FS Regulatory Brief

Cross-border clarity:

CFTC exemption gives foreign firms more time and US swap dealers more certainty

December 2012

On December 21, 2012, the Commodity Futures Trading Commission ("CFTC") issued a final "Exemptive Order" and "Further Proposed Guidance" to clarity its approach to regulating cross-border swaps activities under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). In issuing this release, the CFTC continues to juggle the competing tasks of regulating US swap activity, avoiding competitive inequity, discouraging evasion and deferring to local regulation.

The release follows the original proposal with some important modifications that seek to answer questions such as:

- What is a "US person?"
- When does a foreign entity have to register as a swap dealer under the aggregation rule?
- Which Title VII rules apply to a foreign swap dealer?
- Which Title VII rules apply to a foreign branch of a US swap dealer?

The release also provides assurance that good faith compliance during the start of the swap regulatory regime is sufficient to avoid enforcement action.

This **FS Reg Brief** discusses the CFTC's approach to these cross-border questions and offers insight into some of the expected practical impacts on foreign and US swap dealers.

What are the key take-aways?

This release provides the industry – particularly foreign-based dealers – with relief and guidance in several key areas. It is important to note that this clarity may be time-limited, as this Final Exemptive Order expires on July 12, 2013, and final guidance on certain cross-border matters is forthcoming. The key takeaways include:

- **A narrower definition of US person** – Firms may use a five-part test to identify a US person, at least until the CFTC finalizes its guidance on this topic. This test is narrower than the original proposal but includes the entity's principal place of business (as of April 1, 2013) and place of incorporation, to distinguish between a US and foreign person.
- **No aggregation outside of the US** – If a foreign firm has a registered swap dealer within its group, it may base its analysis on whether it has to register any other non-US entities as a swap dealer based on each entity's standalone swap dealing transactions with US persons. This means that unless a non-US entity exceeds the $8 billion *de minimis* limit for swaps with US persons (or $25 million with Special Entities) on a stand-alone basis and engaged in swap dealing on December 21, 2012, ***it does not have to register as a swap dealer.*** Other relief may be available for foreign firms that engaged in swap dealing on December 21, 2012, and do not have a registered swap dealer in the family. This aggregation rule applies until July 12, 2013, and includes specific protections against firms using this relief to evade registration.

pwc

- **Dodd-Frank applies to swap dealing with US persons globally** – Any registered US or foreign swap dealer must eventually provide US persons with all Dodd-Frank transactional protections under Title VII. As a result of no-action that has been separately provided, compliance deadlines for many of these protections has been delayed. For example, external business conduct deadlines were recently extended until May 2013.
- **Geography-based rules apply to swap dealing with foreign persons** – Registered foreign swap dealers and foreign branches of US swap dealers may trade swaps with foreign persons under local laws until the Exemptive Order expires. This time-limited exemption has done away with the need for foreign dealers to submit a compliance plan identifying areas where substituted compliance may apply, allowing time for foreign regulators to "catch up" with US regulations. However, the CFTC indicated in the release that this may not be the last word on the topic of regulatory deference.
- **Good faith effort to comply is sufficient** – Good faith compliance during the start of the swap regulatory regime is sufficient to avoid enforcement action. The CFTC "does not intend to bring an enforcement action against a swap dealer for failing to fully comply with applicable Dodd-Frank requirements prior to July 12, 2013" as long as the dealer is acting in good faith, the release asserted. This assertion was not limited to cross-border topics.

What is a US person?

The CFTC relies on the definition of "US person" to implement its cross-border authority to regulate swaps activities that have a "direct and significant connection with activities in, or effect on, commerce of the United States" under Dodd-Frank. Whether a foreign firm has to register as a swap dealer, or any firm has to comply with transaction-based regulations when trading swaps, depends on whether the firm trades swaps with a US person.

The CFTC originally proposed a seven-part test to define the term "US person." However, commenters found this definition operationally challenging given current systems and limited information available about counterparty nationality. In subsequent no-action relief, the CFTC narrowed its definition of "US person" to a five-part test.

