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Legal Update
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US Commodity Futures Trading Commission Proposes Changes to Cross-Border Swaps Framework and Extends Phase-In Period for Reduction of the *De Minimis* Threshold

On October 11, 2016, the Commodity Futures Trading Commission ("CFTC") issued for public comment proposed rules and interpretations (the "Proposal") that would:

- Re-interpret and codify certain key terms relevant to the cross-border application of its swap regulations; and
- Change the existing Guidance[1] approach to cross-border application of (A) the thresholds for swap dealer ("SD") and major swap participant ("MSP") registration and (B) the external business conduct rules[2] ("BCS") applicable to SDs and MSPs.[3]

Significantly, the Proposal would modify how the *de minimis* threshold applies with respect to a number of non-US Persons and all non-US branches of US SDs. Additionally, the Proposal is the first proposed CFTC rulemaking to address issues raised by a 2013 staff advisory[4] (suspended by no-action relief shortly after its issuance) on the application of transaction-level swap regulations to non-US SDs that use personnel located in the United States to arrange, negotiate or execute swaps. Under the Proposal, such activity would trigger application of the anti-fraud and fair dealing provisions of the BCS but would not be relevant in determining which transactions are counted toward the SD/MSP registration thresholds. Interested parties have until December 19, 2016, to submit comments on the Proposal.

Separately, on October 13, 2016, the CFTC issued an order to extend the SD registration *de minimis* threshold phase-in termination date until December 31, 2018, at which time the *de minimis* threshold for swaps with non-special entities will be reduced to $3 billion unless the CFTC determines otherwise. Absent this change, the current threshold of $8 billion would have been reduced to $3 billion on December 31, 2017, and non-SD counterparties would have faced effective limitations on their swap dealing activity beginning in January 2017.

Proposed Changes to Cross-Border Swaps Framework

CHANGES TO KEY DEFINITIONS

The Proposal would adopt definitions of the terms "US Person" and "Foreign Consolidated Subsidiary" ("FCS") and revise the Guidance interpretation on the types of arrangements that constitute "guarantees." Although the SD/MSP registration thresholds and BCS are the only substantive rules addressed in the Proposal, the CFTC intends that the US Person and FCS definitions will be relevant for future cross-border rulemakings on other substantive requirements "unless the context or a specific rule … otherwise requires." In particular, the CFTC states that it would not necessarily treat an FCS the same as a US Person (or non-US

Person guaranteed by a US Person) in the context of other Dodd-Frank swaps provisions.

US Person. The Proposal adopts the definition of "US Person" from the cross-border margin rules. The Guidance had established a non-exhaustive eight-part definition of the term "US Person."[5] The proposed definition of "US Person" differs in several respects from the Guidance, including:

a) The Proposal's definition is an exhaustive definition (i.e., it no longer uses the "include, but not be limited to" introductory clause).

b) The Proposal's definition no longer includes non-US commodity pools, pooled accounts, investment funds or other collective investment vehicles on the basis that they are majority-owned by US Persons. This would effectively relieve non-US collective investment vehicles of the burden of having to track the US Person status of their beneficial owners (even though they still may qualify as a US Person under one of the other prongs of the US Person definition).

c) The Proposal's definition includes legal entities, including non-US collective investment vehicles, that have a US Person owner who has unlimited liability for the obligations and liabilities of the legal entity, regardless of minority or majority ownership status. This change is intended to ensure that the definition covers any entity for which a US Person investor serves as "a financial backstop for all of the legal entity's obligations and liabilities."[6]

d) The Proposal provides an express exclusion for international financial institutions, such as the IMF, and multilateral development banks.

Foreign Consolidated Subsidiary. The Proposal would incorporate the definition of FCS from the cross-border margin rules. An FCS would be a non-US Person that is controlled by and consolidated, under US GAAP, into an ultimate parent that is a US Person. As discussed below, because the Proposal also will require an FCS to count all dealing swaps against its *de minimis* threshold calculation, the CFTC expects that at least 14 existing and currently unregistered non-US subsidiaries of US Persons would be required to register as SDs.

Guarantee. The preamble to the Proposal would apply the definition of "guarantee" from the cross-border margin rules to the *de minimis* threshold calculations. The Guidance interpreted the term "guarantee" to "generally include not only traditional guarantees of payment or performance of the related swaps, but also other formal arrangements that, in view of all the facts and circumstances, support the non-US Person's ability to pay or perform its swap obligations with respect to its swaps."[7] Many commenters criticized this definition as being overly broad and difficult to interpret.

