CFTC Guidance on Extraterritoriality

CFTC Releases Proposed Guidance on and Exemptive Relief from Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act

SUMMARY

On June 29, 2012, the Commodity Futures Trading Commission ("CFTC") issued proposed guidance ("Proposed Guidance") on the cross-border application of certain swaps provisions under the Commodity Exchange Act ("CEA") and a proposed exemptive order ("Proposed Exemption") that would delay the obligation to comply with certain entity-level requirements for non-U.S. (or foreign) swap dealers and major swap participants ("MSPs"). The Proposed Guidance and Proposed Exemption were both approved unanimously by the CFTC by private vote. The Proposed Guidance and Proposed Exemption were issued eight days after a scheduled public meeting by the Commissioners to approve these releases was cancelled shortly before it was set to begin. The last-minute cancellation, as well as the concurring statements issued by Commissioners Sommers and O’Malia, suggests that the proper scope of the CFTC’s authority is still subject to debate within the CFTC.

The comment period for the Proposed Guidance is open for 45 days after the publication in the Federal Register and the comment period for the Proposed Exemption is open for 30 days after the publication in the Federal Register.

BACKGROUND

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") establishes a new regime that requires persons that meet the definitions of “swap dealer” and “MSP” to register as such and become subject to a regulatory regime that applies to the registered swap dealer or MSP itself as well as the swap transactions in which it engages. In addition, Title VII imposes certain requirements on swap transactions regardless of whether a swap dealer or MSP is a party to the transaction.
Section 722(d) of Dodd-Frank amended the CEA to include section 2(i), which establishes the scope of the CFTC’s authority to apply the requirements of Title VII extraterritorially. Section 2(i) provides that the provisions of Title VII do not apply to activities outside the United States unless those activities either:

- Have a direct and significant connection with activities in, or effect on, commerce of the United States; or
- Contravene such rules or regulations as the CFTC may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of [Title VII].

The Proposed Guidance represents the CFTC’s interpretation of the scope of that authority.¹

The extraterritorial application of Title VII requirements has generated significant industry comment from foreign and U.S. banking organizations and other institutions that conduct global swap businesses. Non-U.S. institutions have commented on the hurdles they would face complying with multiple, potentially conflicting regimes. U.S. institutions have expressed the same concerns, as well as pointing to the significant potential for competitive harm that U.S. institutions would face in the global swap marketplace. The Proposed Guidance and Proposed Exemption seek to address some of these concerns, but, as is evident from the statements of Commissioners Sommers and O’Malia, discussed below, significant uncertainty remains even within the CFTC regarding whether the Proposed Guidance and Proposed Exemption provide sufficient relief for these purposes.

**DEFINITION OF U.S. PERSON**

The term “U.S. person,” which is defined in general terms in the Proposed Guidance, is the principal starting point for identifying those persons subject to compliance with CEA and those non-U.S. persons that would be required to register as swap dealers or MSPs based on their transactions with U.S. persons. The Proposed Guidance defines a U.S. person to include:

- A natural person U.S. resident;
- A legal entity of any form that is organized under U.S. law or has its principal place of business in the United States, or for which the direct or indirect owners are responsible for the entity’s liabilities and at least one of the owners is a U.S. person;
- An individual account where the beneficial owner is a U.S. person;
- A commodity pool, pooled account, or collective investment vehicle wherever organized if (i) a majority ownership is held, directly or indirectly, by U.S. persons or (ii) the operator would be required to register as a commodity pool operator under the CEA;
- An estate or trust, the income of which is subject to U.S. income tax.

The CFTC further explains in the Proposed Guidance that a foreign branch or agency of a U.S. person would be considered a U.S. person, but a foreign affiliate or subsidiary of a U.S. person would not be considered a U.S. person even if the swap-related obligations of such foreign affiliate or subsidiary are
guaranteed by a U.S. person. The CFTC’s stated basis for this differing treatment is that a branch or agency is part of a larger legal entity and the treatment of the entity should be the same entity-wide.

Notwithstanding the clear statement that a foreign subsidiary of a U.S. person is a foreign person, even if its obligations are guaranteed by the U.S. parent, the Proposed Guidance would require a U.S. guaranteed foreign subsidiary to include all of its transactions with all counterparties (whether a U.S. person or a foreign person) in its swap dealer determination. In addition, despite the general rule that a foreign branch of a U.S. person is considered part of a U.S. person, the Proposed Guidance includes some accommodations for a foreign branch of a U.S. person for certain transaction-level requirements, discussed below.

**SWAP DEALER AND MSP REGISTRATION**

**Swap Dealer Registration**

Under the Proposed Guidance, a foreign person would evaluate the level of its swap dealing transactions with U.S. persons using the same *de minimis* test (“general *de minimis* test”) that the CFTC established for determining whether a person must register as a swap dealer. Under the general *de minimis* test, when a person engages in swap dealing transactions over the prior 12 months at a level above an aggregate gross notional amount of $8 billion, such person meets the definition of a swap dealer under the CEA and is required to register as a swap dealer. Under the general *de minimis* test, a person must include all swap dealing activities of affiliates under common control in the calculations.

