

September 18, 2014

## Court Dismisses Challenge to CFTC Cross-Border Guidance

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### **District Court Dismisses Broad-Based Challenge to CFTC Cross-Border Interpretative Guidance but Remands Several Title VII Dodd-Frank Swaps Rules for Further Cost-Benefit Analysis; Remanded Rules Not Vacated and Will Remain in Force During Remand**

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#### **SUMMARY**

On September 16, 2014, the United States District Court for the District of Columbia dismissed a broad-based challenge to the interpretive guidance and policy statement issued by the Commodity Futures Trading Commission (“CFTC”) in July 2013 relating to the extraterritorial application of the CFTC’s swaps rules adopted pursuant to Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank” or “Dodd-Frank Act”). The guidance specifically addressed the circumstances under which certain Dodd-Frank requirements, such as the CFTC’s swap reporting rules, mandatory clearing requirement, trade execution requirement, and swap dealer registration and business conduct requirements, would apply in connection with transactions and trading activity involving one or more non-U.S. counterparties. Although the Court dismissed the broad challenge to the CFTC’s cross-border guidance, the decision separately concluded that several of the CFTC’s Dodd-Frank rulemakings failed to address the costs and benefits of the extraterritorial application of those rules, and the Court remanded those rules to the CFTC for further cost-benefit consideration. However, the Court elected not to vacate the rules for the duration of the remand, concluding that vacatur would be unnecessarily disruptive to the “CFTC’s mission and the purposes of the Dodd-Frank Act.”

## BACKGROUND

On July 12, 2013, the CFTC issued its Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations (the “Cross-Border Guidance,” or “Guidance”),<sup>1</sup> which was styled as an interpretive statement addressing the cross-border applicability, under section 2(i) of the Commodity Exchange Act, as amended (“CEA”),<sup>2</sup> of the various CFTC rulemakings adopted to implement the swaps provisions of Title VII of the Dodd-Frank Act.

Following the issuance of the Cross-Border Guidance, market participants had expressed concern regarding certain aspects of the Cross-Border Guidance with respect to which there was still substantial ambiguity. Specifically, there was uncertainty with respect to the applicability of certain *transaction-level requirements* to transactions entered into with non-U.S. counterparties by employees or agents of a non-U.S. swap dealer located in the U.S. The only relevant CFTC commentary on the issue appeared only in a brief footnote in the Cross-Border Guidance, and the footnote did not identify all of the circumstances under which the involvement of U.S. personnel in transactions with non-U.S. counterparties would result in CFTC jurisdiction over that transaction, or which rules would apply to that transaction as a result of such jurisdiction.<sup>3</sup> The CFTC sought to clarify the ambiguity by issuing a staff advisory that expressly asserted that the use of “personnel or agents located in the U.S.” to “regularly arrang[e], negotiat[e], or execut[e] swaps for or on behalf of [a swap dealer]” involved conduct that amounts to “performing core, front-office activities of that SD’s dealing business” within the U.S. and would thus subject such

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<sup>1</sup> Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations, 78 Fed. Reg. 45291 (published in the Federal Register on July 26, 2013). For a more in depth discussion of the Cross-Border Guidance, please see the S&C publication “CFTC Approves Final Guidance and Exemptive Order on Cross Border Application of the Swaps Provisions of Dodd-Frank,” dated July 22, 2013, available at: [http://www.sullcrom.com/CFTC\\_Cross\\_Border\\_Application\\_of\\_Dodd\\_Frank\\_Title\\_VII](http://www.sullcrom.com/CFTC_Cross_Border_Application_of_Dodd_Frank_Title_VII).

<sup>2</sup> CEA section 2(i), added by the Dodd-Frank Act, provides that the swaps provisions of the CEA shall not apply “to activities outside the United States” except where (1) “those activities . . . have a direct and significant connection with activities in, or effect on, commerce of the United States”; or (2) those activities “contravene such rules or regulations as the Commission may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of [the CEA, as amended by Title VII of the Dodd-Frank Act].”

