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Introduction to the U.S. Regulation of Cross-Border Transactions Involving Swaps and Security-Based Swaps

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This practice note provides an introduction to U.S. regulation of swaps and security-based swaps executed or negotiated outside the United States that involve at least one U.S. person or certain affiliates thereof, and at least one counterparty that is not organized under U.S. law, which are commonly referred to as "cross-border transactions."

Background

On July 21, 2010, Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") amended the Commodity Exchange Act ("CEA") and the Securities Exchange Act of 1934 (the "Exchange Act") to provide for the comprehensive regulation of swaps and security-based swaps, respectively. Public Law 111-203, 124 Stat. 1376 (2010). For an explanation of the difference between swaps and security-based swaps, please refer to the practice note, "Introduction to the Regulation of Swaps and Security-Based Swaps Under Title VII of the Dodd-Frank Act."

The financial crisis of 2008 demonstrated that cross-border activities can have a substantial impact on the U.S. financial system. U.S.-based companies faced enormous financial losses and credit downgrades when counterparties called for additional collateral on swap positions with the foreign affiliates and subsidiaries of the U.S.-based companies, resulting in liquidity problems for both counterparties and systemic difficulties in both foreign and domestic financial markets.

The Dodd-Frank Act responded to the problems that arose from cross-border transactions by providing a basis for extraterritorial jurisdiction. As discussed below, the fundamental basis of extraterritoriality is different in both statutes as the CEA is focused on the effect of global swaps markets on the financial stability of the United States, while the Exchange Act regards security-based swaps as an object of securities regulation. The Commodity Futures Trading Commission ("CFTC") has implemented the statutory provisions regarding extraterritorial application through interpretive guidance. Similarly, the Securities and Exchange Commission ("SEC") has adopted the first in a series of final rules and interpretative guidance on cross-border security-based swap activities.

Cross-Border Regulation of Swaps Under the CEA and the CFTC Guidance

Section 722(d) of the Dodd-Frank Act amended the CEA by adding Section 2(i), which provides generally that the swaps provisions of the CEA will apply to cross-border activities if such activities have a "direct and significant connection with activities in, or effect on,

commerce of the United States." 7 U.S.C. §2(i). To address the scope of the Dodd-Frank Act's application in other jurisdictions, the CFTC has published guidance regarding how it interprets that provision and regulations promulgated thereunder. 78 Fed. Reg. 45291 (July 26, 2013) ("CFTC Guidance"). According to the CFTC, this provision was intended to address the perceived transfer of risk "across multinational affiliated entities . . . that make it difficult for market participants and regulators to fully assess those risks." CFTC Guidance at 45294.

The CFTC Guidance states that it is "intended to provide an efficient and flexible vehicle to communicate the [CFTC's] current views on how the Dodd-Frank Act swap requirements would apply on a cross-border basis." CFTC Guidance at 45297 n.39. Practitioners generally are treating the pronouncements in the CFTC Guidance as if they were regulatory provisions. The CFTC notes that it "will periodically review [the CFTC] Guidance in light of future developments" and may adopt rules codifying certain aspects of the CFTC Guidance in the future. CFTC Guidance at 45297 & n.39. The CFTC and the banking regulators have already done that, as discussed below.

In 2013, the CFTC Guidance was challenged in a lawsuit filed in the District Court for the District of Columbia alleging that the CFTC Guidance represented an improper rulemaking that violated the Administrative Procedures Act (the "APA"). However, that challenge was dismissed in 2014 on the grounds that the Guidance did not constitute a legislative rule subject to the APA but rather was a nonbinding policy statement and interpretive rule outside the protections of the APA. Sec. Indus. & Fin. Mkts. Ass'n., et al., v. CFTC, 13-CV-1916 slip op. (D.D.C. Sept. 14, 2014).