In applying the *de minimis* test, the following principles and considerations apply:

- **Counterparties.** In general, a foreign person would need to include swap dealing transactions with all U.S. persons. A foreign person would not be required to include the notional value of dealing transactions with foreign branches of registered U.S. swap dealers, because the transactional requirements of Title VII would nonetheless apply to those transactions, as the counterparty is a U.S. swap dealer. Therefore, there is little concern that this exclusion could lead to swap activities occurring outside the Dodd-Frank Act requirements. As a result of this exclusion, a foreign entity would not be required to register as a swap dealer if it largely limits its swap dealing activities with U.S. persons to foreign branches of registered U.S. swap dealers.

- **U.S.-guaranteed foreign swap dealers.** A foreign guaranteed subsidiary of a U.S. person would be required to include all of its swap transactions that are guaranteed by the U.S. parent for purposes of determining its registration status.

- **Aggregation.** Similar to the requirement under the general *de minimis* test, a foreign person would have to include the aggregate notional value of any swap dealing transactions with U.S. persons entered into by its foreign affiliates. The Proposed Guidance also would require that *any* swap dealing transactions of the foreign person’s foreign affiliates under common control where the obligation of the foreign affiliate is guaranteed by a U.S. person be included regardless of whether the counterparty is a U.S. person. A foreign person would not, however, be required to include the swap dealing activities of its U.S. affiliates.

- **Regular business.** Only those swap dealing transactions that are entered into as part of a “regular business” are required to be included in applying the *de minimis* test to an entity and...
its commonly controlled affiliates. Similarly, the Proposed Guidance states that a foreign person that is not guaranteed by a U.S. person would include in the *de minimis* determination only those swap transactions with U.S. persons that are entered into as part of “a regular business,” even if the foreign entity enters into swap transactions with foreign counterparties as part of a regular business. Although not explicitly stated, the CFTC presumably is drawing a distinction between foreign persons that are not guaranteed by a U.S. person from those that are, consistent with the requirement to include U.S.-guaranteed swap transactions in calculating compliance with the *de minimis* test, including the aggregation requirement. Accordingly, it would appear that a foreign person that is guaranteed by a U.S. person would be required to evaluate its swap activities with all counterparties in determining whether it enters into swap transactions as part of a regular business.

**MSP Registration**

The Proposed Guidance takes the same general approach to determining whether a foreign person must register as an MSP as it does in the swap dealer context. In particular, a foreign person would apply the principles set forth above in determining whether its swap positions exceed the applicable MSP thresholds, as set forth in Sections 1.3(jjj)(1) and 1.3(1ll)(1) of the CFTC’s regulations. These thresholds, which were adopted by the CFTC in May 2012, cover substantial net positions in each major category of swaps, substantial net uncollateralized counterparty exposure that could have serious adverse effects on the U.S. and standards for “highly leveraged” entities ("MSP Threshold"). A foreign person would count only its swap positions with U.S. person counterparties in making these determinations. If the foreign person is guaranteed by a U.S. person, the foreign person may exclude those transactions that are guaranteed by the U.S. person, when calculating whether its swap positions exceed the MSP Threshold. Instead, the U.S. guarantor would include those positions in determining whether it exceeds the MSP Threshold. If the foreign person guarantees another foreign person’s swap with a U.S. person then the foreign person would have to count that swap towards the MSP Threshold. Any foreign person that exceeds the MSP Threshold would be required to register as an MSP; however, if the person qualifies as a swap dealer, then it is not an MSP.

**Central Booking Model**

The CFTC proposes to require a U.S. entity serving as a central booking facility to register as a swap dealer if the de minimis threshold is exceeded, even if its foreign affiliates and subsidiaries conduct all dealings with, and effectively execute transactions with, third parties, regardless of whether the third parties are U.S. persons or foreign persons. The foreign affiliate or subsidiary itself also may be required to register as a swap dealer if it independently meets the definition of swap dealer.

A similar analysis would apply where a foreign person with a U.S. presence serves as the central booking facility. Accordingly, the Proposed Guidance provides that, even if a U.S. branch, agency, affiliate, or subsidiary of the foreign person engages in solicitation or negotiation in connection with the swap entered into by the foreign person, the Title VII requirements, including the registration requirement, would apply to the foreign person, as the entity entering into the transaction. For example, a non-U.S. bank with a global operation might utilize a branch office in a European or Asian jurisdiction as its central booking facility.
facility. In such an instance, transactions with U.S. counterparties would be booked with that branch, even if employees of U.S. branches or affiliates conduct all direct dealings with those counterparties.

Although the Proposed Guidance appears to reject the proposals put forward by many commenters that the U.S. branch of a foreign bank should be treated as a separate entity (see, for example, footnote 54 of the Proposed Guidance), the CFTC’s position on the treatment of a U.S. branch or agency of a foreign person that enters into a swap with a U.S. counterparty remains unclear. The Proposed Guidance refers only to situations in which the foreign person is the actual counterparty to the transaction and the U.S. branch, agency or legal entity facilitates the transaction in some way. The Proposed Guidance does not address transactions in which the U.S. branch or agency of the foreign bank is the counterparty to the transaction. Furthermore, it does not appear to address the situation where the U.S. branch, agency, affiliate, or subsidiary of the foreign person enters into the swap transaction and then, for example, enters into a back-to-back transaction with the foreign person.

