

Client Alert

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CFTC Issues Cross-Border Proposal

By Julian Hammar

On October 11, 2016, the U.S. Commodity Futures Trading Commission (“CFTC”) issued proposed rules to address certain issues related to the cross-border application of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), the comprehensive framework for swaps regulation enacted by Congress in 2010. If adopted, the proposed rules would supersede the CFTC’s Cross-Border Guidance, the interpretative statement adopted by the CFTC in 2013 to address cross-border application of Dodd-Frank, with respect to these issues.¹

Among other things, the proposed rules would:

- provide definitions of “U.S. person” and “foreign consolidated subsidiary,” which would apply for purposes of subsequent rulemakings addressing cross-border application of Dodd-Frank;
- clarify in certain respects the treatment of transactions that are “arranged, negotiated, or executed” in the United States by non-U.S. persons; and
- address the cross-border application of swap dealer and major swap participant registration thresholds and the cross-border applicability of the external business conduct standards.

The proposal will be open for public comment until **December 19, 2016**, and is available [here](#).²

DEFINITIONS

The proposed rules would define the terms “U.S. Person” and “Foreign Consolidated Subsidiary” (“FCS”) in line with the definitions contained in the cross-border uncleared swaps margin rules adopted by the CFTC last May.³ The proposed definition of the term U.S. person would, as under the cross-border uncleared swaps margin rules, eliminate the “including, but not limited to” language contained in the U.S. person definition in the Cross-Border Guidance, which created legal uncertainty for market participants as to who is and who is not a U.S. person. Also eliminated is the prong for commodity pools, investment funds, or other collective investment vehicles majority-owned by U.S. persons, which was included in the U.S. person definition contained in the Cross-Border Guidance, but which created difficulties in identifying and tracking fund ownership. The prong for a legal entity

¹ See Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45,292 (July 26, 2013) (“Cross-Border Guidance”).

² Cross-Border Application of the Registration Thresholds and External Business Conduct Standards Applicable to Swap Dealers and Major Swap Participants, 81 Fed. Reg. 71,946 (Oct. 18, 2016).

³ See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants—Cross-Border Application of the Margin Requirements, 81 Fed. Reg. 34,818 (May 31, 2016). For more information on the cross-border uncleared swaps margin rules, please see our client alert [here](#).

Client Alert

owned by one or more U.S. persons bearing unlimited responsibility for such entity's obligations and liabilities, which under the Cross-Border Guidance applied to such entities majority-owned by U.S. persons, has also been modified to remove the majority-U.S. person ownership requirement.⁴

The proposed definition of the term FCS, like the definition under the cross-border uncleared swaps margin rules, would denote a non-U.S. person in which an ultimate parent entity that is a U.S. person has a controlling financial interest, and as a result of that controlling interest the ultimate parent includes the non-U.S. person's operating results, financial position and statement of cash flows in the ultimate parent's consolidated financial statements in accordance with U.S. Generally Accepted Accounting Principles.

These definitions would be used for purposes of the other rules contained in the proposal, and for purposes of any subsequent rulemakings addressing the cross-border application of Dodd-Frank requirements.

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

In addition to these definitions, the proposal contains an interpretation regarding the scope of transactions between non-U.S. persons that are "arranged, negotiated, or executed" in the United States ("ANE") that would be subject to Dodd-Frank.⁵ CFTC staff in 2013, in its Advisory 13-69, took the position that non-U.S. swap dealers registered with the CFTC had to comply with the Transaction-Level Requirements for transactions with non-U.S. persons that were ANE.⁶ The staff subsequently issued a series of no-action letters delaying compliance with the terms of Advisory 13-69 pending CFTC consideration, after the CFTC had issued a request for comment, of whether the advisory should be adopted as Commission policy.

The proposed interpretation adopts the view that ANE transactions between non-U.S. persons implicate regulatory concerns intended to be addressed by Dodd-Frank and that applying specific Dodd-Frank swap requirements to such transactions may be appropriate. The proposed rules discussed below address whether such transactions would count toward the swap dealer and major swap participant thresholds, as well as how the CFTC's external business conduct standards would apply to such transactions.

