

# *FS Regulatory Brief*

## *Swap regulation commences*

### *Day 1 closes with a flurry of CFTC relief: What does it all mean?*

October 2012

On Friday, October 12, 2012, regulation of swaps under the Dodd-Frank Act by the Commodity Futures Trading Commission (CFTC) officially began. However, in what can best be characterized as a false start for the new regulatory regime, compliance with the panoply of new CFTC regulations governing swap transactions will be phased in over the coming months. As we have previously reported, compliance with the majority of the Dodd-Frank Act Title VII regulations will be triggered when institutions acting as swap dealers officially register as such -- which, for the largest dealers, is on or before December 31, 2012.

Nevertheless, some market participants remain confused about the scope and impact of this change. Although October 12th marked the effective date for many Title VII regulations, the CFTC rule set is incomplete and the interpretation of several key requirements is uncertain. In particular, foreign-based banking organizations engaging in swaps with US counterparties are struggling to discern the extraterritorial impacts of Title VII on their businesses. We understand that there are hundreds of requests for relief or interpretive guidance pending before the CFTC and its staff.

In partial response to the wave of industry requests for more clarity, the CFTC on October 11th and 12th released a flurry of no-action letters, staff interpretive guidance and Frequently Asked Questions (FAQs) covering various Title VII topics of interest to market participants (collectively, the "Releases"). This PwC Financial Services Regulatory Brief summarizes the CFTC actions and, as important, what is still not addressed.

The Releases offer some limited relief and clarity to swap market participants, but did little to reduce the pressure they are feeling to understand and prepare for compliance with Dodd-Frank swap regulation. Of primary importance to many prospective swap dealers are two no-action letters concerning the handling of potentially exempt FX swaps and forwards and the definition of "US person" for the purpose of the *de minimis* test; an interesting FAQ response that appears to answer the question of whether the swap positions of an affiliated registered swap dealer can be excluded from the *de minimis* calculation (the answer was "no"); and an extension of time for investment advisors to register their commodity advisory activities. We discuss these and other developments below.

- **Treatment of FX swaps and forwards in the *de minimis* calculation:** The FX no-action letter provides relief from the obligation to include FX swaps and forwards in the *de minimis* calculation. According to the terms of the no-action relief, the Division of Swap Dealer and Intermediary Oversight (DSIO) will not recommend enforcement action against an entity for failure to include in its *de minimis* calculation of the aggregate gross notional amount any FX swaps or FX forwards that are covered by an exemption issued by the Treasury that is effective prior to December 31, 2012. However, if by December 31, 2012 an entity enters into other types of swaps dealing in excess of the thresholds, then FX swaps and forwards must be counted for the purpose of determining the date of required registration. We believe that post-election, the Treasury will issue this interpretation, so this early action by the CFTC is welcome relief.

- **US persons and the *de minimis* calculation:** The “US person” letter provides that, for purposes of the *de minimis* calculation, from now until December 31, 2012 or the effective date of a final definition of “US person” if earlier, non-US persons/prospective swap dealers should only count swaps with the following types of counterparties: **(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, 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.

In a departure from the proposed Cross Border guidance, a non-US person/prospective swap dealer does not need to count swap dealing transactions with a counterparties that are not US persons as defined above, even if the swap is guaranteed by a US person. Similarly, as opposed to the definition of “US person” in the proposed guidance, the definition in Friday’s guidance does not include the following as “US persons:”

- Entities that have their principal place of business in the United States
- Corporate entities in which the direct or indirect owners are responsible for the liabilities of the entity and on or more such owners are US persons
- Commodity pools, pooled accounts, or collective investment vehicles (whether or not organized or incorporated in the US) of which a majority ownership is held, directly or indirectly, by a US person or persons

- Commodity pools, pooled accounts, or collective investment vehicles, the operator of which would be required to register as a CPO.

