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CFTC Issues Final Exemptive Order Temporarily Limiting Cross-Border Application of the Swaps Provisions of the Dodd-Frank Act

On December 21, 2012 the US Commodity Futures Trading Commission (the “CFTC”) issued a final order granting temporary relief from certain swap provisions of Title VII of the Dodd-Frank Act in connection with non-US activity (“Final Order”). Under the Final Order, until July 12, 2013, a non-US person that registers as a swap dealer (“Swap Dealer”) or major swap participant (“MSP”) may delay compliance with certain entity-level requirements of the Commodity Exchange Act (“CEA”) (and CFTC regulations promulgated thereunder). Further, until July 12, 2013, non-US Swap Dealers and MSPs and foreign branches of US Swap Dealers and MSPs may delay compliance with certain transaction-level requirements of the CEA (and CFTC regulations promulgated thereunder), subject to specified conditions. The CFTC has also provided additional proposed interpretive guidance concerning the extent to which the new registration and regulatory requirements for swaps under the Dodd Frank Act apply to transactions and persons outside of the United States.¹

Background: Proposed Guidance

On July 12, 2012, the CFTC proposed guidance setting forth the manner in which it proposed to interpret section 2(i) of the CEA as it applies to the requirements under the Dodd-Frank Act and the CFTC’s regulations promulgated thereunder

¹ Final Exemptive Order Regarding Compliance with Certain Swap Regulations; Further Proposed Guidance, (December 21, 2012) available at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister122112.pdf> (last accessed December 26, 2012).

regarding cross-border swap activities (“Proposed Guidance”).² Specifically, in the Proposed Guidance, the CFTC described the general manner in which it proposed to consider (1) whether a non-US Person’s swap dealing activities are sufficient to require registration as a Swap Dealer, (2) whether a non-US Person’s swap positions are sufficient to require registration as an MSP, and (3) the treatment of foreign branches, agencies, affiliates, and subsidiaries of US Swap Dealers.³ The Proposed Guidance also generally described the policy and procedural framework under which the CFTC may permit compliance with a comparable regulatory requirement of a foreign jurisdiction to substitute for compliance with the requirements of the CEA. In addition, the Proposed Guidance set forth the manner in which the CFTC proposed to interpret section 2(i) of the CEA as it applies to the clearing, trading, and certain reporting requirements under the Dodd-Frank Act with respect to swaps where neither counterparty is a Swap Dealer or MSP.

At the same time it issued the Proposed Guidance, the CFTC also proposed a separate exemption that would provide a delayed timetable for compliance with the Title VII requirements of the Dodd-Frank Act and certain other Swap Dealer and MSP regulatory requirements (“Proposed Order”).⁴ According to the CFTC, this compliance delay is intended to allow time for the CFTC, foreign regulators and market participants to continue to consult and coordinate on the regulation of cross-border swaps activity, as well as the appropriate implementation of substituted compliance. The Final Order is the modified version of the Proposed Order and generally tracks the Proposed Guidance and Proposed Order, but changes certain key terms, as described below. The CFTC is not, however, finalizing the Proposed Guidance at this time.

On October 12, 2012, the CFTC’s Swap Dealer and MSP entity definitions became effective and in order to ensure compliance with the registration requirement, market participants needed to begin performing the calculations associated

² For further information regarding this proposal you may wish to refer to our publication on this topic, available at: <http://www.shearman.com/cross-border-application-of-the-swaps-provisions-of-the-dodd-frank-act-07-18-2012/>.

³ The Proposed Guidance defines US Person as:

- (i) Any natural person who is a resident of the United States;
- (ii) any corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund, or any form of enterprise similar to any of the foregoing, in each case that is either:
 - (A) organized or incorporated under the laws of the United States or having its principal place of business in the United States (“legal entity”); or
 - (B) in which the direct or indirect owners thereof are responsible for the liabilities of such entity and one or more of such owners is a US person;
- (iii) any individual account (discretionary or not) where the beneficial owner is a US person;
- (iv) any commodity pool, pooled account, or collective investment vehicle (whether or not it is organized or incorporated in the United States) of which a majority ownership is held, directly or indirectly, by a US person(s);
- (v) any commodity pool, pooled account, or collective investment vehicle the operator of which would be required to register as a commodity pool operator under the CEA;
- (vi) a pension plan for the employees, officers, or principals of a legal entity with its principal place of business inside the United States; and
- (vii) an estate or trust, the income of which is subject to United States income tax regardless of source.