In addition, the proposed interpretation would provide guidance regarding the meaning of the terms "arranged," "negotiated," and "executed," terms not defined in Advisory 13-69. The interpretive guidance regarding these terms is substantively identical to the interpretation adopted by the Securities and Exchange Commission ("SEC") defining these terms earlier this year in connection with cross-border security-based swap dealing.⁷

Specifically, the proposed interpretation provides that the terms "arrange" and "negotiate" refer to market-facing activity normally associated with sales and trading, as opposed to internal, back-office activities, such as

⁴ See generally Proposed Reg. 1.3(aaaaa) for these definitions.

⁵ See generally 81 Fed. Reg. at 71,952-54.

⁶ See CFTC Staff Advisory No. 13-69, Applicability of Transaction-Level Requirements to Activity in the United States (Nov. 13, 2013).

⁷ See Security-Based Swap Transactions Connected With a Non-U.S. Person's Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office or in a U.S. Branch or Office of an Agent; Security-Based Swap Dealer De Minimis Exception, 81 Fed. Reg. 8,597 (Feb. 19, 2016).

Client Alert

ministerial or clerical tasks, performed by personnel not involved in the actual sale or trading of the relevant swap. The terms would not encompass activities such as 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. The term “executed” would refer to the market-facing act of becoming legally and irrevocably bound to the terms of a swap under applicable law.

COUNTING SWAPS TOWARD SWAP DEALER AND MAJOR SWAP PARTICIPANT THRESHOLDS

The proposal includes rules for counting dealing swaps, in the cross-border context, toward the swap dealer de minimis thresholds, as well as counting cross-border swaps toward the major swap participant thresholds. These proposed rules, if adopted, would supersede the counting rules contained in the Cross-Border Guidance.

Swap Dealer De Minimis Thresholds

In general, a market participant is exempt from registration as a swap dealer if its aggregate gross notional value of swap dealing over the prior 12-month period does not exceed the de minimis threshold, which currently is set at \$8 billion (except for certain special entities, where the threshold is \$25 million) and will be reduced to \$3 billion on December 31, 2018 (recently extended from December 2017),⁸ absent further CFTC action. The proposed rules address, based on a counterparty’s status as either a U.S. person, U.S. Guaranteed Entity, FCS, or a non-U.S. person that is neither an FCS nor a U.S. Guaranteed Entity (“Other Non-U.S. Person”), which swaps in the cross-border context count toward the de minimis thresholds.

Under the proposed rules, in making its swap dealer de minimis calculation:

- A U.S. person would include all of its swap dealing transactions.
- A non-U.S. person would include all swap dealing transactions with respect to which it is a “U.S. Guaranteed Entity.” For purposes of the proposed rules, the proposal notes in a footnote that “guarantee” has the same meaning as in the cross-border margin rules, except that application of the term would not be limited to uncleared swaps.
- An FCS would include all of its swap dealing transactions.
- An Other Non-U.S. Person would include all of its swap dealing transactions with counterparties that are U.S. persons (including their non-U.S. branches), U.S. Guaranteed Entities, or FCSs, unless the swap is executed anonymously on a designated contract market, swap execution facility, or foreign board of trade and cleared.⁹

Other Non-U.S. Persons would not, however, include any of their swap dealing transactions with Other Non-U.S. Persons, even if they constitute ANE transactions. This approach differs from the SEC’s, which generally requires that ANE transactions be included in a non-U.S. person’s security-based swap dealing de minimis calculation. The SEC also does not exclude ANE transactions that are executed anonymously on an exchange or

⁸ See Order Establishing De Minimis Threshold Phase-In Termination Date, 81 Fed. Reg. 71,605 (Oct. 18, 2016).

⁹ See Proposed Reg. 1.3(ggg)(7).

Client Alert

swap execution facility from the security-based swap dealing de minimis calculation, but such transactions would not be required to be counted under the CFTC's proposed rules.¹⁰

Notably, the proposal does not address “conduit affiliates,” which, under the Cross-Border Guidance, are required to count all of their swap transactions toward the de minimis threshold, although it includes a series of questions requesting comment regarding conduits. Another notable difference is the treatment of FCSs, which were not a recognized category under the Cross-Border Guidance. Currently under the Cross-Border Guidance, only U.S. persons, guaranteed affiliates of U.S. persons, and conduit affiliates of U.S. persons are required to count all of their dealing swap transactions, whether with U.S. or non-U.S. counterparties. FCSs, which by definition are non-U.S. persons and are not guaranteed affiliates of U.S. persons, and unless they meet the requirements for conduit affiliates would not be such affiliates either, would not be required to count all of their swaps under the Cross-Border Guidance. Such FCSs would be required, however, to count all of their swaps under the proposed rules. Another change to the counting rules from the Cross-Border Guidance, about which the CFTC requests comment, is that under the proposed rules, Other Non-U.S. Persons would be required to count swaps with non-U.S. branches of U.S. persons, which is not required under the Cross-Border Guidance.

