

## Proposed CFTC Guidance Regarding the Cross-Border Application of US Swap Regulations

On Friday, June 29, 2012, the US Commodity Futures Trading Commission (the “CFTC”) released its proposed interpretive guidance and policy statement (the “Proposed Guidance”) regarding the cross-border application of the swaps provisions of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”).<sup>1</sup> The Proposed Guidance complements the recent adoption by the CFTC and the US Securities and Exchange Commission (the “SEC”) of their joint final rules (the “Final Entities Rulemaking”) further defining the terms “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” and “Major Security-Based Swap Participant,” all of which were added to the Commodity Exchange Act (the “CEA”) and the Securities Exchange Act of 1934 by the Dodd-Frank Act.<sup>2</sup> The Proposed Guidance addresses both (i) when non-US persons, including legal entities, must register as a swap dealer or major swap participant (“MSP”), and (ii) the extent to which a non-US person will be subject to the substantive regulatory requirements applicable to registered swap dealers and MSPs.

We identify and summarize below key aspects of the Proposed Guidance, including page references to the version of the Proposed Guidance posted on the CFTC’s website. Comments on the Proposed Guidance are due 45 days after publication in the Federal Register, which is expected shortly. The SEC has announced plans to issue its separate release on

cross-border issues for security-based swap dealers and major security-based swap participants later this summer.

Even before it was released, the Proposed Guidance was already controversial and is likely to generate substantial comment. The CFTC’s public meeting to discuss and approve the guidance was cancelled almost two weeks ago because of the lack of consensus among the Commissioners. Both of the Republican Commissioners, Scott O’Malia and Jill Sommers, issued “concurring statements” supporting the issuance of the proposed guidance in order to begin a public dialogue, but also raising significant concerns about it. Among the themes they raise are the lack of full rulemaking process (e.g., the lack of any cost-benefit analysis), inadequate coordination with the SEC on its companion cross-border release and with non-US regulators, a continued overreach by the CFTC in interpreting the extraterritorial application of Title VII, a vague approach to comparability determinations for non-US regulatory systems, and lack of fair treatment of US market participants.

In connection with the Proposed Guidance, the CFTC also released a proposed exemptive order (the “Proposed Order”) that would conditionally permit swap dealers and MSPs that are not US persons (as defined in the Proposed Guidance) to: (i) defer compliance with certain swap Entity-Level Requirements (as defined below) until 12 months after publication of the

Proposed Order; and (ii) satisfy certain swap Transaction-Level Requirements (as defined below) through so-called “substituted compliance” with applicable non-US law.<sup>3</sup> The Proposed Order would not, however, delay swap dealer and MSP registration deadlines for non-US persons. We will be covering the Proposed Order in a separate Legal Update.

## Definition of “US Person”

**General Definition.** Much of the Proposed Guidance is dependent upon whether one or both parties to a swap transaction is a “US person.” Many earlier commenters had proposed that the CFTC adopt the SEC’s Regulation S definition of US person. The CFTC rejected this suggestion, instead proposing to define US person as including, without being limited to, the following:<sup>4</sup>

1. any natural person who is a US resident;
2. any corporation, partnership, limited liability company, trust, association, joint-stock company, fund, or any similar enterprise (A) that is organized or incorporated under US law or has its principal place of business in the United States, or (B) the direct or indirect owners of which are responsible for liabilities of the enterprise and one or more of such owners is a US person;
3. any individual account (discretionary or not) where the beneficial owner is a US person;
4. any commodity pool, pooled account, or collective investment vehicle (whether or not organized in the United States) that is directly or indirectly majority-owned by US persons;
5. any commodity pool, pooled account, or collective investment vehicle the operator of which would be required to register with the CFTC as a commodity pool operator;
6. a pension plan for the employees, officers, or principals of a legal entity with its principal place of business in the United States; and
7. any estate or trust, the income of which is subject to US income tax (16).

**Non-US Branches of US Persons.** The Proposed Guidance expressly provides that a non-US branch or agency of a US person would be covered by the “US person” definition because the branch or agency “is a part, or an extension, of a US person” (16).

**Non-US Subsidiaries and Affiliates of US Persons.** The Proposed Guidance states that a non-US affiliate or subsidiary of a US person would not be within the scope of the definition, even if all swap-related obligations of such affiliate or subsidiary are guaranteed by a US person (16). The Proposed Guidance does not reconcile this statement with prong (2.) of the “US person” definition set forth above, which seems to provide that a non-US company guaranteed as to liabilities by its US owner is a US person. However, the CFTC states that it is considering, and seeks comment on, whether the definition of “US person” should be expanded to include a non-US affiliate or subsidiary that is guaranteed by a US person (16).

