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Regulatory brief

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Derivatives: CFTC finalizes cross border guidance and extends timeframe for conformance – July 12th deadline met

Overview

The Commodity Futures Trading Commission (CFTC) continued its progress this week toward a scheme for regulating global swap transactions, culminating in a final framework for regulated cross-border activities of US and non-US swap dealers. The public meeting that took place on July 12th finalizing the CFTC's cross-border guidance and providing more time for firms to conform came just before an important deadline – the temporary Exemptive Order under which many global swap dealers had been operating was set to expire the same day.[1]

While the industry awaits the guidance's specifics in the form of definitive language, the CFTC's vote provides firms with important new clarity. Some key takeaways, based on the CFTC's summary documents and the public meeting, include the following:

- The US Person definition has been expanded to include certain off-shore hedge funds.
- Foreign branches of US swap dealers (SDs) have seemingly been placed on a more level playing field with their non-US SD competitors. Foreign branches will be able to obtain substituted compliance for certain transaction level requirements in their transactions with certain counterparties, allowing both foreign branches of US SDs and their non-US SD competitors to operate under the same set of rules in those instances.
- If not located in one of the six major market jurisdictions (as described below), foreign branches of US SDs may be able to conform to their local country rules without a CFTC comparability declaration "under certain circumstances," which we understand to mean that their derivatives activities would have to fall below a certain low threshold.
- The aggregation rule has changed from what was allowed under the now expired Exemptive Order, requiring new analysis of notional volumes.
- Transactions with US-guaranteed foreign subsidiaries will be subject to certain Dodd-Frank requirements – substituted compliance may apply.

This **Financial Services Regulatory Brief** describes the approach taken by the CFTC in its final guidance and extension of relief, and provides context and perspective for global dealers as they press forward under the clarified regime.

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[1] We had anticipated last month that the CFTC would take action by July 12th and provide firms with additional conformance time. See PwC *Financial Services Regulatory Brief: Derivatives: Cross-border at the cross roads* (June 2013).

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The road to final cross-border guidance

As the industry waited for this final cross-border guidance, it had received a preview on July 11th with a press release announcing that the CFTC and European Commission ("EC") had agreed to a "path forward" for the treatment of cross-border transactions. The CFTC later provided a series of staff "no-action" letters implementing portions of the agreement.

The July 12th meeting was the culmination of a process the CFTC embarked upon exactly one year ago. The CFTC first proposed an approach to the regulation of cross-border transactions in July of 2012. Since that time, the agency has modified its proposal with an assortment of no-action letters issued in the run-up to SD registration, the temporary Exemptive Order[2] that altered some requirements outlined in the CFTC's proposed guidance, more proposed guidance,[3] and a surprisingly public debate among the commissioners regarding how and when to best to tackle cross-border issues.

At its public meeting, the CFTC approved two releases: final cross-border guidance and an exemptive order providing a phase-in for compliance with regulations affected by the guidance.[4] Both releases were approved by a 3-1 vote of the Commission.

The final guidance

As discussed below, the final guidance addressed a number of nagging questions raised over the preceding 12 months, including:

- Who is a US person subject to CFTC rules?
- Which swaps count toward thresholds for SD registration?
- Can CFTC rules be satisfied by compliance with comparable foreign requirements?
- Will the playing field for foreign branches of US swap dealers be level with foreign swap dealers?
- How much time will firms have to get their house in order?

The definition of US person

The final guidance contains the CFTC's much anticipated definition of "US person" – a concept important to determining which transactions are in scope for CFTC regulation as well as for determining registration thresholds for SDs and Major Swap Participants (MSPs). The definition would be primarily "territorial-based" and would include: natural persons that are US residents; corporations, business entities and funds that are organized in the US or have their principal place of business in the US; and collective investment vehicles such as hedge funds and commodity pools if they have their principal place in the US or if they are majority-owned by US persons (with a carve out for collective investment vehicles that are publicly offered but not offered to US persons).

This latter point is important for hedge funds that are incorporated outside the US. The definition will focus on the location of the investment managers, fund sponsors and promoters, and the sales and trading desk used by the fund to determine whether a fund outside the US would be treated as a US person.

Notably, a non-US person that is guaranteed by an affiliate of a US person is not included in the definition of US person.

In order to fully understand the implications of the new "US person" definition, the language used by the CFTC will require careful scrutiny when published. Nevertheless, the broader definition will require SDs and MSPs to re-examine both their methodology for determining who among their counterparties is a "US person" and the integrity of their past determinations.

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[2] Exemptive Order Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 858 (Jan. 7, 2013) (Exemptive Order); see PwC *Financial Services Regulatory Brief: Cross-border clarity – CFTC provides guidance and additional time for industry to address cross-border swaps* (December 2012).