The Further Proposed Guidance continues to use this narrower five-part test, with certain modifications. It defines a US person as:

- A natural person who is a resident of the US,
- A corporation, other form of enterprise or fund that is,
  - Organized or incorporated under the laws of a state or other jurisdiction in the United States, or
  - Has its principal place of business in the United States (to be included as of April 1, 2013, but not for funds or collective investment vehicles),
- A pension plan for the employees, officers or principals of a legal entity described above, unless the pension plan is primarily for foreign employees of such entity,
- An estate of a decedent who was a resident of the United States at the time of death, or certain trust subject to state law, or
- An individual account or joint account where a beneficial owner is a person described above.

This definition applies as of January 1, 2013. The guidance describes the definition as part of a phase-in to provide firms with more time to improve their systems' tracking of counterparty identity. This phase-in suggests that a final definition of US person may be more expansive.

While the Further Proposed Guidance pulls back on some of the more problematic aspects of the initial definition – it eliminates consideration of underlying guarantees, for example – it continues to pose implementation challenges. For example, firms generally do not track the principal place of business of a client in their systems or receive this information during client onboarding. Even if the delay until April allows for system modifications, obtaining this information for all clients may pose problems – especially for firms that are not registering as dealers. The CFTC did indicate that firms may reasonably rely on a representation from their counterparties as to their US person status. In a footnote, they also noted that an acceptable proxy for the principal place of business is the corporate headquarters.

When does a foreign firm have to register as a swap dealer under the aggregation rule, and what counts toward the de minimis thresholds?

The CFTC requires any firm with swap dealing transactions that exceed $8 billion total gross notional with all counterparties or $25 million with Special Entities to register as a swap dealer.[1] In performing this calculation, a firm may exclude certain types of swaps for a variety of reasons (e.g., not dealing swaps or exempt swaps). It must, however, *include* or aggregate dealing swaps entered by any affiliate.

This rule has led many foreign firms and their affiliates to the conclusion that they may have to register multiple off-shore entities as swap dealers as of year-end 2012. To avoid disruption during the transition to the new Dodd-Frank swap regulatory regime, the Exemptive Order applies a cross-border rationale for allowing ***a foreign firm that already has a registered swap dealer in its group or that engaged in swap dealing with US persons as of December 21, 2012*** to temporarily exclude certain swaps and swaps of certain affiliates from its *de minimis* calculation for registration.

[1] The *de minimis* test applies on a rolling twelve month basis. It may lower to $3 billion total gross notional within the next five years. The MSP test includes all swap positions under different calculations, not just dealing swaps.

Depending on the circumstances, this modification of the *de minimis* test and the aggregation rule until July 12, 2013, may allow a foreign firm to exclude from the calculation its swaps with:

- Non-US (or foreign) persons, and
- Foreign branches of US swap dealers or of US firms that intend to register as swap dealers by March 31, 2013.

It also may not have to include certain swap dealing transactions that are otherwise required by the aggregation rule. These consist of swap dealing transactions of:

- Any US affiliate, and
- Any affiliated central booking entity.

Finally, a foreign firm that is affiliated with a registered swap dealer would not have to aggregate its US person swaps with any other foreign affiliate in the group or with the registered swap dealer, provided that the affiliates are engaged in their US persons dealing activities as of December 21, 2012. These conditions require close scrutiny and were created to provide registration relief to current market participants without encouraging evasion.

Cross-border release retains the entity- and transaction-level rule approach, but holds-off on substituted compliance

The Exemptive Order continues to distinguish between “entity-level” and “transaction-level” rules in order to determine which rules apply to foreign swap dealers or foreign offices of US swap dealers.

The rules in each category did not change materially. Entity-level rules include rules regarding capital, chief compliance officer, risk management, diligent supervision, recordkeeping, reporting to a swap data repository and large trader position reports. Transaction-level rules include rules regarding clearing and execution, margin for uncleared swaps, swap documentation, credit support arrangements, real-time reporting, confirmation, compression, daily trading records and external business conduct. The CFTC said that it would reconsider the classification of these rules in connection with future guidance on cross-border issues.

The CFTC's original cross-border release distinguished between entity and transaction level requirements as part of a substituted compliance regime, whereby non-US dealers would be permitted to comply with comparable home country regulations rather than Title VII. It also required firms to submit compliance plans describing how they would meet comparable requirements under their home country regime. The Exemptive Order does not elaborate on the "substituted compliance" process for establishing comparable regulation, but notes that the exemption until July 12, 2013, offers more time for a substituted compliance approach to work. In addition, the CFTC eliminated the requirement for firms to submit a compliance plan but suggested that firms may hear more on this topic in the future.

