

FS Regulatory Brief

Extraterritorial Derivatives Guidance Proposed by CFTC: More Analysis Required, Impact Unclear

July 2012

On June 29, 2012, the Commodity Futures Trading Commission (CFTC) released its much anticipated proposed cross-border guidance to interpret when Dodd-Frank Act derivatives regulations reach beyond US shores. It also released a proposed exemptive order that would grant temporary relief from compliance dates for certain regulations.

The Commission clearly struggled with the challenges of being first to regulate an otherwise unregulated global market. Its Guidance at times sacrifices clarity in pursuit of comity and competitive equity. When reading, it helps to keep the three goals that underpin this Guidance in mind. First, the CFTC intends to regulate, to some extent, swaps entered by anyone, wherever located, with a US person. Second, the CFTC expects registered swap dealers (and major swap participants) to operate in a Dodd-Frank compliant manner globally, irrespective of whether they are US or foreign based. Third, the CFTC seeks to defer to home country regulators that are building Dodd-Frank style regulatory systems at a slower pace than the United States.

The Guidance attempts to strike a balance between these goals through a combination of patchwork jurisdictional reach, selective application of “Entity” and “Transactional-Level” rules, and different compliance deadlines for US and foreign-based swap dealers. Depending on the dealing entity, its location, the nationality of its counterparties, and the particular regulatory requirement, a

bank or its affiliates can be in or out of scope for Dodd-Frank style regulation. This will create new operational challenges to analyze during the comment period that differ for US and foreign dealers.

We explore the implications of the Guidance further below. In general, however, US swap dealers would need to register and comply with all Dodd-Frank requirements on current schedules. Registration is expected in October 2012 and deadlines for several Transaction level requirements are projected for the same month. The Guidance would grant an extension for complying with Entity-level requirements until January 1, 2013. Foreign branches and affiliates of US swap dealers may request certain compliance delays for trades with foreign persons if they operate in jurisdictions that are creating Dodd-Frank comparable regulatory regimes.

Foreign swap dealers need to register as dealers and comply with certain Dodd-Frank transactional regulations for swaps with US persons on the same schedule as US swap dealers. Foreign based swap dealers appear able to use a different test for registration versus their US competitors. For swaps with foreign persons, foreign swap dealers may ask for a delay to permit compliance with local regulations (substituted compliance) which will initially be granted for one year.

Determining the impact of the Guidance on any part of a complex global financial institution is highly situational. Keeping these core questions in mind will help inform this analysis:

- Where and out of which entities do I trade swaps with US persons (or their functional equivalent)?
- How and by whom are my US and non-US swaps regulated?
- Which of my entities are or potentially could be swap dealers?
- Do I have to comply with Dodd-Frank now, something comparable later or some combination thereof?
- If I can delay certain aspects of Dodd-Frank regulation, does it make business sense to do so?

Because ultimately each firm needs to do its own firm-specific analysis, this **FS Regulatory Brief** offers general observations for US and foreign swap dealers to consider. It also provides a high-level table for assessing the projected regulatory impact on the particular entity or office engaged in swap activities.

1. Identifying swaps with US persons is a necessary but burdensome first step for understanding the impact of the Guidance

Trading swaps with a US person is the global trigger for CFTC regulation under Dodd-Frank. The Guidance offers an expansive definition of the term “US person” that in some cases looks beyond formality to the underlying investors. Managed accounts, commodity pools, pension plans and trusts with a sufficient US nexus are in scope. See Appendix A. Foreign persons that enter swaps with a US guarantee or as a conduit for a US person would be the functional equivalent of a US person for various compliance obligations. If not already done, US and foreign entities should conduct a global inventory of swaps with US persons, including functionally equivalent US persons, to complete a full Dodd-Frank analysis under the new Guidance.

2. Swaps with US persons must meet Dodd-Frank transaction regulations globally

Swaps with US persons would be Dodd-Frank regulated wherever they occur and irrespective of the regulatory status of either counterparty. Specifically, the Guidance would require any foreign (or US) person that enters into a swap with a US person to comply with certain “Transaction Level” requirements regarding the processing and reporting of those trades. See Appendix B. This is the case whether an entity is a registered swap dealer or not. The question then becomes whether compliance is required with Dodd-Frank regulations on the current schedule (deadlines expected this fall) or if waiting for comparable home country regulations via substituted compliance would be permitted.