**Non-US Persons.** “Non-US person” is not formally defined in the Proposed Guidance. While logical, it is not clear that it would be defined as any person who is not a US person. Presumably a non-US bank with a US branch or agency would be treated as a non-US person.

## Swap Dealer *De Minimis* Calculation for Non-US Persons

Under the Final Entities Rulemaking, a person that engages in more than a *de minimis* level of swap dealing generally would be required to register as a Swap Dealer. However, under the Proposed Guidance, a non-US person would only count swap transactions with US persons

under the *de minimis* test. The Proposed Guidance modifies this general test in the following additional ways.

**Exclusion for Swaps with Non-US Branches of US Swap Dealers.** In determining whether its swap dealing activities exceed the *de minimis* threshold, a non-US person would not include dealing transactions with non-US branches of registered US swap dealers, e.g., the London branch of a US bank that had registered as a swap dealer (21).

**Aggregation Rules.** A non-US person would include in its *de minimis* calculations the swap dealing transactions with US persons of all of its non-US affiliates under common control and any swap dealing transactions of non-US affiliates under common control the obligations of which are guaranteed by a US person (21-22). However, swap dealing transactions of affiliated US persons would not be included in the *de minimis* calculation (22). The Proposed Guidance does not expressly state whether a non-US bank should aggregate the swap dealing activities of its US branch or agency for these purposes. However, in light of the CFTC's apparent rejection of the argument that a US branch of a non-US bank is a separate legal entity subject to independent swap dealer registration (discussed further below), it would appear that the swap dealing activities of a non-US bank for purposes of the *de minimis* calculation would be deemed to include swaps of its US branch or agency, at least with US counterparties.

**Guarantee Relationships.** A non-US person (e.g., a non-US subsidiary of a US bank) must include any swap dealing transactions where its obligations (or the obligations of its non-US affiliate) are guaranteed by a US person, such as its US parent bank. This includes swap dealing transactions with non-US counterparties that would not otherwise be included (26-27).

**Inter-Affiliate Swaps.** A non-US person would not include transactions with its US affiliates that are majority-owned. The Proposed Guidance does not address transactions between a non-US bank and its US branch, but presumably these would also not be included (20-21, FN 43).

### MSP Threshold Calculations for Non-US Persons

Similarly, the MSP thresholds established under the Final Entities Rulemaking are modified for non-US persons. In particular, a non-US person who is not a swap dealer must only count swap positions with counterparties who are US persons when assessing whether MSP registration is required (24). That is, swap positions with a counterparty who is not a US person are generally not included in determining whether a non-US person's swap positions exceed the MSP thresholds.

**Swaps with Non-US Branches of US Persons.** The Proposed Guidance does not provide any exclusion for swaps between a non-US person and the non-US branch of a US person for purposes of the MSP threshold calculations, including non-US branches of registered US swap dealers. Accordingly, a non-US person would be required to count its swap positions where a non-US branch of a US person is the counterparty, even if the US person is a swap dealer. The CFTC has requested comment on whether the proposed exclusion of swaps with non-US branches of registered US swap dealers that would apply in the context of swap dealer *de minimis* calculations should also apply for purposes of MSP threshold calculations (32).

**Swaps with Non-US Persons Guaranteed by US Persons.** Unlike for purposes of the swap dealer *de minimis* calculation, a non-US person would exclude from its MSP threshold calculations any swap positions with a US counterparty where the obligations of the non-

US person are guaranteed by a US person (26-27). In such cases, the swap position is instead attributed to the US guarantor. A non-US person would include in its MSP threshold calculations any guarantees it provides with respect to the obligations of another non-US person in a swap transaction with a US person (28).

## Treatment of Branches and Agencies for Registration Purposes

**Non-US Branches and Agencies of US Banks.** Under the Proposed Guidance, swap dealer and MSP registration requirements for US persons would apply to banks at the principal entity level—i.e., non-US branches and agencies of US banks would not separately register (28).