The implications for U.S. affiliates and subsidiaries of foreign persons that enter into counterparty-facing transactions and then shift the risk of the transaction to a foreign person is not addressed by the Proposed Guidance and likely will require further clarification from the CFTC.

**APPLICATION OF TITLE VII SUBSTANTIVE REQUIREMENTS**

As suggested by many commenters, the Proposed Guidance would divide Title VII’s substantive requirements into entity-level requirements and transaction-level requirements. The Proposed Guidance includes helpful charts that describe how the requirements apply based on the particular swap dealer and counterparty, which are attached as appendices to this memorandum. The requirements would be applied to foreign swap dealers and MSPs depending on the type of requirement. In general, a substituted compliance regime may be permitted for those entity-level and transaction-level requirements that are addressed by comparable laws and regulations in a foreign jurisdiction. Substituted compliance, however, is very limited and applies only in certain transactions entered into by foreign persons with foreign counterparties. Transactions with U.S. counterparties remain fully subject to CFTC regulations.

In this respect as well, although foreign affiliates and subsidiaries of U.S. persons are treated as foreign persons, and foreign branches and agencies of the U.S. person are treated as part of the U.S. entity, in some cases the Proposed Guidance would apply the substantive requirements in a different manner than it would apply them to other U.S. persons or foreign persons, as described in detail below.

**ENTITY-LEVEL REQUIREMENTS**

Under the Proposed Guidance, the entity-level requirements include:

- Capital adequacy
- Chief compliance officer
The Proposed Guidance further subdivides entity-level requirements into two sub-categories. The first sub-category would include the first four requirements listed above and would have to be applied on an entity-wide basis. The second sub-category includes SDR Reporting and Large Trader Reporting, which the CFTC notes are critical to its market surveillance program and, therefore, must be applied across all swaps regardless of counterparty or location of swap.

Under the Proposed Guidance, a registered foreign swap dealer or MSP would be required to comply with all of the entity-level requirements in the first sub-category. However, a foreign swap dealer or MSP, although subject to SDR Reporting and Large Trader Reporting, may be permitted to substitute compliance with comparable foreign regimes.

**TRANSACTION-LEVEL REQUIREMENTS**

The transaction-level requirements would be defined as follows for purposes of the Proposed Guidance:

- Clearing and swap processing (which applies to dealers and MSPs that are clearing members)
- Margining and segregation for uncleared swaps
- Trade execution
- Swap trading relationship documentation
- Portfolio reconciliation and compression
- Real-time public reporting
- Trade confirmation
- Daily trading records
- External business conduct standards

The Proposed Guidance describes these requirements as generally relating to risk mitigation and market transparency, with the exception of external business conduct standards. In the Proposed Guidance and this memorandum, the transaction-level requirements other than the external business conduct standards are referred to as “Category A transaction-level requirements” and the external business conduct standards are referred to as “Category B transaction level requirements.”

**Application of Transaction-Level Requirements to Non-U.S. Persons**

The obligation to comply with transaction-level requirements would be as follows:

- **Application of Category A transaction-level requirements to transactions with U.S. persons.** A foreign swap dealer or MSP, in connection with a swap with a U.S. person...
counterparty, would be required to comply with all of the transaction-level requirements, except with respect to transactions where the U.S. person is a foreign branch of a U.S. person. (This is broader than the exclusion of transactions with foreign branches for purposes of determining whether a foreign person must register as a swap dealer where the exclusion applied only to foreign branches of U.S. registered swap dealers.)

- **Application of Category A transaction-level requirements to transactions with foreign persons.** In general, transaction-level requirements would not apply to transactions with foreign persons. However, if the foreign person is guaranteed by a U.S. person, then transaction-level requirements would apply, but substituted compliance would be available.

- **Conduit transactions.** The CFTC remains concerned that in an attempt to evade the Title VII requirements, a U.S. swap dealer or MSP might execute a swap with a foreign affiliate or subsidiary, which would then operate as a “conduit” for swaps with an unaffiliated third party in a jurisdiction that is unregulated or lacks transactional requirements comparable to Dodd-Frank requirements. To address this concern, the CFTC proposed a separate regime for conduits, using a three-prong test.

  Under the test, Category A transaction-level requirements would apply to swaps where (i) a U.S. person enters into a transaction with a foreign counterparty that is majority owned, directly or indirectly, by the U.S. person; (ii) the foreign counterparty regularly enters into swaps with one or more other U.S. affiliates or subsidiaries of the U.S. person; and (iii) the financial statements of the foreign counterparty are included in the consolidated financial statements of the U.S. person. Substituted compliance would be permitted in these conduit transactions with respect to Category A transaction-level requirements.

- **Category B transaction-level requirements.** The Category B transaction-level requirements would not apply to any transactions between foreign swap dealers or MSPs and foreign counterparties (whether or not guaranteed by a U.S. person).

