine the threshold calculations for registering as a SD or MSP, the final exemptive order permits a non-U.S. person to exclude the following swaps:¹¹

- Swaps with a counterparty that also is a non-U.S. person.
- Swaps with a counterparty that is a foreign branch of a U.S. person that is registered as a SD or that represents that it intends to register by March 31, 2013.
- For SDs only, swaps of which the non-U.S. person is not a party because "the swap is entered into by an affiliated central booking entity."

Additionally, for the purposes of aggregating swap positions to determine if an entity exceeds the \$8 billion notional amount swap dealer de minimis level, a non-U.S. person engaged in swap dealing activities with U.S. persons may exclude the following swaps:¹²

⁶ See 78 Fed. Reg. at 865.

⁷ See *Id.* at 879.

⁸ See "Exemptive Order Regarding Compliance With Certain Swap Regulations," 77 Fed. Reg. 41110 (Jul. 12, 2012); "Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act," 77 Fed. Reg. 41214, 41218 (Jul. 12, 2012).

⁹ "Further Proposed Guidance Regarding Compliance with Certain Swap Regulations," 78 Fed. Reg. 909 (Jan. 7, 2013).

¹⁰ See Definitions of Swap Dealer and Major Swap Participant, 17 C.F.R. § 1.3(ggg)-(hhh) (2012).

¹¹ 78 Fed. Reg. at 879.

¹² *Id.*

- The aggregate gross notional value of swaps from its U.S. affiliates' swap dealing activities.
- The aggregate gross notional value of swap dealing of any non-U.S. affiliate that is swap dealing with U.S. persons as of the date of the order or is registered as a SD, if the non-U.S. person is an affiliate of a registered SD.
- The aggregate gross notional value of its non-U.S. affiliates' swap dealing activities with non-U.S. counterparties.

In all of these exceptions, according to the CFTC, an entity may reasonably rely on a counterparty's representation regarding the counterparty's U.S. person status.¹³

Effect of Non-U.S. Person Status on SD/MSP Compliance

The CFTC's proposed cross-border guidance and exemptive order would have divided swap rules into two categories for SDs and MSPs — entity-level requirements and transaction-level requirements. The final exemptive order retains this distinction (using the same categories as the proposed order) and, like the proposed order, allows non-U.S. SDs and MSPs to delay compliance with some but not all entity-level requirements and transaction-level requirements under the CFTC's regulations.¹⁴

Entity-level requirements are designed to manage risks to the SD as a whole. These requirements include capital adequacy, risk management, large trader reporting, recordkeeping and swap data repository (SDR) reporting. During the effectiveness of the order, non-U.S. SDs and MSPs can delay compliance with all entity-level requirements except for SDR reporting and large trader reporting as to swaps with U.S. counterparties.¹⁵ Non-U.S. SDs and MSPs that are affiliated with a parent that is a U.S. person that is an SD, MSP, bank, financial holding company or bank holding company must, however, comply with SDR and LTR reporting requirements for transactions with non-U.S. counterparties as well.

As for transaction-level requirements, non-U.S. SDs and MSPs have to comply with all requirements in effect as to transactions with U.S. counterparties. These requirements include but are not limited to external business conduct standards, recordkeeping, clearing for applicable transactions, and real-time public reporting. But, when entering into swaps with non-U.S. counterparties, non-U.S. SDs and MSPs need only comply with transaction-level requirements as may be required in the SDs' or MSPs' local jurisdiction.¹⁶

What effect does the final order have on the compliance dates for SDs and MSPs that are U.S. persons?

The final order has limited effect for SDs and MSPs that are U.S. persons.¹⁷ Such entities must register and comply with all effective entity-level and transaction-level requirements. The only exception is that a foreign branch of a U.S. SD or MSP, at least as to swaps with non-U.S. persons or with other foreign branches of U.S. SDs or MSPs, may comply with transaction-level requirements only as required in the local jurisdiction of the branch.¹⁸

13 See *Id.* at 864.

14 See *Id.* at 879.

15 See *Id.*

16 See *Id.* at 880.

17 See *Id.*

18 See *Id.*

Conclusion

While the CFTC's final exemptive order clarifies the scope of Dodd Frank's cross-border application to swaps, the effect is limited. The relief available under the order expires July 12, 2013. It is expected that sometime before July 12, 2013, the CFTC will adopt final cross-border guidance, which may modify certain aspects of the final order, including the definition of U.S. person. The final cross-border guidance also should explain how the CFTC's jurisdiction will impact non-SD/MSP market participants. In sum, until the CFTC adopts this final guidance, much uncertainty will remain about the impact of Title VII of Dodd-Frank on cross-border swaps.