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A Legal Update from Dechert's Global Commodities and Derivatives Group*

CFTC Issues Cross-Border Swaps Regulation Guidance and Exemptive Order

The U.S. Commodity Futures Trading Commission (“CFTC”) recently approved and issued its eagerly anticipated:

- i. final interpretive guidance and policy statement on the cross-border application of the swap regulation provisions of the U.S. Commodity Exchange Act as amended (“CEA”) and related CFTC regulations (“Guidance”);¹ and
- ii. an exemptive order providing temporary conditional relief from compliance with certain provisions of the Guidance for certain entities subject to the CFTC’s new definition of “U.S. person” (“Exemptive Order”).²

Many collective investment vehicles that previously were deemed to be outside of the CFTC’s swap jurisdiction will be regulated on a going-forward basis under the Guidance. However, the Exemptive Order temporarily delays compliance with the Guidance for some purposes until October 9, 2013 (*i.e.*, 75 days after the publication of the Guidance in the U.S. Federal Register, which occurred on July 26, 2013).

CFTC Guidance Regarding Interpretation of U.S. Person

The Guidance provides the CFTC’s definition of the term “U.S. person” solely with respect to the application of the CEA swap provisions and the CFTC swap regulations promulgated under Title VII (“Title VII”) of the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank”). This U.S. person definition will be used by swap dealers (“Swap Dealers”) and major swap participants (“MSPs”) in determining the U.S. requirements applicable to swap transactions and relationships with such persons.³ The CFTC does not intend for the Guidance to address how U.S. person should be interpreted in connection with any other CEA provisions or CFTC regulations, including CFTC jurisdiction over commodity pool operators (“CPOs”) and commodity trading advisors (“CTAs”).

U.S. Person Definition

Prior to the release of the Guidance, there were three different U.S. person definitions relevant to the derivatives markets:

¹ *Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations*, 78 Fed. Reg. 45292 (Jul. 26, 2013).

² *Exemptive Order Regarding Compliance with Certain Swap Regulations*, 78 Fed. Reg. 43785 (Jul. 22, 2013).

³ The CEA swap provisions generally do not apply to swap activities outside of the United States unless such activities (i) have a direct and significant connection with activities in, or effect on, commerce of the United States, or (ii) contravene CFTC rules preventing the evasion of the CEA swap provisions. CEA Section 2(i). This jurisdictional requirement is met by swap activities outside of the United States by or with U.S. persons.

1. “Non-United States person” definition for purposes of certain CPO and CTA issues under CFTC Regulation 4.7(a);⁴
2. “U.S. person” definition for Title VII purposes under the CFTC’s January 2013 temporary exemptive order;⁵ and
3. “U.S. person” definition for security-based swap purposes proposed by the U.S. Securities and Exchange Commission (“SEC”) in May 2013.

The Guidance provides a fourth U.S. person definition for swap market participants in determining whether swap activities are subject to CFTC jurisdiction. This definition generally encompasses (i) persons located in the United States, and (ii) persons domiciled or operated outside of the United States but whose swap activities satisfy the CEA jurisdictional nexus.⁶

Under the Guidance, the U.S. person definition includes:

- i. any natural person who is a resident of the United States;
- ii. any estate of a decedent who was a resident of the United States at the time of death;
- iii. any 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 (other than an entity described in prong (iv) or (v) below) (“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;
- iv. any pension plan for the employees, officers, or principals of a legal entity described in prong (iii) above, unless the pension plan is primarily for foreign employees of such entity;
- v. 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 supervision over the administration of the trust;
- vi. any commodity pool, pooled account, investment fund, or other collective investment vehicle that is not a legal entity described in prong (iii) above and that is majority-owned by one or more persons described in prong (i), (ii), (iii), (iv), or (v) above, except 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;
- vii. 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 persons described in prong (i), (ii), (iii), (iv), or (v) above and in which such persons bear unlimited responsibility for the obligations and liabilities of the legal entity; and
- viii. any individual account or joint account (discretionary or not) where the beneficial owner (or one of the beneficial owners in the case of a joint account) is a person described in prong (i), (ii), (iii), (iv), (v), (vi), or (vii) above.