As a baseline, anyone that trades swaps with a US person must comply with the Dodd-Frank requirements for trade execution, clearing and real-time reporting on the current schedules, which are expected to be clarified by year end. Substituted compliance would not be permitted. This means that foreign banks and other entities would need to have compliance programs in place to process trades with US persons in a Dodd-Frank compliant manner by Q3/Q4 2012, using current estimates. The Guidance would allow substituted compliance for broader swap data reporting (SDR reporting or confidential regulatory reporting) and recordkeeping, if the CFTC has direct access to data held at the foreign trade repository.

Separately, the Guidance would require any foreign clearing member of a clearing house to comply with the CFTC’s Large Trader Reporting regime. This regime requires clearing members to submit reports regarding specified positions in physical commodity swaps or swaptions. It would not permit substituted compliance.

3. Banks may need to re-check their swap dealer registration analyses, especially if they use central booking models

Entities that deal in swaps with US persons above a *de minimis* threshold would have to register as swap dealers. The Guidance appears to create different tests for US and

foreign banks to use when calculating the notional value of swaps traded as dealer. US banks would need to calculate notional values of swaps entered as dealer with US and foreign persons entered globally to see if the total exceeds the *de minimis* threshold. Foreign banks (and other foreign entities) do not. They would be able to limit their calculation to dealing swaps with US persons. In doing so, foreign banks would be able to exclude dealing swaps entered by their US affiliates, and swaps they enter into with foreign branches of US swap dealers.

US and foreign banks that use central booking models need to read carefully through the discussion of this topic in the Guidance because additional dealer registrations may be required. The CFTC describes the central booking model as one in which an entity negotiates swaps through affiliates or subsidiaries, but books all of the trades in a single parent entity, either directly or through back-to-back transactions. It appears that in the back-to-back model, the CFTC would consider both the client facing and the central booking entity to engage in swap dealing activities. Each would need to register and both may have to fully comply with full Dodd-Frank regulation. However, there is ambiguous language about the allocation of compliance responsibilities to each entity.

4. Mandatory registration begins on the same date for US and foreign banks; branches do not register separately

Irrespective of how the registration analysis is done, all firms that qualify as swap dealers (or major swap participants) will have to file registration documents on the mandatory filing date. Currently, we are projecting that date to fall in mid-October, 2012. This deadline will become certain when the rule implementing final product definitions is released, and the CFTC has scheduled a meeting to discuss those definitions on July 10.

The Guidance formalizes the oft-spoken CFTC view that a branch of a bank, or other entity, cannot register as a swap dealer on a separate basis. Registration applies to the entire legal entity and the place of incorporation, or principal place of business would seem to

determine the baseline regulatory regime applicable to a dealer (i.e., US based Dodd-Frank rules or other home country regime). Foreign branches of a dealer that trade swaps with US persons need to consider whether they must comply with CFTC regulations or should request substituted compliance with applicable foreign regulations.

5. Once registered, compliance requirements depend on nationality: impact on US swap dealers

Once a firm determines that it has to register, it needs to analyze which Dodd-Frank regulations it must comply with, when and in which location. The Guidance would not leave any registered US or foreign swap dealer free to trade swaps without applicable Dodd-Frank style regulation, eventually. It divides Title VII Dodd Frank regulations into “Entity Level” and, as noted above, “Transaction Level requirements” for these purposes. See Appendix B.

US swap dealers must comply with Entity Level requirements globally by January 1, 2013. Their entity-focused compliance programs must include all foreign branches, which may pose new challenges for US firms that have focused their compliance efforts geographically in the United States. They also must comply with Transaction Level requirements when trading swaps with US or foreign persons. Many of those deadlines are expected in Q3 and Q4 2012.

Foreign branches of US swap dealers would not need to build Transaction Level compliance programs for *swaps with foreign persons* if they obtain a substituted compliance determination (process discussed in next section). They do need compliance programs for many, but not necessarily all, of the Transaction Level requirements for trades with US persons, although substituted compliance may be permitted for trades with foreign persons that are guaranteed by, or conduits for, US persons.

Foreign affiliates of US swap dealers generally may seek substituted compliance for their Entity Level obligations and, when trading with foreign persons, their Transaction Level requirements. As noted above, foreign affiliates that are booking entities for a US

swap dealer through back to back trades may not be able to request substituted compliance.

6. *Impact on foreign swap dealers: substituted compliance or full compliance*

The ability for foreign swap dealers (and foreign branches and affiliates of US swap dealers) to seek substituted compliance determinations in lieu of building Dodd-Frank compliant operations, at least for trading with a foreign person, offers the benefit of an up to one year (and possibly longer) regulatory delay. To get this delay, a foreign dealer or branch would file a request with the CFTC together with a “compliance plan” that describes how it would meet comparable requirements under its upcoming home country regime. This filing is due 60 days after a foreign entity registers with the CFTC as a swap dealer.