U.S. Person

A key element of determining whether a particular transaction is subject to U.S. law requires classification of the parties involved. Generally, at least one party must be a "U.S. Person" or an affiliate thereof for U.S. law to apply. The CFTC Guidance sets forth a nonexclusive list of persons that are considered a "U.S. Person" in this context:

1. Any natural person who is a resident of the United States;
2. An estate of a decedent who was a resident of the United States at the time of death;
3. Any corporation, partnership, limited liability company, business or trust association, joint-stock company, fund or any form of enterprise similar to any of the foregoing (other than an entity described in (4) or (5) below) (a "legal entity"), in each case that is organized or incorporated under the laws of a state or other jurisdiction in the United States or having its principal place of business in the United States;
4. A pension plan for the employees, officers or principals of such a legal entity, unless the plan is primarily for the benefit of foreign employees of such entity;
5. Any 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 jurisdiction over the administration of the trust;
6. Any commodity pool, pooled account, investment fund, or other collective investment vehicle that is not described in prong (3) and that is majority-owned by one or more persons described in prongs (1)–(5), expect any commodity pool, pooled account,

investment fund, or other collective investment vehicle that is publicly offered only to non-U.S. persons and not offered to U.S. persons;

7. Any legal entity (other than a limited liability company, limited liability partnership or similar entity where all of the owners of the entity have limited liability) that is directly or indirectly majority-owned by one or more U.S. Persons described in (1)–(4) and in which such person(s) bears unlimited responsibility for this obligations and liabilities of the legal entity; and
8. Any individual account or joint account (discretionary or not) where the beneficial owner (or one of the owners in the case of a joint account) is a U.S. Person described in (1)–(7).

The CFTC expects that situations may arise where the list does not resolve a person's status. In such a case, the CFTC foresees utilizing a facts and circumstances test to determine whether a person is a U.S. Person, taking into consideration:

i. the strength of the connections between the person's swap-related activities and U.S. commerce;
ii. the extent to which such activities are conducted in the United States;
iii. the importance to the United States of regulating such activities relative to other jurisdictions where the person's swap activities may take place;
iv. the likelihood that classifying the person as a "U.S. Person" could create regulatory conflicts with another jurisdiction; and
v. considerations of international comity.

The CFTC also makes clear that the U.S. Person definition in the CFTC Guidance only applies to swap regulation under Title VII of the Dodd-Frank Act and not to other CEA provisions or regulations thereunder. *CFTC Guidance at 45316.*

One aspect of the U.S. Person definition that has created substantial controversy is the sixth prong above, which addresses collective investment vehicles. Such a vehicle will be classified as a U.S. Person in this context if a majority of the interests therein are owned by investors that meet the other criteria of U.S. Person, even if the vehicle is organized under non-U.S. law (such as the Cayman Islands) and managed by a non-U.S. manager (e.g., a person operating from the United Kingdom). Using the ownership of a collective investment vehicle to determine whether it is classified as a U.S. Person differs from the SEC definition of U.S. person discussed below and other definitions of a U.S. Person adopted by the U.S. Internal Revenue Service and even the CFTC itself in other portions of its regulations (see CFTC Regulation 4.7(a)(1)(iv)).

To add to the confusion in this area, the banking regulators have adopted regulations to govern margin on non-cleared swaps that focus only on where a collective investment vehicle is organized (thus, a vehicle's manager can be located in the United States and all of the investors can be U.S. persons, but if it organized under Cayman law, it will not be considered to be a U.S. Person for these purposes). 80 Fed. Reg. 74839, at 74883.

Under the CFTC's proposed regulations that would govern margin on non-cleared swaps in a cross-border transaction, the CFTC would not apply the majority-ownership test to a collective investment vehicle for purposes of the "U.S. Person" definition, in a change from its

general cross-border guidance as discussed above, but it would retain the "principal place of business" requirement for purposes of the "U.S. Person" definition. 80 Fed. Reg. 41376, at 41382-83 (July 14, 2015). As of the end of 2015, the CFTC had not yet adopted final regulations to govern margin on non-cleared swaps in a cross-border transaction, so it remains to be seen if the CFTC will be consistent with the banking regulators with respect to the manager's location. Investment fund managers should note that, for margin on non-cleared swaps purposes, a non-U.S. branch of a U.S. bank swap dealer will be subject to U.S. law with no availability for substituted compliance with the law of the jurisdiction where the branch is located, which is another departure from the general CFTC guidance regarding cross-border transactions.

Please see "**U.S. Person Definition Comparison Chart: Regulation S, SEC Rule, and CFTC Guidance**" for a comparison of the definition of a U.S. Person under the SEC Rule and the CFTC Guidance, with further comparison to the SEC's Regulation S under the Securities Act of 1933.