The CFTC stated that the definition of U.S. person generally includes the foregoing persons, but is “not limited to” such persons. The CFTC noted that there may be situations in which a person not specified

⁴ The Guidance affirmatively states that the U.S. person definition in the Guidance is to apply only to swap regulation promulgated under Dodd-Frank Title VII, and should not be interpreted in connection with any other CEA provisions or CFTC regulations (*Guidance*, at 45316). Moreover, the CFTC specifically declined to adopt the “U.S. person” definition in Regulation S, Rule 902 under the U.S. Securities Act of 1933 as amended (*Guidance*, at 45316).

⁵ Final Exemptive Order Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 858 (Jan. 7, 2013) (“Temporary Order”).

⁶ See *supra* note 3.

within the enumerated definitions is appropriately treated as a U.S. person “in view of the relevant facts and circumstances and a balancing of the various regulatory interests that may apply.”⁷

The CFTC originally proposed a definition of U.S. person in July 2012.⁸ The CFTC later issued a more limited definition of U.S. person in the Temporary Order (see Appendix A).

Collective Investment Vehicles

The Guidance specifically considers the “principal place of business” of collective investment vehicles for determining U.S. person status under prong (iii) above.⁹ The CFTC clarified that the primary focus for identifying the principal place of business with respect to such vehicles will be the location of the investment managers, fund sponsors and promoters, and sales and trading desks used by an investment manager, or the “actual center of direction, control and coordination.”¹⁰ The CFTC will focus primarily on where senior personnel are located.¹¹ The CFTC will consider a vehicle’s principal place of business to be in the United States if its senior principal personnel responsible for either (i) the “formation and promotion” of the vehicle or (ii) the “implementation of the vehicle’s investment strategy” are in the United States.¹² In conducting this inquiry, the CFTC will not look to the location of a vehicle’s board of directors or trustees, because boards (while having the legal authority to manage the overall business of the vehicle and specifically to hire and fire the investment managers) do not have the function of actually implementing the investment objectives of funds, and so would not be viewed as “key personnel.”¹³ Additionally, the locations of the vehicle’s board meetings, registered office, or books and records are generally not relevant to the vehicle’s U.S. person status.

The CFTC specifically stated that it would not consider a collective investment vehicle to be a U.S. person where some investment personnel or an independent, hired sub-adviser’s personnel are located in the United States, so long as such persons report to non-U.S. persons who are considered to be fulfilling the “key functions relating to [the vehicle’s] formation or the achievement of its investment objectives.”¹⁴ This puts to rest the concern that a non-U.S. vehicle would be considered a U.S. person solely because it employs a U.S. CTA that functions under the direction of senior personnel located outside of the United States.

The Guidance provides that, similar to collective investment vehicles, an individual, institution, pension plan, or operating company will not be considered a U.S. person solely because it hires an asset management firm located in the United States, if the vehicle would not otherwise be deemed within the U.S. person definition (including by being incorporated in the United States, or having its principal place of business in the United States, or being majority-owned by U.S. persons).¹⁵

⁷ *Guidance*, at 45316.

⁸ Cross-Border applications of certain swap provisions of the Commodity Exchange Act, 77 Fed. Reg. 41214 (Jul. 12, 2012).

⁹ The Guidance specifies additional attributes from those applicable to an operating company that are relevant to the determination of the principal place of business of a collective investment vehicle.

¹⁰ *Guidance*, at 45309.

¹¹ *Guidance*, at 45310.

¹² *Id.*

¹³ *Id.*

¹⁴ *Guidance*, at 45311, n. 207.

¹⁵ *Guidance*, at 45311-45312.