While the CFTC has provided a definition of US person that may be easier to apply, it has limited application. The agency says that the definition is to be used for calculation of gross notional dealing activity; it does not resolve questions regarding, for example, the treatment of US branches of foreign banks for registration purposes.

- **Treatment of the swap positions of registered swap dealer affiliates for purposes of *de minimis* calculation:** The CFTC’s FAQ on Swap Entities indicates that an entity relying on the *de minimis* exception to the definition of swap dealer may not exclude the swap positions of any affiliate that registers as a swap dealer. This message appears to be inconsistent with CFTC staff’s statements that they would not attribute dealer status to other entities under the same group as a registered swap dealer. Further clarification appears to be pending from the CFTC on this topic.

Other CFTC letters addressed registration issues more generally. These include:

- **Registration of other swap entities:** One of the letters extends until December 31, 2012, the deadline for non-swap dealer CFTC registrant (commodity pool operators, commodity trading advisors and introducing brokers) engaged in swaps business to register their swap activities with the CFTC. Absent this relief, registration would have been required on October 12, 2012. This relief effectively harmonizes the earliest required registration date for all CFTC-regulated swap market entities to December 31, 2012. However, the temporary no action relief for registration of swap entities does not apply to futures commission merchants (FCMs) who must register solely for swaps activity, as they can and do accept funds in their name from customers. Entities currently registered as FCMs have until December 31, 2012 to notify the National Futures Association (NFA) that they engage in swaps activity.

- **Statutory disqualification/APs of swap dealers:** Another letter provides an avenue for individuals with statutory disqualifications to potentially act as associated persons (APs) of swap dealers. APs of swap dealers who are subject to statutory disqualifications can submit supporting documentation to NFA for review regarding the incident causing the statutory disqualification. NFA will indicate whether or not the AP would have been registered as an AP had the AP gone through the current registration process for APs of futures firms. If NFA reviews the documents and indicates the individual would have been registered as an AP, the AP can continue to engage in swaps activities. If NFA would not have registered the individual as an AP, the individual must cease all swap activities.

Among the remaining Releases were those:

- Providing eligible contract participant (ECP) relief primarily for lending-related swap transactions involving small and medium businesses and persons or entities guaranteeing these obligations;
- Providing further guidance and clarification around what constitutes “*bona fide* hedging” for purposes of determining whether a registered investment company investing in listed futures products is required to register as a commodity pool operator or trading advisor;
- Providing interim relief / exclusion from *de minimis* threshold calculations for swaps referenced to exempt commodities and agricultural commodities; and
- Resetting the *de minimis* threshold for non-financial companies trading energy swaps with Utility Special Entities from \$25MM to \$800MM.

The CFTC remained silent on, or did not fully address, key questions important to potential swap dealers, particularly those entities that are parts of larger financial holding companies. These key open questions include the following:

- What relief may be provided with respect to swap dealer reporting and business conduct rules where a dealer’s ability to comply with requirements is dependent upon collection of key data from counterparties? For example, timely availability of CICI/LEIs and counterparty adherence to the ISDA Protocols or voluntary provision of KYC data required for DFA compliance will present particular challenges for dealers. Will a participant’s “reasonable efforts” to obtain key identity and classification data about counterparties suffice? Or is the obligation to obtain and verify all required information subject to some higher standard?
- The definition ECP became final and effective on October 12, 2012, and the CFTC provided some clarity about this definition. What it did not do, however, is speak to the basic statutory prohibition in Dodd-Frank which appears to prevent any person -- swap dealer or not -- from trading swaps off-exchange unless that person is an ECP. How this plays out in a newly regulated market is yet to be seen. However, all market participants should be working with counsel and reviewing KYC data to ensure they clearly understand how to verify their US person counterparties are ECPs and how to handle potential exceptions.

While swap dealer regulation has officially started, there remain numerous open issues that the CFTC needs to clarify between now and the December 31st registration date. We will continue to update you on the latest developments as they arise.

# Additional information

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