

ClientAlert

Capital Markets/Derivatives

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Final Exemptive Order Regarding Compliance With Certain Swap Regulations; Further Proposed Guidance

On December 21, 2012, the Commodity Futures Trading Commission (the "Commission" or "CFTC") approved an exemptive final order (the "Final Order") providing time-limited relief from certain cross-border applications of the swaps provisions of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and the Commission's regulations. The purpose of the exemptive order is to foster an orderly phase-in of the new swaps regulatory regime and to provide market participants greater certainty regarding their obligations with respect to cross-border swap activities.

The Commission had published on July 12 of this year a proposed order (the "Proposed Order") that outlined temporary conditional relief from certain provisions of the Commodity Exchange Act ("CEA") as well as its proposed interpretive guidance and policy statement ("Proposed Guidance") with respect to the cross-border application of the swaps provisions of the CEA added by Title VII of the Dodd-Frank Act. The Final Order finalizes the Proposed Order with certain modifications and clarifications. Along with the Final Order, the Commission also proposed further guidance on certain elements of the Proposed Guidance (the "Further Proposed Guidance"); however, as noted below, the Commission determined not to finalize the Proposed Guidance at this time.

The relief of the Final Order will expire on July 12, 2013.

Overview of the Final Order and Further Proposed Guidance

The Final Order provides a new definition of "US person" (for the limited purposes set forth in the Final Order) and addresses compliance obligations with entity-level and transaction-level requirements by non-US persons and foreign branches of US swap dealers and major swap participants. The Final Order also provides revised guidance on the determination of whether a non-US person is engaged in more than a *de minimis* level of swap dealing or holds swap positions above any of the major swap participant thresholds.

While the Commission is not, at this time, taking action on the Proposed Guidance, it has offered, under Further Proposed Guidance for consideration and comment, alternatives for certain aspects of the definition of "US person" and for the aggregation requirement of the swap dealer determination.



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Phase-In of a New “US Person” Definition

The Final Order includes a definition of “US person,” which is the third version of the definition of “US person” proposed by the Commission in the last six months.

The first definition of “US person” proposed by the Commission is found in the Proposed Guidance and is the broadest of the three versions.¹ The second definition of “US person” was proposed on October 12, 2012, by the CFTC Division of Swap Dealer and Intermediary Oversight in a no-action letter² (“CFTC Letter No. 12-22”). This second version of the term is the narrowest and is defined as follows:

- 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 organized or incorporated under the laws of the United States;
- iii. A pension plan for the employees, officers, or principals of a legal entity described in (ii) above, unless the pension plan is exclusively for foreign employees of such entity;
- iv. An estate or trust, the income of which is subject to US income tax, regardless of source; or
- v. An individual account (discretionary or not) where the beneficial owner is a person described in (i) through (iv) above.

The Final Order’s definition of “US person” is based upon the narrower definition set forth in the CFTC Letter No. 12-22, but with modifications relating to (1) the location of an entity’s principal place of business, (2) the treatment of pension plans for foreign employees, (3) the treatment of estates and trusts, and (4) the treatment of joint accounts.

This latest version reads as follows:

- 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 (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 (i) through (iv) above.

As a result of the Commission’s expanded prong (ii) of the definition, legal entities not incorporated in the United States but that have their principal place of business in the United States will be treated as US persons. To give market participants time to implement the treatment of these entities as US persons, they have phased-in this part of the definition—it is not effective until April 1, 2013. Finally, as the application of the principal place of business element may be complex for funds and collective investment vehicles, the Commission has determined that this element will not apply at this time to funds or collective investment vehicles.

1. The definition of the term “US person” set forth in the Proposed Guidance would include, but not be limited to:

- (i) any natural person who is a resident of the United States;
- (ii) 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, in each case that is either (A) organized or incorporated under the laws of the United States or having its principal place of business in the United States (legal entity) or (B) in which the direct or indirect owners thereof are responsible for the liabilities of such entity and one or more of such owners is a US person;
- (iii) any individual account (discretionary or not) where the beneficial owner is a US person;
- (iv) any commodity pool, pooled account or collective investment vehicle (whether or not it is organized or incorporated in the United States) of which a majority ownership is held, directly or indirectly, by a US person(s);
- (v) any commodity pool, pooled account or collective investment vehicle the operator of which would be required to register as a commodity pool operator under the CEA;
- (vi) a pension plan for the employees, officers or principals of a legal entity with its principal place of business inside the United States; and
- (vii) an estate or trust, the income of which is subject to US income tax regardless of source.