SD and MSP Registration Requirements

An entity whose swap-dealing activity exceeds the *de minimis* threshold (in the case of a swap dealer ("SD") or the major swap participant ("MSP") calculation (in the case of a MSP)) must register as an SD or MSP, respectively, under the CEA. These registration requirements apply not only to U.S. Persons, but also to non-U.S. Persons if the counterparty is a U.S. Person or an affiliate guaranteed by a U.S. Person (with certain exceptions, such as if the guarantor is a nonfinancial entity or the guaranteed affiliate is itself registered as an SD). The CFTC Guidance in this respect differs from CFTC treatment under Part 30 of its regulations of foreign intermediaries for futures and option transactions made on behalf of US customers on or subject to the rules of a foreign board of trade, which are not required to register under the CEA if registered with a foreign regulator. 17 C.F.R. §30.10.

SDs and MSPs are subject to certain "Entity-Level Requirements" (as described below); SDs and MSPs that are U.S. Persons or that transact with U.S. Persons in certain circumstances are subject to "Transaction-Level Requirements" (as described below). SDs and MSPs that are non-U.S. Persons may be able to satisfy certain of these requirements through substituted compliance with their home country regulations, as described below.

Foreign Branch of a U.S. Bank SD

A "foreign branch" of a U.S. Person is considered to be a part of the U.S. Person. To be classified as a foreign branch, the non-U.S. office must:

i. be subject to Regulation K, the Federal Deposit Insurance Corporation International Banking Regulation or designated as a "foreign branch" by the U.S. bank's primary regulator;

ii. maintain accounts independently of the home office and other foreign branches with profit or loss accrued at each branch determined as a separate item for each branch; and

iii. be subject to substantive regulation in banking or financing in the jurisdiction where the foreign branch is located. *CFTC Guidance* at 45329.

The foreign branch of a U.S. Bank SD must comply with all Transaction-Level Requirements (as discussed below) if the U.S. Person is a SD or MSP. However, acknowledging that certain foreign entities may otherwise cease doing business with foreign branches of U.S. Bank SDs to avoid application of the CEA, the CFTC Guidance permits foreign branches of U.S. SDs that are banks to comply with their obligations under the Dodd-Frank Act through substituted compliance with local law with regard to certain Transaction-Level Requirements for swap trades between the foreign branch and the non-U.S. Person. Generally, the CFTC would only permit substituted compliance where it finds local law to be comparable to U.S. law.

Substituted compliance will only be permitted for required transactions between the foreign branch and a non-U.S. Person. Generally, the CFTC would consider a swap to be with the foreign branch and not the U.S. bank, when all of the following factors are present:

i. the employees negotiating the terms of the swap are located in the foreign branch;

ii. the foreign branch is the office through which the United States makes and receives payments and delivers under the swap on behalf of the foreign branch pursuant to a master netting or similar trading agreement, and the documentation of the swap certifies that the office for the U.S. bank is such foreign branch;

iii. the swap is entered into by the foreign branch in its normal course of business;

iv. the swap is treated as a swap of the foreign branch for tax purposes; and

v. the swap is reflected in the local amounts of the foreign branch. *CFTC Guidance* at 45330.

Entry-Level Requirements and Transaction Requirements

As mentioned above, the CFTC Guidance divides the CEA's swap provisions for SDs and MSPs into two categories: "Entity-Level Requirements" and "Transaction-Level Requirements."

The Entity-Level Requirements apply to the entity as a whole because each requirement is intended to provide that SDs and MSPs "maintain a comprehensive and robust system of internal controls to ensure…the protection of the financial system." *CFTC Guidance* at 45338. These include requirements related to:

i. capital adequacy,

ii. chief compliance officer,

iii. risk management,

iv. swap data recordkeeping,

v. SDR reporting, and

vi. physical commodity large swaps trader reporting.

The Entity-Level Requirements are divided into the "First Category" consisting of items (i)–(iv) and the "Second Category" consisting of items (v)–(vi).