<sup>3</sup> This footnote 513 in the Cross-Border Guidance provided that:

*Consistent with the foregoing rationale, the Commission takes the view that a U.S. branch of a non-U.S. swap dealer or MSP would be subject to Transaction-Level requirements, without substituted compliance available. As discussed above, a branch does not have a separate legal identity apart from its principal entity. Therefore, the Commission considers a U.S. branch of a non-U.S. swap dealer or non-U.S. MSP to be a non-U.S. person (just as the Commission considers a foreign branch of a U.S. person to be a U.S. person). Nevertheless, the Commission also recognizes its strong supervisory interest in regulating the dealing activities that occur with [or within] the United States, irrespective of the counterparty (just as the Commission allows for substituted compliance for foreign branches in certain instances to take into account the strong supervisory interest of local regulators).*

Cross-Border Guidance, *supra* note 1, at 45350 n.513.

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transactions arranged, negotiated or executed by such persons to *transaction-level requirements*.<sup>4</sup> This more expansive interpretation of the CFTC's jurisdictional reach provoked criticism by non-U.S. regulators and both U.S. and non-U.S. market participants.

On December 4, 2013, responding to both the Cross-Border Guidance and the subsequent CFTC staff advisory, the Securities Industry and Financial Markets Association ("SIFMA"), the International Swaps and Derivatives Association, Inc. ("ISDA") and the Institute of International Bankers ("IIB") sued the CFTC in the U.S. District Court for the District of Columbia, claiming that the issuance of the Cross-Border Guidance and multiple CFTC swaps rules, to the extent they may apply in cross-border situations, constituted improper rulemakings under the Administrative Procedures Act ("APA") and the CEA.<sup>5</sup> In their complaint, ISDA, SIFMA, and IIB (collectively, the "Plaintiffs") specifically asked the Court to vacate the Cross-Border Guidance and to issue an injunction preventing the CFTC from applying the various Dodd-Frank swaps rules (the "Title VII Rules")<sup>6</sup> on an extraterritorial basis, arguing that the Cross-Border Guidance and the Title VII Rules were promulgated in violation of the APA's notice-and-comment and the CEA's cost-benefit analysis requirements.

The CFTC responded first by issuing no-action relief that suspended the application of certain transaction-level requirements for non-U.S. swap dealers through December 31, 2014.<sup>7</sup> The CFTC also suspended the DSIO Advisory and requested further comment on the issues therein.<sup>8</sup> Separately, the CFTC responded to the Plaintiffs' lawsuit by filing a motion to dismiss the complaint, arguing that the trade groups lacked standing to sue in lieu of their constituent members. The CFTC further filed a motion

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<sup>4</sup> See CFTC Staff Advisory No. 13-69, issued by the CFTC's Division of Swap Dealer and Intermediary Oversight ("DSIO") on November 14, 2013, addressing the applicability of certain "transaction-level requirements" to activities involving U.S. based personnel of non-U.S. persons (the "DSIO Advisory").

<sup>5</sup> *Sec. Indus. & Fin. Markets Ass'n et al. v. CFTC*, No. 13-CV-1916 (D.D.C. Dec. 4, 2013). For a more in depth discussion of the regulatory environment that preceded the lawsuit, please see the S&C publication "CFTC Cross-Border Jurisdiction and Comparability Determinations," dated January 7, 2014, available at: <http://www.sullcrom.com/CFTC-Cross-Border-Jurisdiction-and-Comparability-Determinations>.

<sup>6</sup> The complaint challenged the CFTC's rules addressing swap entity registration, swap entity definitions, portfolio reconciliation and documentation, real-time reporting, daily trading records, the trade execution requirement, straight through processing, mandatory clearing determinations, the requirement to have a Chief Compliance Officer, risk management, reporting to a swap data repository ("SDR"), historical SDR reporting, swaps large trader reporting, and the swap execution facility ("SEF") registration requirement.