The CFTC plans to issue substituted compliance determinations to foreign swap dealers and branches if their home country rules are “comparable to cognate requirements” under the Commodity Exchange Act and CFTC rules. If a foreign dealer cannot point to a comparable cognate in its home country, it must meet the CFTC requirements on the current deadlines.

The CFTC plans to review 14 of the 15 enumerated Entity and Transaction Level requirements when making substituted compliance determinations. It would not require foreign swap dealers to demonstrate an ability to comply with External Business Conduct standards for trading with foreign persons or their equivalents. This appears to mean that a foreign swap dealer may continue to trade, permanently, with a foreign person (and the US guaranteed/conduit equivalent) without requiring compliance with the extensive documentation and disclosure requirements otherwise applicable to trading with US persons. A US swap dealer would not appear to be able to suspend External Business Conduct review for trades with foreign persons from US locations.

There are many factors involved in determining which of the Transaction requirements a foreign swap dealer must comply with under CFTC rules versus those which it may defer via substituted compliance.

As noted above, a foreign swap dealer must comply with CFTC requirements regarding trade execution, clearing and real-time reporting when trading swaps with a US person. Whether the foreign dealer is a booking entity can change this analysis.

7. *Next steps for US and foreign swap dealers*

US banks should continue full-steam ahead with compliance efforts in the United States. They may need to revalidate the entities they plan to register, with special attention to the treatment of central booking models under the proposed Guidance. US banks also should evaluate their global compliance plans to determine whether to seek substituted compliance for their foreign branches or affiliates. This may be an easy call for some, or a competitive necessity for others, in which case, teams should begin to evaluate comparability for each foreign branch location and draft compliance plans for submission to the regulators by year end.

On the regulatory advocacy side, US banks may wish to raise concerns about incremental advantages accruing to their foreign bank competitors that can use the Guidance to delay operating and trading under Dodd-Frank-like standards for a year or more. They also may raise competitiveness concerns connected with having to enforce External Business Conduct requirements in circumstances when foreign dealers do not.

For foreign banks, separating trades with US persons from those with foreign persons will take on renewed importance in order to seek to shelter temporarily part of their trading activities from Dodd-Frank style regulation. They should consider re-running their swap dealer analyses to confirm whether the correct entities are being registered, since the swap dealer test seems to change under the Guidance. Foreign banks also must plan to register in October 2012 and file compliance plans for substituted compliance by year end.

Foreign bank swap dealers should continue to build Title VII compliant programs for US persons at least on a Transaction Level basis. Some may wish to evaluate whether operationalizing regulation of swaps with US persons only now, then building a

“comparable” program for non-US persons later, is functionally or economically practical.

For both US and foreign swap dealers, the Guidance may reshape the global derivatives trading strategy. An analysis of regulatory, capital and tax factors may be warranted in an effort to optimize swap operating and booking models.

8. How do US and foreign swap dealers compare under the Guidance?

The Guidance struggles to achieve a regulatory trifecta by (1) rolling out full Dodd-Frank regulation of swaps activities for US banks and US derivatives transactions, (2) permitting foreign firms to comply with home country regulations which are coming, but are not yet in place, and (3) keeping US firms on equal footing abroad with foreign competitors that do not yet have the burden and cost of building a full Dodd-Frank style derivatives compliance program.

As best we can tell, the Guidance falls short of achieving this goal in principal, although we wonder to what extent it can ever truly be achieved. Foreign banks and other foreign swap dealers would not have to operationalize Entity Level or, for trades with foreign persons, Transaction Level regulations for an indeterminate amount of time if comparable regulation is developing in their home countries. Meanwhile, US banks must continue to build fully compliant Dodd-Frank operations for US based swaps businesses, at minimum. Foreign branches and affiliates of US swap dealer banks would operate on similar footing as their foreign counterparts, but not the same. The upshot appears to be that foreign swap dealers may continue to trade swaps, other than for trade processing purposes, per business as usual with presumably lower compliance costs if they opt to build out their compliance program for US swap transactions but not for foreign.

Whether compliance delays amount to a meaningful business advantage will depend on an analysis of each institution. We will continue to review this Cross Border release, together with the many other CFTC regulatory releases, to provide guidance into how to proceed with building toward Dodd-Frank derivatives compliance.