The Transaction-Level Requirements apply on a transaction-by-transaction basis and include the following:

i. required clearing and swap processing,
ii. margining and segregation for non-cleared swaps,
iii. trade execution,
iv. swap-trading relationship documentation,
v. portfolio reconciliation and compression,
vi. real-time public reporting,
vii. trade confirmation,
viii. daily trading records, and
ix. external business conduct standards.

Similar to the Entry-Level Requirements, the Transaction-Level Requirements are divided into two categories. The CFTC Guidance refers to items (i)–(viii) as “Category-A” requirements, while item (ix), external business conduct standards, constitutes “Category B” requirements.

Notwithstanding the above, if a U.S. Person is a party to a swap, generally the Dodd-Frank Act requirements will apply without the availability of substituted compliance. The application of certain categories of Entity-Level Requirements and Transaction-Level Requirements in the context of substituted compliance for cross-border swaps is discussed below.

Substituted Compliance

As referred to above, the CFTC has articulated a “substituted compliance” regime whereby the CFTC will allow certain non-U.S. SDs and MSPs to satisfy their Dodd-Frank Act obligations by complying with the swap regulations of their home country. The CFTC has identified the following jurisdictions as having regulations that may qualify for substituted compliance: Australia, Canada, the European Union, Hong Kong, Japan, and Switzerland. If the foreign branch is located in a jurisdiction other than the six listed in the preceding sentence, the CFTC may still permit substituted compliance if the aggregate notional value of all the swaps of the U.S. SD’s foreign branches in such other countries does not exceed 5 percent of the aggregate notional value of all of the swaps of the U.S. SD and the U.S. SD maintains records (a) with supporting information for the 5 percent limit, and (b) to identify, define, and address any significant risk that may arise from the non-application of the Transaction-Level Requirements.

Non-SDs and Non-MSPs

Several of the CEA’s swap provisions and CFTC regulations apply to persons who are not registered SDs or MSPs (“non-registrants”). Generally, a non-registrant is required to comply with certain Entity-Level Requirements (such as SDR reporting), as well as certain Transaction-Level Requirements (such as clearing). Unlike SDs/MSPs, the applicable requirements for non-registrants are typically applied together or not at all. Persons that are not financial entities, such as commercial end-users, may satisfy the clearing and exchange execution requirements by claiming the clearing exception for hedging or risk-mitigating transactions.

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In a swap where one or both of the non-registrant counterparties is a U.S. Person, the counterparties are required to comply with the non-registrant requirements; substituted compliance is not permitted.

Cross-Border Application of the Dodd-Frank Act (referred to in this chart as "DFA") and the CFTC's Swap Rules

	U.S. Person registered as SD/MSP	Non-U.S. Person registered in U.S. as an SD/MSP	Other non-U.S. Person not guaranteed by or conduit of U.S. Person	Other non-U.S. Person guaranteed by or conduit of U.S. Person	Foreign branch of U.S. bank that is a U.S. SD
U.S. entity	DFA/CFTC rules apply	DFA/CFTC rules apply	Limited DFA/CFTC requirements apply	Limited DFA/CFTC requirements apply	DFA/CFTC rules apply
Non-U.S. affiliate guaranteed by or conduit of U.S. entity	DFA/CFTC rules apply	Category A Transaction-Level Requirements apply, but substituted compliance permitted	DFA/CFTC rules do not apply	Limited DFA/CFTC requirements apply, but substituted compliance permitted	Category A Transaction-Level Requirements apply, but substituted compliance permitted
Non-U.S. affiliate not guaranteed by or conduit of U.S. entity	DFA/CFTC rules apply	DFA/CFTC rules do not apply	DFA/CFTC rules do not apply	DFA/CFTC rules do not apply	Category A Transaction-Level Requirements apply, but substituted compliance permitted

Factors that are relevant to the consideration of whether a non-U.S. Person is an "affiliate conduit" include whether: the non-U.S. Person is majority-owned, directly or indirectly, by a U.S. Person;

i. the non-U.S. Person controls, is controlled by, or is under common control with the U.S. Person;

ii. the non-U.S. Person, in the regular course of business, engages in swaps with a non-U.S. third party(ies) for the purpose of hedging or mitigating risks faced by, or to take positions on behalf of, its U.S. affiliate(s), and enters into offsetting swaps or other arrangements with such U.S. affiliate(s) in order to transfer the risks and benefits of such swaps with a third party(ies) to its U.S. affiliates; and

iii. the financial results of the non-U.S. Person are included in the consolidated financial statements of the U.S. Person. Other facts and circumstances also may be relevant.