<sup>7</sup> See CFTC Letter No. 14-74, issued jointly by the CFTC's DSIO, Division of Clearing and Risk, and Division of Market Oversight, providing no-action relief through December 31, 2014 with respect to the application of certain transaction-level requirements for non-U.S. swap dealers.

<sup>8</sup> Request for Comment on Application of Commission Regulations to Swaps Between Non-U.S. Swap Dealers and Non-U.S. Counterparties Involving Personnel or Agents of the Non-U.S. Swap Dealers Located in the United States, 79 Fed. Reg. 1347 (Jan. 8. 2014).

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for summary judgment contending that the Plaintiffs' claims were unripe for judicial review and that the guidance, as a statement of CFTC policy, was not judicially reviewable.

On September 16, 2014, the D.C. District Court issued a decision that dismissed the Plaintiffs' challenges to the Cross-Border Guidance, ultimately concluding that the Guidance was a non-binding policy statement and interpretive rule, rather than a legislative rule subject to challenge on APA grounds. The Court also generally affirmed the ability of the CFTC to apply and enforce the Title VII Rules in the cross-border context.<sup>9</sup> Although the Court's decision granted the Plaintiffs' motion for summary judgment with respect to several (but not all)<sup>10</sup> of the Title VII Rules, remanding those rules to the CFTC for further cost-benefit analysis with respect to their extraterritorial application, the decision did not vacate the rules during the remand, concluding that vacatur would be unnecessarily disruptive to the CFTC's mission and the purposes of Dodd-Frank. The Court further denied the Plaintiffs' request for an injunction as to the extraterritorial application of the Title VII Rules. Therefore, the Title VII Rules remain in effect for all market participants, and the Cross-Border Guidance remains in force as, according to the Court, "non-binding policies regarding the Title VII Rules' extraterritorial applications."

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### THE COURT'S DECISION

#### A. THE CROSS-BORDER GUIDANCE CONSTITUTED A POLICY STATEMENT AND INTERPRETIVE RULE – NOT A LEGISLATIVE RULE

The primary issue in determining the merits of the Plaintiffs' claims was whether the CFTC's actions in promulgating the Cross-Border Guidance constituted (i) a legislative rule, or (ii) a policy statement or interpretive rule. Only legislative rules constitute a final agency action subject to judicial review under the APA. The Court held that the Cross-Border Guidance was a combination policy statement and interpretive rule, correspondingly denying the Court authority to review the Guidance under the APA requirements applicable to a legislative rule.

In determining the difference between legislative rules and policy statements the Court looked to two factors: "[(1)] the actual legal effect (or lack thereof) of the agency action in question on the regulated entities" and (2) the agency's characterization of its action.<sup>11</sup> Moreover, the Court explained that the difference between legislative and interpretive rules was determined by whether the agency's rule creates a substantial regulatory change to the current regime. Lastly, the court clarified that the difference was

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<sup>9</sup> *Sec. Indus. & Fin. Mkts. Ass'n., et al., v. CFTC*, 13-CV-1916 slip op. (D.D.C. Sept. 14, 2014) ("Decision").

<sup>10</sup> The Court granted the CFTC's motion to dismiss on standing as to the trade execution rule and its motion for summary judgment as to the Cross-Border Guidance, the swaps large trader reporting rules, the straight through processing rules, and the clearing determination rules.

<sup>11</sup> Decision at 56.

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judged in whether the agency statement conveys how the agency intends to enforce a legal norm, making it a policy statement, or whether it construes an existing legal norm, making it an interpretive rule.

The Court found here that the Cross-Border Guidance constitutes a policy statement as it does not purport to be a rule that is binding on either the CFTC or swaps market participants. The Cross-Border Guidance only creates a “general policy” which allows for flexible application as circumstances require. Despite being a strong indicator of the CFTC’s future application of the Title VII Rules, the Court viewed the Cross-Border Guidance as constituting a “flexible, non-binding approach.”<sup>12</sup> The consistent use of conditional terms, such as “generally” and “ordinarily,” and an advisory to consult with CFTC staff regarding application of the guidance to individual situations indicated that the CFTC intends to use a “case-by-case approach to enforcement.”<sup>13</sup> As the Cross-Border Guidance could not be construed as “setting forth binding norms” on when the Title VII Rules would apply extraterritorially, the court concluded that it could only be regarded as a statement of CFTC policy.