The recent cross-border margin rules define a guarantee more narrowly as an "arrangement pursuant to which one party to an uncleared swap has rights of recourse against a guarantor, with respect to its counterparty's obligations under the uncleared swap."[8] The preamble to the Proposal states that the CFTC plans to adopt this definition for purposes of the SD *de minimis* threshold calculation as discussed below, adjusting it for the fact that the Proposal applies to all swaps, not just uncleared swaps.

SD *DE MINIMIS* THRESHOLD CALCULATIONS

Consistent with the Guidance, the Proposal would require that a US Person include all of its swap dealing transactions in its *de minimis* threshold calculation, without exception. US Person status would be determined at the legal entity level, and a US Person would include the swap dealing activity of foreign branches or operations that are part of the same legal entity in its calculations. Also, all potential SDs, whether US Persons or non-US Persons, would continue to aggregate their swap dealing

transactions with those of their affiliates—i.e., persons controlling, controlled by or under common control with the potential SD—to the extent that those affiliates are themselves required to include those swaps in their own *de minimis* threshold calculations, unless the affiliate is a registered SD.

The Proposal would diverge from the Guidance's approach to the *de minimis* threshold calculation in several key respects.

First, the Proposal would require FCS to include all of their swap dealing transactions in the *de minimis* threshold calculation, without exception. Under the Guidance, this approach applies only to non-US Persons that are "guaranteed affiliates" or "conduit affiliates" of a US Person. The CFTC states in the preamble to the Proposal that, subsequent to the issuance of the Guidance, some US Persons removed guarantees from non-US subsidiaries that engage in swap dealing primarily with non-US Person counterparties. Accordingly, these non-US swap dealing subsidiaries have not been required to register as SDs because their relevant dealing activity never exceeded the *de minimis* threshold. In the CFTC's view, swap dealing transactions of all FCS should be treated in the same manner as the swap dealing transactions of US Persons, given the nature of the relationship between an FCS and its US Person parent and the resulting risks to the US parent entity. By treating all non-US subsidiaries that are consolidated into a US Person as FCS, the CFTC intends to eliminate this "regulatory loophole."

Second, while the Proposal would retain the general approach taken in the Guidance of requiring all non-US Persons to include swap dealing transactions with respect to which the counterparty is a US Person or is guaranteed by a US Person, the manner in which this approach is implemented differs from the Guidance in several ways. Most significantly, non-US Persons would now include in their *de minimis* calculations all dealing swaps with counterparties that are non-US branches of US Persons, including swaps with non-US branches of US SDs (which are excluded under the Guidance).[9] The CFTC states in the preamble that the exclusion under the Guidance for swaps with the non-US branches of US SDs constitutes another "regulatory loophole" as it would permit certain non-US Persons to engage in potentially unlimited swap dealing activity with US SDs without having to register. Also, under the Proposal, non-US Persons who are not FCS and are not guaranteed by a US Person (referred to as "Other Non-US Persons") would include in their *de minimis* calculations swap dealing activities with counterparties that are (i) US Persons, (ii) FCS and (iii) non-US Persons who are guaranteed by US Persons—in the latter case, without regard to whether the US Person guarantor is a non-financial entity. Under the Guidance, swaps with non-US Persons guaranteed by a non-financial entity are excluded from the calculation. Other Non-US Persons would continue to exclude from the calculation (i) transactions with Other Non-US Persons (even if the transaction is an ANE Transaction, defined below) and (ii) transactions that are executed anonymously on an SEF, DCM or FBOT and cleared through a registered or exempt DCO.

In addition to these proposed changes to the *de minimis* calculation framework, the Proposal also requests comment on whether the CFTC should require a non-US Person affiliate of a US SD ("SD Conduit") to count outward facing swaps towards its *de minimis* threshold calculation. The Guidance provided detailed interpretations of when a non-US Person was acting as an affiliate conduit and how the *de minimis* threshold calculations applied with respect to affiliate conduits.[10] The definition of "affiliate conduit" under the Guidance, however, was generally considered to be extremely complex. Also, under the Guidance, an affiliate of an SD could not be an affiliate conduit, and very few, if any, affiliate conduits were used by

market participants. The Proposal omits "affiliate conduit" as a relevant category of market participant and requests comment as to whether an SD Conduit should be required to count some or all of its outward facing swaps towards its *de minimis* threshold calculation. If SD Conduits were required to count outward facing swaps towards their *de minimis* threshold calculations, a significant number of non-US subsidiaries of non-US financial groups may be required to register with the CFTC as SDs.