Appendix A

CFTC Proposed Definition of US Person

Natural Person that is a Resident of the US	Legal entity* organized or incorporated under the laws of the United States
Individual account where the beneficial owner is a US person	Legal entity with its principal place of business in the United States
Commodity pool, pooled account or collective investment vehicle (organized anywhere) of which a majority ownership is held, directly or indirectly, by US person(s)	Legal entity in which the direct or indirect owners thereof are responsible for the liabilities of such entities and one or more such owners is a US person**
Commodity pool, pooled account or collective investment vehicle operated by a registered commodity pool operator under the Commodity Exchange Act	Estate or trust, the income of which is subject to United States income tax regardless of source
Pension plan for employees, officers or principals of a legal entity with its principal place of business inside the United States	Foreign branch, agency or office of a US person

*Legal entity includes: corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund or any form of enterprise similar to the foregoing.

** In the release, the CFTC notes that a foreign affiliate or subsidiary of a US person would be a non-US person, even where such an affiliate or subsidiary has certain or all of its swap-related obligations guaranteed by a US person. This seems potentially inconsistent with the statement that a US person *includes* a legal entity that has a US person responsible for its liabilities. Perhaps a guarantee is different from responsible for liabilities in the view of the CFTC.

Appendix B

CFTC Registration, Entity Level and Transaction Level Requirements: Swap Dealers

Registration (applies to firm as a whole)						
	Foreign Firm and Foreign Branches	US Branch of Foreign Swap Dealer	Foreign Affiliate of Foreign Swap Dealer	US Firm	Foreign Branch of US Swap Dealer	Foreign Affiliate of US Swap Dealer
<i>Registration deadline requires final product definitions:</i>	Register if dealing swaps with US persons ¹ directly and across foreign affiliates exceed <i>de minimis</i> levels	Part of SD	Register if dealing swaps with US persons* directly and across foreign affiliates exceed <i>de minimis</i> levels	Register if dealing swaps directly and across affiliates exceed <i>de minimis</i> levels	Part of SD	Register if dealing swaps with US persons* directly and across foreign affiliates exceed <i>de minimis</i> levels
<i>Estimated deadline to register currently October 2012</i>	Swaps with certain US CPs excluded from aggregation		Swaps with certain US CPs excluded from aggregation			Swaps with certain US CPs excluded from aggregation
	Look through to booking entities		Look through to booking entities			Look through to booking entities

¹ Include swaps that foreign affiliates enter with a guarantee from a US person.

Entity Level Requirements (apply to swap dealer as a whole)						
	Foreign SD and Foreign Branches	US Branch of Foreign SD	Foreign Affiliate of Foreign SD	US SD	Foreign Branch of US SD	Foreign Affiliate of US SD
<i>Capital</i>	Substituted compliance permitted, with some conditions	Presumably part of SD but not expressly discussed	Substituted compliance permitted, with some conditions	Compliance by Jan. 1, 2013	Part of SD	Substituted compliance permitted with some conditions
<i>Chief Compliance Officer</i>						
<i>Risk Management</i>						
<i>Swap Data Recordkeeping</i>						
<i>Swap Data Reporting</i>						
<i>Large Trader Reporting (Physical Commodity Swaps)</i>						

Transaction Level Requirements
(apply to each swap)

	Foreign SD and Foreign Branches	US Branch of Foreign SD	Foreign Affiliate of Foreign SD	US SD and US Branches	Foreign Branch of US SD	Foreign Affiliate of US SD
<i>Clearing and Swap Processing</i>	Comply with Dodd-Frank for swaps with US persons but not foreign branches of US persons	Not expressly discussed	Comply with Dodd-Frank for swaps with US persons but not foreign branches of US persons	Compliance by date in the applicable final rules	Compliance by date in the applicable final rule but substituted compliance permitted for swaps with foreign counterparties	Same as foreign firm
<i>Margin and Segregation</i>						
<i>Trade Execution</i>						
<i>Swap Trading Relationship Documentation</i>	Substituted compliance permitted for swaps with foreign persons with US guarantor and foreign affiliate conduit for US persons		Substituted compliance permitted for swaps with foreign persons with US guarantor and foreign affiliate conduit for US persons			
<i>Portfolio Reconciliation/Compression</i>						
<i>Real Time Reporting</i>						
<i>Trade Confirmation</i>						
<i>Daily Trading Records</i>						
<i>External Business Conduct Standards</i>	Comply with regard to swaps with US persons other than foreign branches of US persons No compliance for swaps with non-US persons		Comply with regard to swaps with US persons other than foreign branches of US persons	Compliance by date in final rule	Compliance by date provided in final rule, but only with regard to swaps with US counterparties	Comply with regard to swaps with US persons other than foreign branches of US persons

* Non-US affiliate conduit is a non-US counterparty that is majority-owned directly or indirectly by a US person, non-US counterparty regularly enters swaps with one or more US affiliates or subsidiaries of a US person, and financial of such non-US counterparty are consolidated in the financial statements of the US person.

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