Under this interpretation, the term “US person” generally means that a foreign branch or agency of a US person would be covered by virtue of the fact that it is a part, or an extension, of a US person. By contrast, a foreign affiliate or subsidiary of a US person would be considered a non-US person, even where such an affiliate or subsidiary has certain or all of its swap-related obligations guaranteed by the US person.

⁴ Exemptive Order Regarding Compliance with Certain Swap Regulations, 77 Fed. Reg. 41110 (July 12, 2012) (proposed order).

with the definitions to determine if registration was required.⁵ The Proposed Guidance provided that, in most cases, a non-US Person need only count swaps with US Persons when performing its Swap Dealer and MSP calculations. Given the number of interpretive issues raised by the definition of US Person, market participants were faced with a great degree of uncertainty when applying this definition.

In response to comments received from market participants expressing concern over these interpretive issues, the CFTC's Division of Swap Dealer and Intermediary Oversight issued a no-action letter ("No-Action Letter") that contained, among other things, a much more narrow definition of US Person than that which was contained in the Proposed Guidance.⁶ The No-Action Letter definition of US Person is the starting point of the Final Order's definition of US Person.⁷ The Final Order supersedes the No-Action Letter, including its definition of US Person, but permits market participants to use either definition for the period of time between December 21, 2012 and December 31, 2012. After December 31, 2012, the Final Order definition of US Person must be used.

Who Is a US Person?

In response to comments received to the Proposed Guidance and the No-Action Letter, the Final Order uses the No-Action Letter's narrower US Person definition, adjusted as follows.⁸

The Final Order defines US Person as:

- (i) A natural person who is a resident of the United States;
- (ii) A corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund or any form of enterprise similar to any of the foregoing, in each case that is (A) organized or incorporated under the laws of a state or other jurisdiction in the United States or (B) effective as of April 1, 2013 for all such

⁵ For further information regarding this rule you may wish to refer to our publication on this topic, available at: <http://www.shearman.com/swap-dealer-major-swap-participant-and-eligible-contract-participant-sec-and-cftc-adopt-entity-definition-rules-07-13-2012/>.

⁶ Time-Limited No-Action Relief: Swaps Only With Certain Persons to be Included in Calculation of Aggregate Gross Notional Amount for Purposes of Swap Dealer De Minimis Exception and Calculation of Whether a Person is a Major Swap Participant, CFTC No-Action Letter No. 12-22 (October 12, 2012).

⁷ The No-Action Letter defines US Person as:

- (i) A natural person who is a resident of the United States;
- (ii) A corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund or any form of enterprise similar to any of the foregoing, in each case that is organized or incorporated under the laws of the United States;
- (iii) A pension plan for the employees, officers or principals of a legal entity described in (ii) above, unless the pension plan is exclusively for foreign employees of such entity;
- (iv) An estate or trust, the income of which is subject to US income tax regardless of source; or
- (v) An individual account (discretionary or not) where the beneficial owner is a person described in (i) through (iv) above.

⁸ Notwithstanding the Final Order, this definition of US Person is still subject to comment and revision and may differ from the definition the CFTC will ultimately adopt in its final cross-border interpretive guidance.

entities other than funds or collective investment vehicles, having its principal place of business in the United States;

- (iii) A pension plan for the employees, officers or principals of a legal entity described in (ii) above, unless the pension plan is primarily for foreign employees of such entity;
- (iv) An estate of a decedent who was a resident of the United States at the time of death, or 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; or
- (v) An individual account or joint account (discretionary or not) where the beneficial owner (or one of the beneficial owners in the case of a joint account) is a person described in (i) through (iv) above.