A collective investment vehicle that is not deemed a U.S. person under prong (iii) above may still be deemed a U.S. person under prong (vi) above, if it is majority-owned by U.S. persons. However, the Guidance also provides that a vehicle “that is publicly offered only to non-U.S. persons and not offered to U.S. persons” is not considered a U.S. person, even if it is organized or incorporated in the United States.¹⁶ As an example, the Guidance states that, so long as a UCITS¹⁷ is not offered to U.S. persons either indirectly or directly, it would not be a U.S. person.¹⁸ In addition, a pension plan primarily established and offered to foreign employees of U.S.-based entities would not be encompassed in the U.S. person definition.¹⁹ A pension plan that is not a U.S. person under another prong of the Guidance definition would also not be a U.S. person solely because some individuals that manage the plan’s investments are in the United States.²⁰

Non-U.S. Branches, Affiliates, and Subsidiaries

The CFTC confirmed its earlier proposed interpretation of U.S. person with respect to foreign branches of U.S. persons. Because branches of banks are neither separately incorporated nor separately capitalized and the rights and obligations of a branch are the same as the parent entity/head office, the CFTC concluded that foreign branches of U.S. persons are U.S. persons themselves.²¹

However, an affiliate²² or subsidiary of a U.S. person, even if such affiliate’s or subsidiary’s swap obligations are guaranteed by a U.S. person, is not considered a U.S. person solely by reason of being affiliated with such U.S. person.²³ For an affiliate or subsidiary to be considered a U.S. person by reason of its affiliation with a U.S. person, the affiliate or subsidiary must be majority-owned by a U.S. person and U.S. persons must bear the risk of unlimited liability for the obligations of the affiliate or subsidiary.²⁴ If the affiliate or subsidiary is structured as a corporation, limited liability company, limited liability partnership, or similar structure, the U.S. person owner of the affiliate or subsidiary would not be subject to potential unlimited liability (although the owner might be liable for certain affiliate or subsidiary obligations pursuant to a guarantee or other credit support), and therefore the affiliate or subsidiary would not be a U.S. person.²⁵

Substituted Compliance and EMIR²⁶ No-Action Relief

The Guidance provides that certain entities may comply with the regulatory regimes of the non-U.S. jurisdiction in which they operate instead of the CFTC regulations (subject still to CFTC examination and enforcement authority) if the CFTC makes a determination that the foreign jurisdiction’s requirements “are comparable with and as comprehensive as the corollary area(s) [under the CFTC’s] Entity- and Transaction-

¹⁶ *Guidance*, at 45314.

¹⁷ Undertakings for Collective Investment in Transferable Securities (“UCITS”).

¹⁸ *Guidance*, at 45314, n. 244. Among other things, this addresses the concern that “ownership verification” is particularly difficult for publicly-offered collective investment vehicles.

¹⁹ *Guidance*, at 45314.

²⁰ *Id.*

²¹ *Guidance*, at 45315. As discussed below, foreign branches can be treated differently from other U.S. persons for purposes of the application of certain CFTC swap requirements.

²² The term “affiliate” for purposes of this article does not include “affiliate conduit,” which is an entity through which a group (including U.S. person Swap Dealers) conduct the group’s market-facing swap business and applies solely to affiliates of Swap Dealers. *Guidance*, at 45358.

²³ *See Guidance*, at 45312.

²⁴ *Id.*

²⁵ *Guidance*, at 45302.

²⁶ European Market Infrastructure Regulation (“EMIR”).

Level Requirements.”²⁷ A collective investment vehicle that is a non-U.S. person transacting with a non-U.S. branch of a U.S. person Swap Dealer would benefit from this substituted compliance regime. However, a U.S. Swap Dealer and MSP cannot take advantage of substituted compliance regardless of the U.S. person status of its counterparty, and must comply fully with the CFTC swap regulations promulgated under Dodd-Frank.²⁸ A non-U.S. Swap Dealer or MSP (including an affiliate of a U.S. persons) is subject to all CFTC “Entity-Level Requirements,” but substituted compliance is available for certain CFTC “Transaction-Level Requirements” (described below) for swap transactions with entities that are not U.S. persons.²⁹