Which Dodd-Frank rules apply to a foreign swap dealer?

A foreign swap dealer may delay compliance with the Entity-Level rules until July 12, 2013, except that it must report data to a swap data repository ("SDR") and submit large trader position reports for swaps with its US counterparties. If the foreign swap dealer is affiliated with a US swap dealer, these reports must be submitted for swaps with US *and* foreign counterparties.

A foreign swap dealer also may comply with local Transaction-Level rules (rather than Dodd-Frank rules) for swaps with foreign persons until the Exemptive Order expires. Swap transactions with US counterparties must, however, comply with all of the Dodd-Frank transaction level rules. Note that compliance with many of these rules has been delayed under separate no-action relief.

This appears to mean that, at least until July 12, 2013, a foreign swap dealer does not have external business conduct duties to foreign counterparties, unless local law requires the same.

Which Dodd-Frank rules apply to a foreign branch of a US swap dealer?

A foreign branch of a US swap dealer has the same reduced compliance obligations as a foreign swap dealer, with the exception of reporting. That branch's trades with foreign counterparties may comply with local law, although trades with US persons must meet all Dodd-Frank Transaction-Level rules. All branches of a US swap dealer must send swap data to an SDR and large trader reports with US *and* foreign counterparties. This data is for regulatory use and remains confidential.

In order for a swap transaction to qualify as being with a foreign branch of a US dealer, a person located in that foreign branch must negotiate and agree to the terms of the swap, documents must reflect the foreign branch as the counterparty and this must be done in the "normal course of business." This test requires close examination for voice and electronic trades and for US firms exploring booking options that address requests from foreign counterparties.

But what about US branches of foreign swap dealers?

The cross-border release is silent on the treatment of US branches of foreign swap dealers. It does not provide mirror image regulation by stating that all trades executed in these branches face full Title VII regulation. This silence in the face of yawing competitive issues leaves some foreign and US swap dealers in the position of having to plan strategic responses to the many booking model options available. The compliance delays appear to provide extra time to address some of these issues before clients are actually impacted, however.

Good faith efforts continue to be key

The CFTC provided comfort to firms working to comply with the many new requirements applicable to swap dealers in the release. It "does not intend to bring an enforcement action against a swap dealer 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 requirements and the SD or MSP is acting in good faith to fully comply with the applicable Dodd-Frank requirements, which would include, at a minimum (i) material progress towards timely implementation and compliance; (ii) identification of any implementation or interpretative issue as soon as reasonably possible; (iii) timely elevation of such issue(s) to the SD's or MSP's senior management for consideration and resolution; and (iv) timely consultation with other industry participants and the Commission as necessary to seek resolution of any such issue(s)."

Bringing 2012 to a close and preparing for 2013

The flurry of CFTC releases and no-action letters issued in the last weeks of 2012 has brought much needed clarity and relief to the industry. While many operational and compliance issues and tasks have been delayed, they have not been completely resolved. Even within this release, the CFTC was clear that it will be revisiting both the US person definition and the application of the aggregation rule to ensure that it is meeting its obligations to effectively regulate the market and ensure that any potential loopholes to avoid registration or regulation are closed.

Clearly, the CFTC has been listening to merit based arguments of the industry and is attempting to develop a workable compliance schedule – while continuing its "first mover" global regulatory leadership role. The efforts of the industry to comment and inform should be commended and should set the standard for proactive regulatory interaction heading into what will be another busy year in 2013.

Additional information

For additional information about PwC's Financial Services Regulatory Practice and how we can help you, please contact:

Dan Ryan
Financial Services Regulatory Practice Chairman
646 471 8488
daniel.ryan@us.pwc.com

Alison Gilmore
Financial Services Regulatory Practice Marketing & Communications Leader
646 471 0588
alison.gilmore@us.pwc.com

Contributors: Phyllis Cela, Margaret Paulsen, Richard Paulson, William Penner, Christopher Scarpati, and Melissa Slade.

www.pwcregulatory.com

To learn more about financial services regulation from your iPad or iPhone, click here to download PwC's new Regulatory Navigator App from the Apple App Store.

Follow us on Twitter @PwC_US_FinSrvcs