APPLICATION OF DODD-FRANK SWAP REQUIREMENTS TO TRANSACTIONS ARRANGED, NEGOTIATED OR EXECUTED BY US PERSONNEL

In the 2013 Staff Advisory, the CFTC's Division of Swap Dealer and Intermediary Oversight ("DSIO") set forth its view that a non-US SD (whether or not an affiliate of a US Person) regularly using personnel or agents located in the United States to arrange, negotiate or execute a swap with a non-US Person generally would be required to comply with the certain "transaction-level requirements," including mandatory clearing and trade execution, real-time public reporting and external business conduct standards.[11] In response to a request for comment on the 2013 Staff Advisory, the CFTC received 17 comment letters, most of which opposed the 2013 Staff Advisory and emphasized that the risks associated with transactions encompassed by the 2013 Staff Advisory lie outside the United States.

The Proposal indicates that the CFTC has preliminarily concluded that the locus of the risk is not determinative of the scope of the Dodd-Frank Act. Rather, the inquiry must also consider whether a non-US Person is engaged in the United States in any of the indicia of dealing activity encompassed in the definition of "swap dealer," even if the risk is ultimately booked outside the United States. In the CFTC's view, applying specific Dodd-Frank requirements to swap transactions that are "arranged, negotiated or executed" using personnel located in the United States ("ANE Transactions") is appropriate because the associated activities indicate "a level of involvement, and intention to participate, in the US swap market that may raise concerns regarding customer protection, market transparency and financial contagion intended to be addressed by the Dodd-Frank Act."[12]

SCOPE OF ANE TRANSACTIONS

In the Proposal, the CFTC provides guidance on the scope of activity that would constitute ANE Transactions. The terms "arrange" and "negotiate" refer to market-facing activity normally associated with swap sales and trading rather than to internal, back-office activities performed by personnel not involved in the actual trading or sale. Examples of activities outside the scope of ANE Transaction activity include swap processing, document preparation (including negotiation of a master agreement and related documentation), the involvement of a US-based attorney in negotiations regarding terms of a transaction and provision of research information to non-US personnel. The term "execute" refers to the market-facing act of becoming legally and irrevocably bound to the terms of the transaction under applicable law.

Under the Proposal, ANE Transactions would not be limited to swaps "regularly" arranged, negotiated or executed using US personnel, nor would a swap transaction fall outside the scope of the Proposal because a counterparty seeks to enter into the swap outside of its jurisdiction's regular trading hours. Algorithmically traded swaps could be viewed as ANE Transactions if US personnel specify the trading strategy or techniques carried out through algorithmic trading or automated electronic execution.[13]

The CFTC would look to the activities of the personnel "assigned to (on an ongoing or temporary basis) or regularly working" in a US location for the dealing entity or its agents.[14] Thus, the Proposal would not capture activities of personnel assigned to a non-US location who

are only incidentally present in the United States (e.g., to attend a conference) when they arrange, negotiate or execute a transaction. Formal designation of personnel as salespersons or traders would not be relevant, and ANE Transaction status would attach to a transaction if US personnel direct other personnel to arrange, negotiate or execute the transaction.

PROPOSED CROSS BORDER APPLICATION OF THE EXTERNAL BUSINESS CONDUCT STANDARDS FOR SWAP DEALERS AND MAJOR SWAP PARTICIPANTS

The Proposal's approach to the cross-border application of the BCS largely follows the Guidance. The one notable change is the introduction of the concept of ANE Transaction.

Under the Guidance, the BCS did not apply to transactions (or transactions offered but not entered into) between a non-US Person SD or a foreign branch of a US SD on the one hand and a non-US Person or a foreign branch of a US SD on the other. Under the Proposal, the application of the BCS is the same, except if the SD uses personnel located in the United States to arrange, negotiate or execute a transaction in swaps or a swap that is offered but not entered into. In such circumstance (i.e., if the transaction is an ANE Transaction or an offered ANE Transaction), the SD would be subject to the anti-fraud (CFTC regulation 23.410) and fair dealing (CFTC regulation 23.433) provisions of the BCS. In the CFTC's view, limiting the applicable BCS requirements to the antifraud and fair dealing provisions would provide a basic level of counterparty protections while recognizing the supervisory interests of the relevant foreign jurisdictions in applying their own sales practices requirements. The CFTC requests comment on whether this limitation is appropriate or whether other BCS requirements should also apply.