Additionally, on July 11, 2013, the CFTC issued no-action relief to Swap Dealers and MSPs organized in the United States or European Union from certain documentation, portfolio reconciliation, and other regulatory requirements under Title VII when subject to existing European Union risk mitigation regulations that are “essentially identical” to CFTC regulations.³⁰ This no-action relief applies solely to (i) uncleared swaps and (ii) physically-settled foreign exchange forward and swap agreements exempted from the definition of swap by the U.S. Department of the Treasury.³¹

Exemptive Order Delaying Effectiveness of Guidance

Simultaneous with the issuance of the Guidance, the CFTC also issued the Exemptive Order to temporarily delay the effectiveness of certain provisions of the new Guidance. The Exemptive Order specifies a 75-day phase-in of the new U.S. person definition, so that swap market participants can continue to rely on the limited definition of U.S. person set forth in Appendix A. It is expected that, by October 9, 2013 (after the 75-day period), the new U.S. person definition specified in the Guidance will become effective and supersede the definition in Appendix A.

In addition, the Exemptive Order provides a temporary delay for foreign branches of U.S. Swap Dealers in six specified jurisdictions from complying with the CFTC’s Transaction-Level Requirements in anticipation of the CFTC making a substituted compliance determination with respect to those jurisdictions (which has yet to occur).³² Instead, the foreign branch of a U.S. Swap Dealer may comply with applicable foreign law in lieu of complying with the CFTC’s Transaction-Level Requirements until the earlier of (i) December 31, 2013 or (ii) 30 days after the CFTC makes a substituted compliance determination.³³ However, this does not apply to compliance with the mandatory clearing requirements for applicable swaps (currently only certain credit default index and interest rate swaps), effective for all swap participants starting on October 9, 2013. Requirements applicable to U.S. persons trading with a non-U.S. Swap Dealer do not appear to be subject to a delay beyond October 9, 2013.³⁴ In determining whether substituted compliance is available to Swap Dealers and MSPs, the CFTC must determine that certain laws and regulations of a foreign jurisdiction are

²⁷ *Guidance*, at 45342. These entities include a non-U.S. Swap Dealer or MSP, U.S. bank that is a Swap Dealer or MSP with respect to its foreign branches, and a non-U.S. non-registrant that is a guaranteed or conduit affiliate of a U.S. person.

²⁸ *Guidance*, at 45347.

²⁹ *Id.*

³⁰ CFTC Letter No. 13-45 (pub. avail. Jul. 11, 2013).

³¹ *Id.*

³² Australia, Canada, European Union, Hong Kong, Japan, and Switzerland. *Exemptive Order*, at 43788. At this time, certain other significant financial services jurisdictions are not included, such as Singapore, South Korea, and Taiwan (among others).

³³ *Exemptive Order*, at 43789.

³⁴ This is because transactions between a U.S. person and a non-U.S. Swap Dealer are not subject to substituted compliance. Instead, the non-U.S. Swap Dealer may comply with home jurisdiction requirements so long as they are essentially identical to the Transaction-Level Requirements.

“comparable to and as comprehensive” as certain U.S. regulations.³⁵ In making this determination the CFTC would weigh all relevant factors, including:

- i. the comprehensiveness of the foreign regulatory requirement(s);
- ii. the scope and objectives of the requirement(s);
- iii. the comprehensiveness of the foreign regulator’s supervisory compliance program; and
- iv. the home jurisdiction’s authority to support and enforce its oversight of the registrant.³⁶

In addition, swap data repository reporting and real-time public reporting would generally be eligible for substituted compliance, but only if the CFTC has direct access to all of the reported swap data elements that are stored in a foreign trade repository.³⁷

Impact on Collective Investment Vehicles

The Guidance addresses the CFTC’s extraterritorial jurisdictional issues for compliance with swap clearing, reporting, and other aspects of Dodd-Frank. It does not impact the analysis of whether a CPO or CTA may be subject to CFTC jurisdiction.