**US Branches and Agencies of Non-US Banks.** The Proposed Guidance does not directly address how swap dealer and MSP registration and related requirements would apply to the US branches and agencies of non-US banks. The CFTC begins to address the question of whether US branches could be eligible for registration and regulation on an independent basis, but does not provide a clear answer (29-30, FN 54). Instead, in footnote 54 of the Proposed Guidance, the CFTC directs readers to further discussion of this issue in a “subsection E,” which does not appear in the published text of the Proposed Guidance. Based on the treatment of non-US branches of US banks and the CFTC’s apparent rejection of the argument that branches should be treated as separate legal entities, it seems unlikely that US branches of non-US banks would be eligible to register as swap dealers or MSPs. However, the lack of clear guidance on this point and the possibility that the CFTC elected to strike further clarification during the editing process may signal a lack of consensus among the Commissioners.

## Application of Entity-Level and Transaction-Level Requirements to Swap Dealers and MSPs That Are Not US Persons

In determining whether and to what extent Title VII will apply extraterritorially, the CFTC proposes to divide these provisions conceptually into (i) “Entity-Level Requirements,” which apply to a swap dealer or MSP on a firm-wide basis and (ii) “Transaction-Level Requirements,” which apply to an individual swap (36).<sup>5</sup>

- **Entity-Level Requirements:** capital adequacy; chief compliance officer; risk management; swap data recordkeeping; swap data reporting (“SDR Reporting”); and physical commodity swaps reporting (“Large Trader Reporting”) (37-43).
- **Transaction-Level Requirements:** clearing and swap processing; margining and segregation for uncleared swaps; trade execution; swap trading relationship documentation; portfolio reconciliation and compression; real-time public reporting; trade confirmation; daily trading records; and external business conduct standards (43-49).

**Applicability of Entity-Level Requirements.** The Proposed Guidance would require that swap dealers and MSPs that are not US persons comply with all Entity-Level Requirements, subject to the potential availability of “substituted compliance” with non-US regulation, as discussed below (50).

**Applicability of Transaction-Level Requirements – US Counterparties.** Swap dealers and MSPs that are not US persons would generally be required to comply with Transaction-Level Requirements only for swaps with US persons as counterparties (excluding the non-US branches of US persons) (52,55). Substituted compliance generally would not be available for these requirements.

### **Applicability of Transaction-Level Requirements – Non-US Counterparties.**

Swap dealers and MSPs that are non-US persons would not be required to comply with Transaction-Level Requirements for swaps with non-US counterparties unless the performance of the non-US counterparty is guaranteed (or otherwise supported) by a US person (55). Compliance generally would be required in the case of such guaranteed transactions (except with respect to the external business conduct standards, which would never apply to the swaps of a swap dealer or MSP that is not a US person with a non-US counterparty) (55-56). Substituted compliance would generally be permitted for swaps with a non-US person guaranteed by a US person (53-55, 59).

**Conduits for US Persons.** Notwithstanding that Transaction-Level Requirements generally would not apply to swaps between a swap dealer or MSP that is a non-US person and a non-US counterparty (unless there is US guarantor), the Proposed Guidance includes a special rule that would impose these requirements on transactions with non-US “conduits” for US persons. Under this rule, the Transaction-Level Requirements would apply to swaps with a non-US person where: (i) the non-US person is majority-owned by a US person, (ii) the non-US person regularly enters into swaps with other US affiliates or subsidiaries of the US person, and (iii) the non-US person is consolidated with the US person for financial statement purposes (55). Substituted compliance may be permitted.

### **Substituted Compliance with Non-US Swaps Regulation by Swap Dealers and MSPs Who Are Not US Persons**

Under the Proposed Guidance, a swap dealer or MSP that is not a US person would be permitted, under certain circumstances, to conduct business in compliance with home country regulations without satisfying additional

requirements arising under US law (56-57). This substituted compliance would only be available upon a specific finding by the CFTC that the non-US home country requirements are “comparable to cognate requirements under the CEA and [CFTC] regulations” (57). The CFTC proposes to make such comparability determinations on an individual requirement basis—i.e., not as to non-US regimes as a whole (57).

**Entity-Level Requirements.** The CFTC proposes to permit substituted compliance with respect to all Entity-Level Requirements where swap dealers or MSPs that are not US persons are subject to comparable non-US home-country regulation (58). Under this framework, a swap dealer or MSP that is not a US person would be permitted to meet its SDR reporting obligations by reporting to a non-US trade repository, but only if the CFTC has direct access to swap data stored with the non-US repository (58).

**Transaction-Level Requirements.** Substituted compliance generally would not be available for transactions by a swap dealer or MSP that is not a US person with a counterparty that is a US person (59). However, substituted compliance for Transaction-Level Requirements would be permitted for swaps with a non-US person guaranteed by a US person or a non-US person that is a “conduit” for a US person (59).