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

[4] The documents approved by the CFTC, entitled "Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations" and "Exemptive Order Regarding Compliance with Certain Swap Regulations" had not been made public as of the release of this Regulatory Brief. Descriptions of their contents are based on summary documents provided by the CFTC and the comments of staff and commissioners at the public meeting.

Aggregation

With respect to the swap dealer *de minimis* calculations, CFTC staff explained that the guidance provides that:

- A US person, or a non-US person that is a guaranteed affiliate, will have to count towards its *de minimis* calculation all of its dealing swaps whether with US or non-US counter parties.
- A non-US person that is not a guaranteed affiliate will have to count swaps with US persons and swaps with certain guaranteed affiliates.
- A non-US person that is not a guaranteed affiliate may exclude any swaps that are entered into anonymously on a registered DCM or foreign board of trade and cleared.

Broadly speaking, the CFTC's interpretation would allow US and non-US persons in an affiliated group to engage in swap dealing activity up to the *de minimis* threshold. When the affiliated group meets the *de minimis* threshold in the aggregate, one or more affiliate(s) (inside or outside the United States) would generally have to register as an SD to ensure that dealing activity of the unregistered affiliates remain below the threshold.

Entity- and transaction-level requirements and substituted compliance

Consistent with the earlier proposed guidance, the CFTC's final guidance categorizes rules applicable to parties to cross-border transactions as either "entity" or "transaction-level" requirements. Entity-level transactions would include capital adequacy, chief compliance officer, and swap data repository reporting requirements. Transaction-level requirements would include items such as clearing and swap processing requirements, margin and segregation for uncleared swaps, mandatory trade execution, swap trading relationship documentation, portfolio reconciliation and compression, real-time public reporting, trade confirmation, daily trading records, and external business conduct standards. The distinction is important in order to determine whether and which CFTC rules apply to a particular cross-border transaction, and if substituted compliance is available.

In broad terms, US SDs would be expected to comply with all entity-level requirements, and substituted compliance would not be available. Non-US SDs would also be expected to comply with entity-level requirements, but substituted compliance would be available for some of these requirements.

With regard to transaction-level requirements, US SDs would be expected to comply with transaction-level requirements, but a foreign branch of a US bank/SD would be eligible for substituted compliance with respect to some requirements for swaps with certain counterparties. Non-US SDs would be expected to comply with transaction-level requirements for swaps with US persons and with guaranteed or conduit affiliates, but would be eligible for substituted compliance for swaps with certain counterparties. The CFTC's intent seems to be to provide foreign branches of US SDs rough parity with non-US SDs, at least where transactions with non-US persons are concerned.

As has been the case since the CFTC initially proposed guidance last year, determining when substituted compliance may be available (and to which transactions) is an exercise requiring a matrix of possible permutations, and industry participants are undoubtedly anxious to parse the language in the final guidance. As it stands now, the summary documents released by the CFCT raise some significant questions. Likewise, the CFTC has committed to examining each of the 13 categories of rules – five entity-level and eight transaction-level – to make separate determinations of substituted compliance. This undertaking will create its own layer of complexity for SDs attempting to define where substituted compliance may or may not apply.

The new exemptive order

The final piece to the CFTC's cross-border blitz is another exemptive order, referred to throughout the public meeting as an "interim final" order. The order is apparently final and will provide for a phased-in period of time for industry participants to adjust to the implications of the final guidance, but it also provides for a 30 day period for public comment. In theory, it could be amended in response to comments received by the CFTC.

As described at the public meeting, the order provides that:

- Market participants may continue to apply the "US person" definition and perform SD/MSP registration threshold calculations as allowed by the prior exemptive order, from July 13, 2013 until 75 days after the final guidance is published in the Federal Register. Consequently, during this time period, a non-US person may continue to exclude from its *de minimis* calculations:
  - Any swap where the counterparty is not a US person, or
  - Any swap where the counterparty is a foreign branch of a US person that is registered as an SD.

- With regard to aggregation of affiliate positions for purposes of the SD *de minimis* calculations:
  - A non-US person that was engaged in swap dealing activities with US persons as of December 21, 2012 may exclude the aggregate gross notional amount of swaps connected with the swap dealing activity of its US affiliates under common control.
  - A non-US person that was engaged in swap dealing activities with US persons as of December 21, 2012 and is an affiliate under common control with a person that is registered as an SD may also exclude the aggregate gross notional amount of swaps connected with the swap dealing activity of any non-US affiliate under common control that is either (i) engaged in swap dealing activities with US persons as of December 21, 2012 or (ii) registered as an SD.
  - A non-US person may exclude the aggregate gross notional amount of swaps connected with the swap dealing activity of its non-US affiliates under common control with other non-US persons as counterparties.
- A non-US person that was previously exempt from registration as a swap dealer but must now register as a swap dealer because of changes to the scope of the term "US person" or changes to the swap dealer *de minimis* calculation is not required to register as a swap dealer until two months after the end of the month in which such person exceeds the *de minimis* threshold for swap dealer registration.