The Court accorded further weight to this determination due to the CFTC’s consistent characterization of the Cross-Border Guidance as a non-binding policy statement. The court highlighted the absence of enforcement actions relying on the Cross-Border Guidance, the issuance of exemptive orders, and the issuance of “no action” letters regarding the Guidance as indicators of the CFTC’s intention to use the Cross-Border Guidance only as a statement of flexible CFTC policy. The Court did note that swap market participants will feel pressure to conform their conduct to this policy, but that despite this pressure, the fact that the alternative of not following the Cross-Border Guidance was still available, even if it means risking significant legal sanctions, underscored the Guidance’s nature as a policy statement.

Separately, the court focused on a section of the Cross-Border Guidance entitled “Interpretation of [CEA] Section 2(i),” which explicitly “reflect[ed] the CFTC’s construction of the statutory language” of the Dodd-Frank Act’s extraterritorial application. The Court concluded that this section was meant as an interpretation of the CFTC’s authority and could not be considered a legislative rule, noting that the section analyzes the existing statutory backdrop of the CFTC’s extraterritoriality authority, does not draw upon its “general rulemaking authority” or attempt to “amend any prior legislative rules,” and is not published in the Code of Federal Regulations.<sup>14</sup>

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<sup>12</sup> Decision at 59.

<sup>13</sup> Decision at 59.

<sup>14</sup> Decision at 70.

**B. THE COURT REMANDED CERTAIN OF THE TITLE VII RULES TO THE CFTC FOR FURTHER COST-BENEFIT ANALYSIS**

The remaining issue arose from Plaintiffs' challenges to the Title VII Rules, alleging that deficiencies in the rulemaking process invalidated the rules.

**1. CEA Section 2(i) Is Sufficient to Apply the Title VII Rules on an Extraterritorial Basis**

The Court decided that CEA section 2(i), as added by the Dodd-Frank Act, was sufficiently explicit in conferring extraterritorial reach to the Title VII Rules, absolving the CFTC from conducting a formal rulemaking on extraterritoriality. In reaching this conclusion the Court compared the plain text of the Dodd-Frank Act with similar language reviewed in *F. Hoffmann-La Roche Ltd. v. Empagran S.A.*, 542 U.S. 155, 162 (2004). In that case, the Court found that Congress' use of a general provision denying extraterritorial application of regulation except in specified circumstances indicated Congressional intent to apply the regulations extraterritorially in those specified circumstances. As there was no statutory requirement to proceed via formal rulemaking, the Court concluded that it remains within the CFTC's discretion to define the scope of the Title VII Rules extraterritorial application through *ad hoc* litigation and enforcement.

**2. The CFTC's Failure to Address the Title VII Rules' Extraterritorial Applications Is Not a Deficiency**

The Court also determined that the CFTC's failure to address publicly the extraterritorial application of the Title VII Rules or to respond to public comments were not deficiencies in the rulemaking. Given the CFTC's discretion to determine its preferred course of rulemaking (whether through formal rulemaking or *ad hoc* litigation), the Court found no affirmative requirement that the CFTC was first required to clarify or expound upon the scope of the Title VII Rules' extraterritorial application prior to seeking to enforce those rules in the cross-border context. Rather, the Court said that the CFTC's rulemaking obligation was only to define the issues "it sought to address within its Title VII Rules."<sup>15</sup> The court concluded that, the CFTC having chosen only to address the "substantive and procedural requirements applicable to regulated market participants," the CFTC was not bound to extend its explanation to the question of "to whom the Rules would apply extraterritorially."<sup>16</sup> Therefore, the Court concluded that the basic expectation that the CFTC would later apply the Title VII Rules in an extraterritorial context, to the extent permitted by CEA section 2(i), serves as independent clarification and explanation of the Rules' extraterritorial scope.