**Application of Transaction-Level Requirements to Non-U.S. Branches and Agencies of U.S. Swap Dealers**

In the context of transaction-level requirements, special allowances would be extended to foreign branches and agencies of U.S. swap dealers, which are otherwise treated as U.S. persons, when transacting with a foreign branch of a U.S. person or a foreign counterparty.

- **Application of Category A transaction-level requirements to transactions with foreign counterparties.** Although foreign branches and agencies of U.S. swap dealers are considered U.S. persons, the Proposed Guidance would permit substituted compliance with respect to Category A transaction-level requirements for swaps with a foreign counterparty (regardless of whether the foreign counterparty’s obligations are guaranteed by a U.S. person).

- **Application of Category B transaction-level requirements to transactions with foreign counterparties.** The Proposed Guidance would not apply Category B requirements to transactions with a foreign counterparty.

- **Participation in emerging markets.** To enable foreign branches and agencies of U.S. swap dealers to participate in the swap markets in emerging markets (which is not defined) where the foreign regulations may not meet the comparability requirement, the Proposed Guidance would permit compliance with the transaction-level requirements generally applicable to market participants in that jurisdiction, subject to certain limitations. However, the aggregate notional value of the swaps of the U.S. swap dealer’s branches and agencies in that jurisdiction may not exceed 5% of the aggregate notional value of all of the swaps of the U.S. swap dealer. In addition, the U.S. swap dealer would be required to maintain records...
documenting eligibility for the exception and to address any significant risks that may arise from the differing regulations.

APPLICATION OF SUBSTANTIVE REQUIREMENTS TO NON-U.S. AFFILIATES AND SUBSIDIARIES OF U.S. SWAP DEALERS

The application of entity-level and transaction-level requirements to foreign affiliates and subsidiaries of U.S. swap dealers would depend on two factors—where the swaps are booked and whether the entity itself engages in activity that would trigger swap dealer registration. The following general guidelines would apply:

- If the entity itself engages in activity that would trigger swap dealer registration regardless of where the swaps are booked, then the entity must register separately as a swap dealer and comply with the substantive level requirements, using substituted compliance where available.
- If the entity merely acts as a disclosed agent for transactions that are booked with the U.S. person, for example, and does not independently meet the definition of swap dealer, then swap dealer registration and the accompanying compliance with the substantive requirements would not apply.

Under the Proposed Guidance, if both a foreign affiliate or subsidiary and the U.S. person are required to register as swap dealers, both entities must comply with the Title VII requirements. However, with respect to the performance of an obligation owed to a third party counterparty by both entities, one entity may rely on the other’s compliance. As noted in the Release, “with respect to the performance of an obligation owed to a third party; satisfactory performance by one may satisfy the obligations of both, but an unsatisfactory performance of an obligation owed to a counterparty is a responsibility that will be borne by both entities.”

SUBSTITUTED COMPLIANCE

Under the Proposed Guidance, the CFTC would permit substituted compliance with certain Title VII requirements for foreign swap dealers or foreign major swap participants, allowing such entities to conduct business by complying with their home country regulations, if the CFTC finds that such requirements are comparable to analogous requirements under Title VII. However, the CFTC retains broad discretion in its determination of whether to permit substituted compliance with foreign regulations and the scope of substituted compliance under the Proposed Guidance remains limited. In making its assessment, the CFTC will consider the scope and objectives of the relevant regulatory requirements, the comprehensiveness of those requirements, the foreign regulator’s supervisory compliance program, and the foreign regulator’s authority to oversee the foreign swap dealer or MSP. The CFTC will measure the comparability and comprehensiveness of a foreign jurisdiction’s regulatory requirements using an outcomes-based approach to determine whether the foreign requirements are designed to meet the same regulatory objectives as Dodd-Frank. Where the foreign regulatory system meets some, but not all, of the objectives of Dodd-Frank, the CFTC will recognize substituted compliance only in those areas that are deemed comparable to CFTC regulations.
Process

In connection with its application to register as a swap dealer or MSP, a foreign person may directly request from the CFTC permission to comply with the comparable requirements of its home jurisdiction. Alternatively, a group of foreign persons from the same jurisdiction or a foreign regulator may apply for substituted compliance on behalf of foreign persons subject to a foreign supervisory regime.

An applicant must state with specificity the factual basis for requesting that the CFTC find comparability of a foreign regulation with respect to a particular Dodd-Frank requirement, providing all applicable foreign legislation, rules and policies. An applicant must also state that it is licensed and in good standing with the supervisor in its home country.

While existing information-sharing and enforcement arrangements indicate a foreign regulator’s ability to cooperate with the CFTC, the CFTC also expects to establish a supervisory memorandum of understanding (“MOU”) or other arrangement with the foreign regulator that would provide for information sharing and cooperation in the supervision of swap dealers and MSPs. An MOU would establish procedures related to oversight, access to information, on-site visits and notification and procedures for certain situations.