**Comparability Determinations.** Before a swap dealer or MSP that is a non-US person may rely on substituted compliance, the CFTC must make a comparability and comprehensiveness determination with respect to the relevant laws and regulations of the non-US jurisdiction (68-69). The Proposed Guidance sets forth in general terms the procedure by which non-US persons—either individually, in connection with a swap dealer or MSP application, or as part of a group of non-US persons from the same jurisdiction—may apply to the CFTC to be permitted to rely on



substituted compliance (70-72). The Proposed Guidance also notes that non-US regulators may apply on behalf of persons subject to their jurisdiction (70). The CFTC anticipates the use of MOUs to establish protocols for information-sharing and cooperation as to swap dealer and MSP supervision (71-72).

### Application of Swap Provisions to Non-US Branches, Agencies, Affiliates and Subsidiaries of US Swap Dealers

**Non-US Branches and Agencies.** Because the non-US branch or agency of a US swap dealer is deemed part of that US person, the swap dealer would be responsible for compliance with all applicable Entity-Level Requirements for the swap dealing activities of its non-US branches and agencies (60). Under the Proposed Guidance, swaps entered into by a US person through a non-US branch or agency would also be subject to the Transaction-Level Requirements, regardless of whether the counterparty is a US person or non-US person (except for the external business conduct standards, which apply only in the case of US counterparties) (60).

**Non-US Branches and Agencies – Substituted Compliance.** The Proposed Guidance would permit substituted compliance with non-US regulatory requirements of the host jurisdiction by a non-US branch or agency for swaps with its non-US counterparties, subject to the required CFTC comparability determinations (60-61). Moreover, the Proposed Guidance would permit non-US branches and agencies of US swap dealers to participate in the swap markets in “emerging market” countries, subject to quantitative limits, any transaction-level

requirements applicable in those non-US jurisdictions and certain additional recordkeeping and risk management requirements (61,62).

**Non-US Subsidiaries and Affiliates.** The applicability of swap provisions to the non-US subsidiaries and affiliates of a US swap dealer turns on where swaps are booked and whether the non-US affiliate or subsidiary independently triggers the swap dealer registration requirement. Thus, swap dealer regulations would not apply to a non-US subsidiary or affiliate acting as a disclosed agent on behalf of the US swap dealer, provided that the non-US person does not itself trigger the swap dealer definition (63). Non-US subsidiaries and affiliates that enter into swaps that are not directly booked at the US swap dealer are treated in a manner consistent with other non-US persons (64).

### Swap Transactions of Other Market Participants That Are Not US Persons

**Swaps Between Non-US Persons.** Where a non-US person enters into a swap with another non-US person outside the United States and neither counterparty is required to register as a swap dealer or MSP, the swap generally would not be subject to swap regulations arising under Title VII of the Dodd-Frank Act (75).

**Swaps Between a US Person and Non-US Person.** Under the Proposed Guidance, swaps involving at least one party that is a US person would be subject to Title VII requirements relating to clearing, trade-execution, real-time public reporting, Large Trader Reporting, SDR Reporting, and recordkeeping (i.e., those swap provisions that apply to counterparties other than swap dealers and MSPs).

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## Endnotes

- <sup>1</sup> The Proposed Guidance, which is subject to technical correction prior to Federal Register publication, is available at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister062912.pdf>.
- <sup>2</sup> Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant,” 77 Fed. Reg. 30596 (May 23, 2012). A Mayer Brown Legal Update analyzing the Final Entities Rulemaking is available [here](#).
- <sup>3</sup> A copy of the Proposed Order is available from the CFTC website at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister062912b.pdf>.
- <sup>4</sup> The CFTC’s election to propose an apparently non-exhaustive list of persons that would be US persons, rather than a complete formal definition of the term, creates uncertainty that will hopefully be better addressed in final guidance.
- <sup>5</sup> Please note that swap dealers and MSPs that are subject to the capital and margin regulations of a “prudential regulator” such as the Board of Governors of the Federal Reserve System or the Office of the Comptroller of the Currency would be subject to the “cross-border” approach contained in those regulations, not to the CFTC’s Proposed Guidance. Thus, non-US banks with US branches or agencies and the non-US branches of US banks will be subject to those prudential regulations, when they are adopted in final form, with respect to capital and margin requirements (38-39, FN 67).

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