Finally, certain relief in the order depends upon the foreign jurisdiction in which the non US SD or foreign branch is located.[5] For example, non-US SDs in Australia, Canada, the European Union, Hong Kong, Japan or Switzerland may delay compliance with most entity-level requirements for which substituted compliance is possible under CFTC guidance until the end of the year or issuance of a substituted compliance determination for the relevant requirements. Similarly, non-US SDs and foreign branches of US SDs located in these jurisdictions may comply with any law and regulation of the jurisdiction in which it is established (and only to the extent required by such jurisdiction) in lieu of complying with any transaction-level requirement for which substituted compliance is possible under the CFTC's regulations.

[5] We had suggested the CFTC would pursue this type of course in our *Financial Services Regulatory Brief: Inter-Affiliate Swaps Clearing Exemption – a trade worth making?* (April 2013).

Foreign branches of US SDs operating outside these six major jurisdictions will also be able to avoid Dodd Frank requirements and instead operate under local law in certain circumstances. While the documents summarizing the guidance and order do not specify the circumstances, the July 2012 proposal allowed for a de minimis amount of transactions in emerging market countries, which we understand is expected to be applied.

The prequel

Friday's public meeting was preceded by a series of preliminary actions that paved the way for the final guidance.

The press release

On Thursday, July 11th, the CFTC issued a press release announcing the intention of the CFTC, the EC and the European Securities and Markets Authority ("ESMA") to work together to "address conflicts of law, inconsistencies and legal uncertainties" that would arise from the simultaneous application of EU and US requirements to cross-border transactions. The CFTC's initial cross-border proposal had come under a good deal of criticism from EU regulators, among others, so the announcement was significant because it reflected some rapprochement between the two sets of regulators. More importantly, the agreement reflected a roadmap for the regulators, who can move forward on a consistent basis with rules and guidance describing how they will treat transactions that touch multiple jurisdictions.

The general direction of the press release was not particularly surprising: the release described the regulators' intention to defer to one another's regulatory regimes where appropriate – the CFTC through "substituted compliance" and the EU through a system of equivalence. Among the guiding concepts outlined in the release were indications that:

- For CFTC-registered foreign SDs not affiliated with (or guaranteed) by US persons, transaction level requirements would apply only to transactions with US persons.
- CFTC's approach will allow for compliance with entity-based rules through substituted compliance, as well as for transaction-based rules with guaranteed affiliates.
- If swaps are executed on an anonymous, cleared basis on a registered designated contract market, swap execution facility, or on a foreign board of trade, the CFTC will consider transaction level requirements met, including trade execution requirements.

- With regard to the trade execution requirement, the CFTC will permit foreign boards of trade that have received direct access no-action relief to also list swaps.

To be sure, the press release was simply a statement of the regulators' intentions but it does reflect a commitment to greater cooperation and harmonization, and gives some hope for the prospect of a more coherent global approach to regulation of cross-border transactions.

No action letters

Finally, the CFTC released four no-action letters, each touching upon some aspect of the plan laid out in the earlier press release. Three of the letters were fairly narrow in their focus:

- Two letters grant US person clearing members of two European clearing houses no-action relief from the requirement to clear certain proprietary index CDS and interest rate swaps through a registered DCO. The relief is conditioned and temporary, lasting only until the end of the year or when the two clearing houses obtain their registrations, whichever is first.
- Another letter expands the relief previously provided under which foreign boards of trade (FBOTs) can allow participants located in the US to enter trades directly into the trade matching system of the FBOT with respect to futures and option contracts. The current letter amends the previous relief to permit those FBOTs to list swap contracts for trading by direct access, subject to conditions.

The final, and perhaps most significant letter, provides relief from certain risk mitigation requirements applicable to registered SDs (and MSPs) in the US or EU with respect to certain uncleared transactions, when such transactions are subject to both the Commodity Exchange Act and regulations on the one hand, and the European Market Infrastructure Regulation (EMIR) on the other. Under the terms of the no-action letter, CFTC staff stated that relief would be extended to SDs and MSPs for whom, under both regimes, the requirements are deemed "essentially identical" and the SD or MSP complies with the requirements under EMIR. The scope of relief provided in the no-action letter is subject to the specific conditions including limitations to specified products and participants.

What now?

Comments by staff and commissioners at the CFTC's public meeting suggested that the CFTC's final guidance may have to undergo some "technical" edits before the guidance can be posted on the CFTC's website and submitted to the Federal Register for publication. This delay may raise questions about what happens next, given the July 12th expiration of the current exemptive order. However, with release of the guidance and order imminent, and what is known about their general contours, global firms can immediately begin evaluating their cross border operating models and make appropriate adjustments.

Additional information

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