Cross-Border Regulation of Security-based Swaps Under the Exchange Act and the SEC Cross-Border Rule

Section 30(c) of the Exchange Act, as added by Section 722(b) of the Dodd-Frank Act states that no provision of the Exchange Act that was added by Title VII of the Dodd-Frank Act "shall apply to any person insofar as such person transacts a business in security-based swaps without the jurisdiction of the United States, unless such person transacts such business in contravention of SEC rules promulgated to prevent evasion of any provision" of the provisions added by Title VII. However, the Dodd-Frank Act also provides that no provision thereof limits the SEC's jurisdiction as in effect prior to the enactment of the Dodd-Frank Act.

The SEC adopted final rules and interpretative guidance to address the extraterritorial application of U.S. securities laws to cross-border security-based swap activities (the "SEC Rule"). The SEC Rule primarily focuses on the application of the definitions of "security-based swap dealer" ("SBSD") and "major security-based swap participant" ("MSBSP") in the cross-border context and the circumstances under which non-U.S. Persons may be required to register as a SBSD or MSBSP. The SEC Rule is generally similar to the CFTC Guidance, but does differ in some important respects. One important conceptual difference is that the SEC Rule applies a territorial approach to the regulation of security-based swaps activity, under which transactions by a non-U.S. Person with certain counterparties are considered to have taken place in the United States regardless of where the activity actually occurred. While perhaps a legal fiction in some circumstances, this approach reflects the more limited extraterritorial reach of the Exchange Act over security-based swaps as compared to the CEA over swaps.

U.S. Person

The SEC Rule defines the term "U.S. Person" to mean:

1. Any natural person who resides in the United States;
2. Any partnership, corporation, trust, investment vehicle or other legal person organized, incorporated, or established under the laws of the United States or having its principal place of business in the United States;
3. Any discretionary or non-discretionary account of a U.S. Person; or
4. Any estate of a decedent who was a resident of the United States at the time of death.

17 CFR 240.3a71-3(a)(4).

Foreign branches of U.S. Persons are generally considered U.S. Persons under this definition. However, non-U.S. Persons are not required to count certain dealing transactions conducted through a foreign branch of a U.S. bank towards the de minimis threshold or computation amount that arise from transactions that are conducted entirely outside the United States through a foreign branch of a U.S. bank that is registered as a security-based

swap dealer or that occur at least to 60 days prior to the effective date of final rules providing for the registration of security-based swap dealers.

Please see "U.S. Person Definition Comparison Chart: Regulation S, SEC Rule, and CFTC Guidance" to this practice note for a comparison of the definition of a U.S. Person under the SEC Rule and the CFTC Guidance, with further comparison to the SEC's Regulation S under the Securities Act of 1933.

SBSD Registration Requirements

Under the SEC Rule, a non-U.S. Person (other than a conduit affiliate) that is engaged in security-based swap dealing or other swaps-related activity may be subject to registration with the SEC as a SBSD or MSBSP in whole or in part as a result of transactions with (i) U.S. Persons and (ii) with non-U.S. Persons that are subject to recourse guarantees by U.S. affiliates. The final rule permits non-U.S. Persons to exclude from the applicable *de minimis* calculation certain positions that arise from transactions conducted entirely outside the United States through a foreign branch of a U.S. bank that is registered as a SBSD. A non-U.S. Person that is a conduit affiliate of a U.S. Person must count all transactions against the applicable *de minimis* exception. A "conduit affiliate" is a non-U.S. affiliate that enters into security-based swaps with non-U.S. Persons or with certain foreign branches of a U.S. bank on behalf of its U.S. affiliates and enters into offsetting transactions with its U.S. affiliates to transfer the risks and benefits of those security-based swaps.

Substituted Compliance

Unlike the CFTC, the SEC did not identify certain jurisdictions that may qualify for substituted compliance. Instead, the SEC adopted a procedural rule for entities to request a substituted compliance order under the Exchange Act.

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