Additionally, the Court found that public comments requesting that the CFTC address the cross-border impact of the rules, even if significant in nature or amount, cannot themselves "unilaterally expand the scope of the Title VII Rules" and compel the CFTC to explain the extraterritorial application of the Title VII

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<sup>15</sup> Decision at 77.

<sup>16</sup> Decision at 77.

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Rules.<sup>17</sup> Concluding that the CFTC was not required to address publicly the scope of the rules or to respond to these comments, the Court did not find any deficiencies in the rulemakings.

### 3. The CFTC Failed to Perform the Necessary Cost-Benefit Analysis

However, the Court independently assessed Plaintiffs' challenge as to whether the CFTC undertook an adequate cost-benefit analysis to justify its anticipated extraterritorial application of the Title VII Rules. The Court found that, for several rules, the CFTC had failed to undertake any cost-benefit analysis with respect to cross-border application, and therefore those Title VII Rules were arbitrary and capricious.

Under CEA section 15(a), the CFTC is required to conduct a cost-benefit review of any rule promulgated under the CEA. The Court explained that courts generally review such analyses with deference and only seek to determine whether the agency's review consulted relevant factors or contained any clear judgment errors. The court clarified that the cost-benefit analysis does not require the agency to "gather market data or conduct empirical studies," but only instead to note its sources and any data limitations.

In the decision, the Court found a lack of any cost-benefit analysis to support the CFTC's intended extraterritorial application of Title VII Rules. The CFTC argued that such a cost-benefit analysis was unnecessary for multiple reasons, including that (1) the Congressional determination of the Title VII Rules' extraterritorial applicability, per CEA section 2(i), relieved the CFTC of its 15(a) cost-benefit obligations in this instance, (2) the Plaintiffs failed to identify existing data that the CFTC did not consult in its analysis, and (3) the speculative nature of a cost-benefit analysis relating to incomplete foreign swap regulatory regimes rendered the analysis unnecessary. The Court was unpersuaded by each of these arguments, finding that the CFTC's complete failure to analyze the costs of extraterritorial application of the Title VII rules rendered the Rules arbitrary and capricious.

The Court noted that the usual remedy upon finding this nature of deficiency in a rule is the vacatur and remand of the rule. But the Court also noted that courts may remand a rule without vacating it if vacatur would be unduly disruptive of the regulatory regime and the deficiency is not serious enough to remove any justification for the rule. In determining to remand, but not vacate, several Title VII Rules, the Court relied on its own observation that the likely result on remand would be to "re-institute the existing rules under more explicit justification." Further, the Court considered the cost-benefit deficiency to be more of form than substance, rendering the anticipated disruption to the already established extraterritorial compliance with the Title VII Rules unjustifiable. Based on these conclusions, the Court remanded the rules to the CFTC but did not choose to vacate the rules during the pendency of the remand.

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<sup>17</sup> Decision at 70.

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## CONTACTS

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### New York

David J. Gilberg	+1-212-558-4680	<a href="mailto:gilbergd@sullcrom.com">gilbergd@sullcrom.com</a>
Kenneth M. Raisler	+1-212-558-4675	<a href="mailto:raislerk@sullcrom.com">raislerk@sullcrom.com</a>
Rebecca J. Simmons	+1-212-558-3175	<a href="mailto:simmonsr@sullcrom.com">simmonsr@sullcrom.com</a>
John M. Miller	+1-212-558-4839	<a href="mailto:millerjo@sullcrom.com">millerjo@sullcrom.com</a>
Ryne V. Miller	+1-212-558-3268	<a href="mailto:millery@sullcrom.com">millery@sullcrom.com</a>
Christine Trent Parker	+1-212-558-3631	<a href="mailto:parkercc@sullcrom.com">parkercc@sullcrom.com</a>

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### Washington, D.C.

Dennis C. Sullivan	+1-202-956-7554	<a href="mailto:sullivand@sullcrom.com">sullivand@sullcrom.com</a>
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