Consistent with the approach taken in the Cross-Border Guidance, the proposed rules provide that potential swap dealers, whether U.S. or non-U.S. persons, would aggregate their swap dealing transactions with those of persons controlling, controlled by, or under common control with the potential swap dealer to the extent that those affiliates are themselves required to include those swaps in their own de minimis thresholds, unless the affiliated person is a registered swap dealer.

Major Swap Participant Thresholds

An entity that is not a swap dealer would count swap positions toward the major swap participant threshold calculations to the same extent as potential swap dealers count swap dealing transactions toward the swap dealer de minimis calculation discussed above, with the exception of the aggregation requirement. In addition, all swap positions that are subject to recourse would be attributed to a guarantor, whether it is a U.S. person or a non-U.S. person, unless the guarantor, the guaranteed entity, and its counterparty are Other Non-U.S. Persons.¹¹

EXTERNAL BUSINESS CONDUCT STANDARDS

The proposed rules would apply the CFTC's external business conduct (“EBC”) standards to cross-border transactions, as follows:

- U.S. swap dealers and major swap participants (SD/MSPs) would comply with applicable EBC standards, without substituted compliance, except with respect to transactions conducted through a foreign branch of the U.S. SD/MSP.

¹⁰ For more information about the SEC's rules, see our client alert [here](#).

¹¹ See Proposed Reg. 1.3(nnn).

Client Alert

- Non-U.S. SD/MSPs and foreign branches of U.S. SD/MSPs would comply with applicable EBC standards, without substituted compliance, if the counterparty is a U.S. person (other than a foreign branch of a U.S. SD/MSP).
- Non-U.S. SD/MSPs and foreign branches of U.S. SD/MSPs would not be subject to EBC standards for their swaps with non-U.S. persons and foreign branches of a U.S. SD/MSP, except that non-U.S. SDs and foreign branches of U.S. SDs that enter into transactions ANE would be required to comply with CFTC Reg. 23.410 (Prohibition on Fraud, Manipulation, and other Abusive Practices) and 23.433 (Fair Dealing), without substituted compliance.¹²

CONCLUSION

The proposal represents a first step toward addressing the cross-border issues raised by Advisory 13-69 and transactions that are ANE. However, it is only a first step, because the proposal is silent about whether additional Dodd-Frank requirements will apply to ANE transactions, stating that the application of other Dodd-Frank requirements will be considered in subsequent rulemakings as necessary and appropriate. It also represents a first step toward codification of the Cross-Border Guidance with respect to the counting rules and applicability of the external business conduct standards, but does not codify other requirements. Nonetheless, market participants may welcome certain aspects of the proposal, including the proposed codification of the U.S. person definition that promotes legal certainty, as well as the interpretive guidance providing greater clarity regarding ANE transactions. Market participants may, however, question the treatment of FCSs for purposes of the counting rules, which appears to mark a significant change from the Cross-Border Guidance that could impact many U.S. companies that consolidate their foreign subsidiaries on their financial statements. It is also unclear whether existing no-action relief from Advisory 13-69 will be extended as the CFTC considers whether to apply additional Dodd-Frank requirements to ANE transactions.¹³ Treatment of conduit affiliates, while not included in the proposed counting rules, remains a subject about which the CFTC has requested comment, as well as whether the CFTC should conform to the SEC's approach toward ANE transactions for purposes of the counting rules. Market participants may wish to file comments during the comment period to assist the CFTC in its consideration of these issues.

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¹² See Proposed Reg. 23.452.

¹³ Currently, under CFTC Staff Letter 16-64 (Aug. 4, 2016), that relief is set to expire on September 30, 2017.

Client Alert

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