The CFTC has also clarified that any person not listed in (i) to (v) above is a “non-US person” for purposes of the Final Order.

“Principal Place of Business” Interpretation

The CFTC interprets the phrase “principal place of business” to mean the single place where a corporation’s officers direct, control and coordinate the corporation’s activities, which typically will be where the corporation maintains its headquarters. Because this phrase may present difficult interpretive questions, market participants that would be US Persons solely because of the “principal place of business” test will not be considered US Persons until April 1, 2013. Notably, the “principal place of business” test does not apply to funds and collective investment vehicles.

Proposed US Person Definition

The CFTC’s Revised Guidance proposed two additional prongs of the US Person definition and requested comments from market participants on these definitions for purposes of developing final guidance (presumably for the period after July 12, 2013). The first additional prong would cover foreign legal entities that are majority-owned by US residents or legal entities organized or incorporated under the laws of a state or other jurisdiction in the US, but only where a US owner bears unlimited responsibility for the obligations and liabilities of the foreign legal entity. However, this prong of the US Person definition would not capture foreign legal entities solely because the entity’s swap obligations are guaranteed by a US Person, without any further liability.

The second additional prong would cover any commodity pool, pooled account, investment fund or other collective investment vehicle if it is (directly or indirectly) majority-owned by US residents or legal entities organized or incorporated under the laws of a state or other jurisdiction in the US. In this context, majority-owned would mean the beneficial ownership of 50 percent or more of the equity or voting interests in the collective investment vehicle. If the commodity pool, pooled account, investment fund or other collective investment vehicle is publicly traded, then it will only be a US Person if it is offered, directly or indirectly, to US Persons.

Swap Dealer or Major Swap Participant Calculations

The Final Order provides relief with respect to certain swap transactions that would otherwise be included in the calculations of whether Swap Dealer or MSP registration is required. To that end, when performing their Swap Dealer or

MSP calculations, non-US market participants should not include swaps with (i) non-US Persons or (ii) foreign branches of US Persons who are Swap Dealers or who represent that they intend to register as Swap Dealers by March 31, 2013.

Aggregation

Under the Proposed Guidance, non-US Persons were required to count swap dealing transactions entered into by their non-US affiliates under common control toward the *de minimis* registration threshold. However, the Final Order provides that if a non-US Person is (i) engaged in swap dealing with US Persons as of the effective date of the Final Order and (ii) is also an affiliate of a registered Swap Dealer, then the non-US Person does not need to include the swap dealing transactions of its non-US affiliates who are registered Swap Dealers or who are engaged in swap dealing with US Persons as of December 21, 2012, the effective date of the Final Order.

The Proposed Guidance also required non-US Persons whose swaps are guaranteed by a US Person to include swaps with non-US Persons as well as US Persons in their Swap Dealer calculations, but the Final Order contains no such requirement.

Proposed Aggregation Standard

The CFTC's Revised Guidance proposed an alternative aggregation standard that would require affiliates under common control to aggregate all swap dealing activity except the swaps entered into by affiliates registered as Swap Dealers. The CFTC requested comments from market participants on this standard.

Central Booking

The Proposed Guidance stated that where a market participant operates a "central booking system" where swaps are booked into a single legal entity, whether or not such entity is a counterparty to the swap, the entity that books the swaps would be subject to any applicable Swap Dealer registration requirement, as if it had entered into such swaps directly, regardless of whether such entity is a US Person or whether the booking entity is a counterparty to a swap (has booked the swap directly) or has booked a swap indirectly by way of a back-to-back swap or other arrangement with an affiliate. The Final Order does not adopt this position, but instead provides that a non-US Person should exclude from its Swap Dealer calculations any swap to which it is not a party because the swap is entered into by an affiliated central booking entity.

Registration of Non-US Swap Dealers or Major Swap Participants

Foreign persons that meet or exceed the *de minimis* threshold for Swap Dealers or the position thresholds for MSPs (as modified by the Final Order) will be required to register with the CFTC as a Swap Dealer or MSP, respectively, regardless of location. The relief provided by the Final Order is available only to registered Swap Dealers and MSPs, but it no longer requires submission of a compliance plan in order to obtain the relief granted by the order.