The CFTC expects to find comparability with foreign regulatory regimes where the transaction is subject to a foreign mandate comparable to the CFTC’s mandate and cleared through a derivatives clearing organization (“DCO”) that is exempted from registration under the CEA. In addition, the CFTC may use prior comparability determinations with respect to a particular jurisdiction to facilitate subsequent applications for substituted compliance from that jurisdiction.

APPLICATION OF SWAP PROVISIONS TO PERSONS OTHER THAN SWAP DEALERS AND MSPS

The Title VII requirements apply not only to swap dealers and MSPs, but also to all other market participants. Such persons include financial entities (i.e., commodity pools, private funds, employee benefit plans and persons predominantly engaged in banking or financial activities) and commercial end-users. The Proposed Guidance would require swap counterparties other than swap dealers or MSPs to comply with the clearing and swap processing, trade execution and real-time public recording, Large Trader Reporting, SDR Reporting and swap data recordkeeping requirements for any transaction where one of the counterparties is a U.S. person, irrespective of the location of the transaction. Non-U.S. clearing members must also comply with the Large Trader Reporting requirement and report all reportable positions under Part 20 of the CFTC regulations. Substituted compliance with a foreign regulatory regime is not permitted with respect to these requirements. However, the Proposed Guidance would permit for substituted compliance with respect to the SDR Reporting and swap data recordkeeping requirements.
PROPOSED EXEMPTION

PROPOSED EXEMPTIVE ORDER FOR NON-U.S. PERSONS

Under the Proposed Exemption, foreign swap dealers and MSPs, and foreign branches of U.S. swap dealers and MSPs will receive temporary exemptive relief from compliance with certain entity-level requirements and transaction-level requirements, subject to specified conditions discussed below. However, the registration requirement, where applicable, is not delayed.

Under the Proposed Exemption, foreign swap dealers and MSPs may delay compliance with all entity-level requirements, except for the SDR Reporting requirement and the Large Trader Reporting rules, with respect to all swaps with U.S. counterparties, as of the compliance date of the SDR Reporting requirement. However, foreign swap dealers and MSPs that are not affiliates or subsidiaries of a U.S. swap dealer may delay compliance with the SDR Reporting requirement and the Large Trader Reporting rules for swaps with foreign counterparties.

The Proposed Exemption further grants temporary exemptive relief from transaction-level requirements to foreign swap dealers and MSPs, and foreign branches of U.S. swap dealers and MSPs, with respect to any swaps entered into with a foreign counterparty, to allow the entities to comply with regulations in their home jurisdictions. However, these entities must still comply with all transaction-level requirements for any swaps entered into with a U.S. counterparty.

As a condition to receiving this temporary exemptive relief, a foreign swap dealer or MSP must (1) apply for registration as a swap dealer or MSP by the relevant registration deadline, if required to do so, and (2) submit to the National Futures Association ("NFA"), within 60 days of applying for registration, a compliance plan detailing how it intends to comply with applicable requirements under the CEA and related rules and regulations. Any U.S. swap dealer or MSP seeking exemptive relief for a foreign branch must also submit a compliance plan describing how it will comply with the applicable transaction-level requirements once the exemptive relief expires.

For each entity-level and transaction-level requirement, the compliance plan must at least specify whether the foreign swap dealer or MSP intends to comply with each of the entity-level or transaction-level requirements or seek a comparability determination and comply with regulations in its home jurisdiction. If the latter, the plan must also provide a description of the requirements of the home jurisdiction. The foreign swap dealer or MSP may submit amended compliance plans to the NFA as necessary, and the CFTC expects that such updates will occur as new regulations are adopted.

PROPOSED EXEMPTIVE ORDER FOR U.S. PERSONS

The CFTC also proposes to grant temporary exemptive relief to U.S. swap dealers and MSPs with respect to certain entity-level requirements. The exemptive relief applies to entity-level requirements other than the swap data recordkeeping, SDR Reporting, or Large Trader Reporting requirements and
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would allow U.S. swap dealers to delay compliance until January 1, 2013. However, U.S. persons are still required to apply for registration as a swap dealer or MSP.

EFFECTIVE DATES
Under the Proposed Exemption, the exemptive relief for all entities takes effect on the date on which swap dealers and MSPs are first required to apply for registration. For foreign swap dealers and MSPs, and foreign branches of U.S. swap dealers and MSPs, the exemptive relief will expire one year after publication of the Proposed Exemption in the Federal Register. At the expiration date, the CFTC will consider extending the exemptive relief, based in part on the availability of substituted compliance with foreign regulations for foreign persons.

COMMISSIONER STATEMENTS
CFTC Commissioners O'Malia and Sommers each issued a Statement of Concurrence with respect to the Proposed Guidance and Proposed Exemption.

COMMISSIONER O'MALIA
Commissioner O'Malia voted to approve the issuance of the Proposed Guidance and Proposed Exemption but expressed serious concerns regarding the legal analysis and substance of the Proposed Guidance. Commissioner O'Malia emphasized that, if asked to vote on the Proposed Guidance as final, he would vote in the negative.