Under the Guidance, a collective investment vehicle that is deemed to be a U.S. person will be subject to Transaction-Level Requirements for its swaps, which include (among other requirements):

- i. swap clearing and processing;
- ii. margining and segregation for uncleared swaps;
- iii. trade execution;
- iv. trade confirmation;
- v. portfolio reconciliation and compression;
- vi. real-time public reporting;
- vii. large trader reporting; and
- viii. data recordkeeping.

Where a collective investment vehicle that is a U.S. person enters into a swap with a non-U.S. Swap Dealer, obligations that would generally fall to the Swap Dealer (*i.e.*, swap data reporting and recordkeeping) could instead become the responsibility of the U.S. person vehicle. Swap data reporting particularly will be burdensome for vehicles since many non-U.S. Swap Dealers have not established reporting mechanisms or agreements and are subject to later dates for compliance with the Swap Dealer registration and compliance requirements (including reporting).

³⁵ *Guidance*, at 45340.

³⁶ *Guidance*, at 45343.

³⁷ *Guidance*, at 45349.

Where a collective investment vehicle is a non-U.S. person but is trading swaps with a Swap Dealer determined to be a U.S. person, the vehicle will be subject to the CFTC's Transaction-Level Requirements with regard to its swaps. However, the actual compliance obligations will fall to the U.S. person Swap Dealer.

Actions for Collective Investment Vehicles

Investment managers to collective investment vehicles organized or operated outside of the United States should now consider whether the vehicles fall within the Guidance's definition of U.S. person. Vehicles and managers will be expected to certify in writing to swap counterparties as to the vehicles' U.S. person status.

Concerns that collective investment vehicles should consider are the additional costs and compliance burdens under the more expansive U.S. person definition. In addition, investment managers may be subject to potentially conflicting regulation and increased costs of compliance.³⁸ Vehicles and managers should speak with their swap counterparties as soon as possible to determine what, if any, impact the new definition and provisions may have on their trading operations and relationships.

If a U.S. person collective investment vehicle faces an entity that is not a U.S. Swap Dealer or MSP, its investment manager should discuss what compliance obligations the counterparty may be willing to satisfy on behalf of the vehicle. A manager to a U.S. person vehicle also should assess whether the vehicle is trading swaps subject to mandatory central clearing (as noted above, currently only certain credit default index and interest rate swaps), should start negotiating relevant trading documentation to permit clearing, and should confer with its swap counterparties on how they can assist the vehicle with meeting its obligations under the CFTC's Transaction-Level Requirements and completing any required ISDA Dodd-Frank Protocol documentation.

An investment manager to a U.S. person collective investment vehicle must also determine if the vehicle's trades are subject to EMIR risk mitigation rules. If they are, they can rely on the CFTC's no-action position discussed above for some, but not all, Transaction-Level Requirements.

If a collective investment vehicle is not a U.S. person, it can avoid application of the CEA's and CFTC swap provisions by trading only with Swap Dealers or MSPs that are not U.S. persons under the Guidance. It would be prudent for vehicles to discuss this status with their Swap Dealers and confirm their status prior to the expiration of the Exemptive Order. Vehicles should obtain a "non-U.S. person" representation from these Swap Dealers in the transaction documentation.

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³⁸ *Guidance*, at 45298.

APPENDIX A

Temporary Order “U.S. person” Definition (effective until October 9, 2013)

The Temporary Order defined U.S. person as:

- 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, in each case that is (A) organized or incorporated under the laws of a state or other jurisdiction in the United States or (B) effective as of April 1, 2013 for all such entities other than funds or collective investment vehicles, having its principal place of business in the United States;
- iii. a pension plan for the employees, officers, or principals of a legal entity described in prong (ii) above, unless the pension plan is primarily for foreign employees of such entity;
- iv. an estate of a decedent who was a resident of the United States at the time of death, or a 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 supervision over the administration of the trust; or
- v. an individual account or joint account (discretionary or not) where the beneficial owner (or one of the beneficial owners in the case of a joint account) is a person described in prongs (i) through (iv) above.



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