If the Proposal is adopted, non-US Person SDs and US SDs who transact out of a foreign branch will need to determine if their transactions with non-US Persons and foreign branches of a US SD are ANE Transactions and, if so, whether they need to update their swap trading relationship documentation or practices as a result of the application of the anti-fraud and fair dealing provisions of the BCS to such transactions.

Extension of the SD Registration *De Minimis* Threshold Phase-In Termination Date

Shortly after announcing the issuance of the Proposal, the CFTC announced a one-year extension of the SD registration *de minimis* threshold phase-in termination date.[15] Under this extension, the SD *de minimis* threshold will not be reduced from $8 billion to $3 billion until December 31, 2018.[16]

In 2012, the CFTC set the initial *de minimis* threshold used to determine if a person's swap dealing activity requires SD registration at $8 billion in aggregate gross notional amount of swap dealing activity (measured over the prior 12-month period). The CFTC also provided that the permanent *de minimis* threshold of $3 billion would phase-in on December 31, 2017. CFTC staff was also directed to issue a report on the operation of the *de minimis* threshold. Based on the report and public comment, the CFTC could consider changing the threshold or the phase-in period.

The CFTC staff issued the final report on the initial operation of the *de minimis* threshold on August 15, 2016.[17] Market participants would need to adjust their swap dealing activity beginning in January 2017 to meet the lower threshold taking effect on December 31, 2017, which would be calculated off of a person's aggregate swap dealing over the preceding 12-month period. Commenters expressed concern that there was insufficient time following the publication of the final report for the market to respond to potential CFTC revisions to the permanent *de minimis* threshold and that the $3 billion permanent *de minimis* threshold was too low.

By extending the *de minimis* threshold phase-in termination date by one year, the CFTC is providing market participants with an opportunity to develop and submit additional information on the appropriate level of the permanent *de minimis* threshold. In particular, the CFTC notes that its staff have been unable to develop reliable data for swap dealing involving non-financial commodity and equity swaps and foreign exchange derivatives. Commissioner Bowen noted separately that she expects market participants to develop and submit this information over the coming year because, otherwise, she sees "no basis from which to change the phase-in or move the threshold to something other than $3 billion." The delay also gives the CFTC more time to adopt a final rule on SD capital requirements before the threshold is set.

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Endnotes

[1] Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45,292 (July 26, 2013) ("Guidance").

[2] Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. 9,734 (Feb. 17, 2012) ("BCS").

[3] Cross-Border Application of the Registration Thresholds and External Business Conduct Standards Applicable Swap Dealers and Major Swap Participants, 81 Fed. Reg. 71,946 (proposed Oct. 18, 2016).

[4] CFTC Staff Advisory No. 13-69, Applicability of Transaction-Level Requirements to Activity in the United States (Nov. 14, 2103) (the "2013 Staff Advisory").

[5] Guidance at 45,316-17.

[6] 81 Fed. Reg. at 71,949.

[7] 81 Fed. Reg. at 71,965-66 n.152 (quoting the Guidance at 45,320).

[8] CFTC regulation 23.160(a)(2).

[9] The Guidance provided relief to aspects of the *de minimis* threshold calculations to non-US branches of US SDs. As a practical matter, very few, if any, non-US branches of US Persons that are not SDs engage in swap dealing.

[10] The Guidance stated that the relevant factors for determining if a non-US Person is a conduit affiliate are whether: "(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-party(ies) for the purpose of hedging or mitigating risks faced by, or to take positions on behalf of, its US affiliate(s), and enters into offsetting swaps or other arrangements with its US affiliate(s) in order to transfer the risks and benefits of such swaps with third-party(ies) to its US affiliates." Guidance at 45,359.

[11] 2013 Staff Advisory.

[12] 81 Fed. Reg. at 71,953.

[13] The relevance of the CFTC's discussion of this interpretation appears to be limited in context of the substantive rules addressed in the Proposal because the BCS contain an exception for anonymously traded swaps, although treatment of algorithms could be significant in future rulemaking, such as reporting or trade execution requirements.

[14] 81 Fed. Reg. at 71,953.

[15] CFTC, Commission Approves an Order Regarding Swap Dealer Registration *De Minimis* Exception (Oct. 13, 2016).

[16] The $25 million threshold for swaps with municipalities, certain pension plans and other "special entities" continues to apply.

[17] CFTC Staff, Swap Dealer *De Minimis* Exception Final Staff Report (Aug. 15, 2016).

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