In his concurrence, Commissioner O'Malia noted that while section 2(i) of the CEA is intended to limit the CFTC’s authority over foreign activities, the Proposed Guidance “prejudicially switches the analysis,”6 such that market participants now bear the burden of demonstrating why their activities fall outside the CFTC’s jurisdiction. The Proposed Guidance applies section 2(i) analysis inconsistently, often failing to explain why certain transactions are subject to the CFTC’s jurisdiction while other, comparable transactions are not. Furthermore, the Proposed Guidance expands the CFTC’s jurisdiction to the point of being “virtually endless,” but does not encourage collaboration with foreign regulators. Commissioner O’Malia believes the CFTC should work with foreign regulators in a coordinated manner similar to those efforts undertaken by the Basel Commission on Banking Supervision and the International Organization of Securities Commissions. Finally, he contends that the Proposed Guidance in effect implements new requirements for market participants that should have been adopted via formal rulemaking, given that that the Proposed Guidance will impose significant costs on the industry. Therefore, the CFTC should prepare a separate report analyzing the costs resulting from its expanded authority under section 2(i) of the CEA.

Commissioner O'Malia also noted that the expiration date of the exemptive relief should be triggered by the adoption of a final exemptive order rather than on the publication of the Proposed Order in the Federal Register, arguing that the current expiration date “does not make sense in light of the fact that
potential registrants will not know the contours of the final relief until the Commission approves a final
exemptive order."\(^7\)

**COMMISSIONER SOMMERS**

Commissioner Sommers echoed many of Commissioner O'Malia’s concerns. In her view, the Proposed
Guidance upsets the CFTC’s “successful history of mutual recognition of foreign regulatory regimes”\(^8\) and
does not adequately justify the extent of the CFTC’s jurisdictional expansion. Therefore, she believes
that the approach taken in the Proposed Guidance fails to allow for international harmonization and
precludes domestic harmonization with the SEC. Finally, Commissioner Sommers notes that the
Proposed Guidance in effect operates as a part of the entity definitions and registration rules, such that its
promulgation outside the notice-and-comment process and without cost-benefit analysis exposes the
CFTC to potential litigation.

With respect to the Proposed Exemption, Commissioner Sommers believes that the different compliance
dates for U.S. and foreign swap dealers and MSPs may create a disadvantage for U.S.-based market
participants, and she encourages market participants to submit comments on this issue.

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ENDNOTES

1. The scope of the authority of the Securities and Exchange Commission ("SEC") to apply the similar regime established by Title VII for security-based swaps, security-based swap dealers, and security-based MSPs extraterritorially also is expressly limited by Dodd-Frank, although the applicable standard differs somewhat. The SEC intends to address issues related to the application of Title VII to foreign entities as part of a separate release.


4. Note that the discussion in Footnote 54 references subsection E, which does not appear within the Proposed Guidance.

5. Adopting Release, text at 63-4.


7. Id.

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APPENDIX A

ENTITY-LEVEL REQUIREMENTS

The Entity-Level Requirements relate to the management of risks to a swap dealer or MSP as a whole. Accordingly, these requirements apply on a firm-wide basis, inclusive of all swaps and irrespective of whether the counterparty is a U.S. person (or not) or where the transactions are executed.

Capital: CEA section 4s(e) directs the Commission to set capital requirements for swap dealers and MSPs that are not subject to the capital requirements of prudential regulators (i.e., non-bank swap entities). The Commission has proposed rule, § 23.101, which would apply FCM capital requirements if the nonbank swap dealer or MSP is also registered as an FCM, and would apply other capital requirements for those that are not also FCMs. Certain of these non-FCM, nonbank swap entities would be required to meet capital requirements established by the Federal Reserve Board; specifically, SIFIs and nonbank subsidiaries of U.S. bank holding companies.

Chief Compliance Officer: CEA Section 4s(k) requires that each swap dealer and MSP to designate a chief compliance officer (“CCO”) and specify certain duties by the CCO. Pursuant to section 4s(k), the Commission adopted § 3.3, which requires swap dealers and MSPs to designate a CCO responsible for administering the firm’s compliance policies and procedures, reporting directly to the board of directors or a senior officer of the swap dealer, as well as preparing and filing (with the Commission) a certified report of compliance with the CEA.

Risk Management: CEA Section 4s(j) requires each swap dealer and MSP to establish internal policies and procedures designed to, among other things, address risk management, monitor compliance with position limits, prevent conflicts of interest, and promote diligent supervision, as well as maintain business continuity and disaster recovery programs. The Commission adopted implementing regulations (§§ 23.600, 23.601, 23.602, 23.603, 23.605, 23.606, and 23.607). The Commission also adopted: (A) § 23.609, which requires certain risk management procedures for swap dealers or MSPs that are clearing members of a DCO; and (B) § 23.608, which prohibits swap dealers providing clearing services to customers from entering into agreements that would: (i) disclose the identity of a customer’s original executing counterparty; (ii) limit the number of counterparties a customer may trade with; (iii) impose counterparty-based position limits; (iv) impair a customer’s access to execution of a trade on terms that have a reasonable relationship to the best terms available; or (v) prevent compliance with specified time frames for acceptance of trades into clearing.