Registered entities are subject to a number of regulatory requirements under the CEA and CFTC regulations. The Final Order adopts the Proposed Guidance's division of regulatory requirements into entity-level requirements and transaction-level requirements.⁹ It also provides that non-US Swap Dealers and MSPs generally do not need to comply with the entity-level requirements until July 12, 2013, except for the swap data repository reporting and large trader reporting requirements.¹⁰

Also, during this period, Swap Dealers and MSPs that are non-US Persons do not need to comply with the transaction-level requirements for swap transactions with non-US Persons or foreign branches of US Swap Dealers or MSPs,¹¹ except to the extent required by the local jurisdiction of such registrants.¹² Likewise, foreign branches of US Swap Dealers or MSPs do not need to satisfy the transaction-level requirements when entering into swap transactions with either non-US Persons or foreign branches of US Persons registered as Swap Dealers or MSPs.¹³

Enforcement Actions

The CFTC indicated that it does not intend to bring enforcement action against a Swap Dealer or MSP for failing to fully comply with applicable Dodd-Frank requirements prior to July 12, 2013, provided that there is a practical or technical impediment to compliance that results in an inability to comply with relevant compliance deadlines, or uncertainty in interpreting particular Dodd-Frank requirement(s) and the Swap Dealer or MSP is acting reasonably and in good faith to fully comply with the applicable Dodd-Frank requirements. This would include, at a minimum, (i) material progress toward timely implementation and compliance; (ii) identification of any implementation or interpretive issue as soon as reasonably possible; (iii) timely elevation of such issue(s) to the Swap Dealer's or MSP's senior management for consideration and resolution; and (iv) timely consultation with other industry participants and the CFTC as necessary to seek resolution of any such issue(s).

⁹ The entity-level requirements encompass requirements as to capital, chief compliance officer, risk management, swap data recordkeeping and reporting and large trader reporting. The transaction-level requirements encompass mandatory clearing and swap processing, margin for uncleared swaps, trade execution requirements, relationship documentation, portfolio reconciliation and compression, real-time public reporting, trade confirmation, daily trading records and external business conduct standards.

¹⁰ The CFTC clarified that all non-US Swap Dealers and MSPs must comply with the swap data repository reporting and large trader reporting requirements for swaps with US Persons. Non-US Swap Dealers and MSPs that are affiliates or subsidiaries of a US-Swap Dealer or certain other regulated entities must also comply for swaps with non-US Persons.

¹¹ The Guidance provides that relief from the transaction-level requirements is available for a swap between a foreign branch of a US Swap Dealer or MSP and a non-US Swap Dealer and that the non-US Swap Dealer may treat the foreign branch as a non-US Person.

¹² The separate consideration that the Proposed Guidance gave to the external business conduct requirements is not relevant for purposes of the Final Order, in which all transaction-level requirements are provided the same exemptive relief.

¹³ A swap is considered to be with a foreign branch of a US person when (i) the personnel negotiating and agreeing to the terms of the swap are located in the jurisdiction of such foreign branch; (ii) the documentation of the swap specifies that the counterparty or "office" for the US person is such foreign branch; and (iii) the swap is entered into by such foreign branch in its normal course of business. If the swap does not meet these three criteria, it will be treated as a swap of the US Person and not as a swap of the foreign branch of the US Person, and the swap will not be eligible for this relief from the transaction-level requirements.

Conclusion

By providing a definitive, if temporary, definition of US Person, the Final Order ensures that the relief provided by the No-Action Letter will continue to allow non-US market participants to perform their Swap Dealer and MSP calculations. The Final Order also provides non-US Swap Dealers and MSPs with an extension of time to comply with the CFTC's entity-level requirements and for transactions with non-US Persons, transaction-level requirements for the duration of the Final Order. The Final Order will expire on July 12, 2013 and the CFTC expects to provide final cross-border guidance before this date. We will continue to keep clients updated on any regulatory developments.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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