Swap Data Recordkeeping: CEA section 4s(f)(1)(B) requires swap dealers and MSPs to keep books and records for all activities related to their business. Section 4s(g)(1) requires swap dealers and MSPs to maintain trading records for each swap transaction and all related records, as well as a complete audit trail for comprehensive trade reconstructions. Pursuant to these provisions, the Commission adopted §§ 23.201 and 23.203, which require swap dealers and MSPs to keep records including complete transaction and position information for all swap activities, including documentation on which trade information is originally recorded. Swap dealers and MSPs also have to comply with Part 46 of the Commission’s regulations, which addresses the recordkeeping requirements for swaps entered into before the date of enactment of the Dodd-Frank Act (“pre-enactment swaps”) and data relating to swaps entered into on or after the date of enactment but prior to the part 45 compliance date (“transition swaps”).

SDR Reporting: CEA section 2(a)(13)(G) requires all swaps, whether cleared or uncleared, to be reported to a registered swap data repository (“SDR”). CEA section 21 requires SDRs to collect and

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1 SIFIs that are not FCMs would be exempt from the Commission’s capital requirements, and would comply instead with Federal Reserve Board requirements applicable to SIFIs, while nonbank (and non-FCM) subsidiaries of U.S. bank holding companies would calculate their Commission capital requirement using the same methodology specified in Federal Reserve Board regulations applicable to the bank holding company, as if the subsidiary itself were a bank holding company.
maintain data related to swap transactions as prescribed by the Commission, and to make such data electronically available to regulators. Swap dealers and MSPs would be required to comply with Part 45 of the Commission’s regulations, which set forth the specific transaction data that reporting counterparties and registered entities must report to a registered SDR; and Part 46, which addresses the recordkeeping requirements for pre-enactment swaps and data relating to transition swaps.

**Physical Commodity Swaps Reporting (Large Trader Reporting):** CEA section 4t authorizes the Commission to establish a large trader reporting system for significant price discovery swaps, of which the economically equivalent swaps subject to part 20 reporting are a subset, and in order to implement the statutory mandate in CEA section 4a for the Commission to establish position limits, as appropriate, for physical commodity swaps. The Commission published part 20 rules requiring swap dealers, among other entities, to submit routine position reports on certain physical commodity swaps and swaptions.

### ENTITY-LEVEL REQUIREMENTS

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* Where swaps are solicited or negotiated by a foreign affiliate of a U.S. person but directly booked in the U.S. person, the U.S. person must comply with all of the swap dealer duties and obligations related to the swaps, including registration, capital and related prudential requirements.

** Both Entity-Level and Transaction-Level Requirements are the ultimate responsibilities of the U.S.-based swap dealer.

*** With respect to the SDR reporting requirement, the Commission may permit substituted compliance only if direct access to swap data is provided to the Commission.
APPENDIX B

TRANSACTION-LEVEL REQUIREMENTS

The Transaction-Level Requirements cover a range of Dodd-Frank requirements: some of the requirements more directly address financial protection of swap dealers (or MSPs) and their counterparties; others address more directly market efficiency and/or price discovery. Further, some of the Transaction-Level Requirements can be classified as Entity-Level Requirements and applied on a firm-wide basis across all swap transactions or activities. Nevertheless, in the interest of comity principles, the Commission believes that the Transaction-Level Requirements may be applied on a transaction-by-transaction basis.

Category A: Risk Mitigation and Transparency

Clearing and Swap Processing: CEA section 2(h)(1) requires a swap to be submitted for clearing to a DCO if the Commission has determined that the swap is required to be cleared, unless one of the parties to the swap is eligible for an exception under section 2(h)(7) from the clearing requirement and elects not to clear the swap. Finally, the Commission adopted § 23.506, which requires swap dealers and MSPs to submit swaps promptly for clearing and comply with § 23.610, which establishes certain standards for swap processing by swap dealers and MSPs that are clearing members of a DCO.

Margin (and Segregation) Requirement for Uncleared Swap Transactions: Section 4s(e) explicitly requires the adoption of rules establishing margin requirements for swap dealers and MSPs, and applies a bifurcated approach that requires each swap dealer and MSP for which there is a prudential regulator to meet the margin requirements established by the applicable prudential regulator, and each swap dealer and MSP for which there is no prudential regulator to comply with Commission’s margin regulations. In contrast, the “segregation” requirements in 4s(1) don’t use a bifurcated approach – all swap dealers and MSPs are subject to the Commission’s rule regarding notice and third party custodians for margin collected for uncleared swaps.

Mandatory Trade Execution: CEA section 2(h)(8) provides that unless a non-financial end-user exemption applies, a swap that is subject to clearing requirement and made available to trade must be traded on a DCM or SEF.

Swap Trading Relationship Documentation: CEA Section 4s(i) requires each swap dealer and MSP to conform to commission standards for the timely and accurate confirmation, processing, netting documentation and valuation of swaps. Pursuant thereto the Commission has proposed § 23.504(a), which would require swap dealers and MSPs to “establish, maintain and enforce written policies and procedures” to ensure that the swap dealer or MSP executes written swap trading relationship documentation. Under proposed §§ 23.505(b(1), 23.504(b)(3), and 23.504(b)(4), the swap trading relationship documentation must include, among other things: all terms governing the trading relationship between the swap dealer and its counterparty; credit support arrangements; investment and rehypothecation terms for assets used as margin for uncleared swaps and custodial arrangements. Further, the swap trading relationship documentation requirement applies to all transactions with registered swap dealers and MSPs.

Portfolio Reconciliation and Compression: CEA section 4s(i) directs the Commission to prescribe regulations for the timely and accurate processing and netting of all swaps entered into by swap dealers and MSPs. Pursuant to CEA section 4s(i), the Commission proposed regulations (§§ 23.502 and 23.503), which would require swap dealers and MSPs to perform portfolio reconciliation and compression, respectively, for all swap transactions. Portfolio reconciliation is a post-execution risk management tool to

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2 The requirements under section 4s(i) relating to trade confirmations is a Transaction-Level Requirement. Accordingly, proposed 17 CFR 23.504(b)(2), which requires a swap dealer’s and MSP’s swap trading relationship documentation to include all confirmations of swap transactions, will apply on a transaction-by-transaction basis.
ensure accurate confirmation of a swap’s terms and to identify and resolve any discrepancies between counterparties regarding the valuation of the swap. Portfolio compression is a post-trade processing and netting mechanism that is intended to ensure timely accurate processing and netting of swaps. Proposed § 23.503(c) would require all swap dealers and MSPs to participate in bilateral compression exercises and/or multilateral portfolio compression exercises conducted by their SROs or DCOs of which they are members. Further, participation in multilateral portfolio compression exercises is mandatory for dealer to dealer trades.

Real-Time Public Reporting: CEA section 2(a)(13) directs the Commission to promulgate rules providing for the public availability of swap transaction data in real time basis. The Commission promulgated part 43 rules, which provides that all “publicly reportable swap transactions” must be reported and publicly disseminated.

Trade Confirmation: CEA section 4s(i) requires that each swap dealer arid MSP must comply with the Commission’s regulations prescribing timely and accurate confirmation of transactions. The Commission has proposed § 23.501, which requires, among other things, a timely and accurate confirmation of all swaps and life cycle events for existing swaps. In addition, proposed § 23.504(b)(2) requires a swap dealer’s and MSP’s swap trading relationship documentation to include all confirmations of swap transactions.

Daily Trading Records: Pursuant to section CEA 4s(g)(1), the Commission adopted § 23.202, which requires swap dealers and MSPs to maintain daily trading records, including records of trade information related to pre-execution, execution, and post-execution data that is needed to conduct a comprehensive and accurate trade reconstruction for each swap. The final rule also requires that records be kept of cash or forward transactions used to hedge, mitigate the risk of, or offset any swap held by the swap dealer or MSP.

Category B: Sales Practices

External Business Conduct Standards: Pursuant to CEA section 4s(h), the Commission has adopted external business conduct rules, which establish business conduct standards governing the conduct of swap dealers and MSPs in dealing with their counterparties in entering into swaps.
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* Where swaps are solicited or negotiated by a foreign affiliate but directly booked in the U.S. person, the U.S. person must comply with all of the swap dealer duties and obligations, including all Transaction-Level Requirements. The foreign affiliate, if separately required to register as a swap dealer, must comply with those requirements applicable to its swap dealing activities.

** The Transaction-Level Requirements apply to swaps in which: (i) a non-U.S. counterparty is majority-owned, directly or indirectly, by a U.S. person; (ii) the non-U.S. counterparty regularly enters into swaps with one or more U.S. affiliates or subsidiaries of the U.S. person; and (iii) the financials of such non-U.S. counterparty are included in the consolidated financial statements of the U.S. person.

*** Under limited circumstances, where there is not a comparable foreign regulatory regime, foreign branches and agencies of U.S. swap dealers may comply with the local transaction-level requirements rather than the Transaction-Level Requirements, subject to specified conditions.

**** The swap trading relationship documentation requirement applies to all transactions with registered swap dealers and MSPs.

***** Participation in multilateral portfolio compression exercises is mandatory for dealer to dealer trades.
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* Where swaps are solicited or negotiated by an affiliate of a U.S. person but directly booked in the U.S. person, the U.S. person must comply with all of the swap dealer duties and obligations, including all Transaction-Level Requirements. The foreign affiliate, if separately required to register as a swap dealer, must comply with those requirements applicable to its swap dealing activities.

** The Transaction-Level Requirements apply to swaps in which: (i) a non-U.S. counterparty is majority-owned, directly or indirectly, by a U.S. person; (ii) the non-U.S. counterparty regularly enters into swaps with one or more U.S. affiliates or subsidiaries of the U.S. person; and (iii) the financials of such non-U.S. counterparty are included in the consolidated financial statements of the U.S. person.
## All OTHER (NON-SWAP DEALER/MSP) MARKET PARTICIPANTS*

### APPENDIX C

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* The relevant Dodd-Frank requirements are those relating to: clearing, trade execution, real-time public reporting, Large Trader Reporting, SDR reporting and swap data recordkeeping.