2. CFTC Division of Swap Dealer and Intermediary Oversight, Re: Time-Limited No-Action Relief: Swaps Only With Certain Persons to be Included in Calculation of Aggregate Gross Notional Amount for Purposes of Swap Dealer De minimis Exception and Calculation of Whether a Person is a Major Swap Participant, No-Action Letter No. 12-22, Oct. 12, 2012.

Prong (iii) refines the treatment of pension plans under the definition. A plan that is primarily, rather than exclusively, for foreign employees of an entity is not a US person.³

Prong (iv) of the CFTC Letter No. 12-22 definition is also modified in the Final Order. It now provides that an estate should be treated as a US person if the decedent was a resident of the United States at the time of death, and a trust should be treated as a US person if it is governed by the law of a state or other jurisdiction in the United States and a court within the United States is able to exercise primary supervision over the administration of the trust.

Finally, the treatment of a joint account is also addressed. The last prong is expanded to now include not only individual accounts where the beneficial owner is a person described in the preceding criteria, but also joint accounts where any of the beneficial owners is such a person.

A party may reasonably rely on its counterparty's representation in determining whether the counterparty is a US person. In this regard, the Commission adopted a similar approach to the one used in the external business conduct standards. What is reasonable depends upon the facts and circumstances, but a party cannot ignore "red flags" when relying on such representations; it cannot simply accept the representation of its counterparty if it has information that would cause a reasonable person to question its accuracy.

The Commission also addressed the transition from the CFTC Letter No. 12-22 definition to the new definition of "US person" in the Final Order. It acknowledged that market participants may currently be relying upon the criteria set forth in CFTC Letter No. 12-22. Thus, until December 31, 2012, persons may continue to apply those criteria for purposes of the Final Order. In effect, until December 31, 2012, a person may apply either the counterparty criteria in CFTC Letter No. 12-22, or the definition set forth herein for purposes of the Final Order. Beginning on January 1, 2013 (i.e., following the expiration of CFTC Letter No. 12-22), a person must apply the definition set forth in the Final Order for purposes of swaps entered into on or after that date.

The Commission also emphasized that the latest definition and discussion in the Final Order is not, and should not be construed as, an indication of, or a limitation on, the definition of the term "US person" that it may adopt in final cross-border interpretive guidance. The Commission is seeking further comment on the definition for purposes of the cross-border guidance and proposed for comment alternative approaches to the definition.

Further Proposed Guidance—Definition of "US person"

The Commission has proposed alternatives for two "prongs" of the proposed definition of the term "US person" in the Proposed Guidance: prong (ii)(B), which relates to US owners that are responsible for the liabilities of a non-US entity; and prong (iv), which relates to commodity pools and funds with majority-US ownership. Both prongs have been proposed for comment and consideration.

The alternative prong (ii)(B) would be as follows:

- (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 either (A) 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 or (B) directly or indirectly majority-owned by one or more persons described in prong (i) or (ii)(A) and in which such person(s) bears unlimited responsibility for the obligations and liabilities of the legal entity (other than a limited liability company or limited liability partnership where partners have limited liability);

In its discussion around the proposal of this alternative prong (ii)(B), the Commission explains that unlimited liability corporations where US persons have majority ownership and where such US persons have unlimited liability for the obligations and liabilities of the entity would be covered under the alternative to prong (ii)(B). This proposed formulation would treat an entity as a US person if one or more of its US majority owners has unlimited responsibility for losses of, or nonperformance by, the entity. However, the Commission confirmed that this alternative proposed prong would not cover a legal entity organized or domiciled in a foreign jurisdiction simply because the entity's swap obligations are guaranteed by a US person.

The alternative prong (iv) would be as follows:

- (iv) A commodity pool, pooled account, investment fund, or other collective investment vehicle that is not described in prong (ii) and that is directly or indirectly majority-owned by one or more persons described in prong (i) or (ii), except any commodity pool, pooled account, investment fund, or other collective investment vehicle that is publicly-traded but not offered, directly or indirectly, to US persons;

3. We note that the Commission, in its discussion of the modification of this prong of the definition on page 20 of the version of the Final Order made available to the public on December 21, seems to have incorrectly stated that "...a pension plan that is 'primarily' (rather than exclusively) for the foreign employees of an entity is also a 'US person' for purposes of the Final Order." The actual text of the Final Order clearly states otherwise, however.

With reference to prong (iv), the Commission stated that (i) “majority-owned” would mean the beneficial ownership of 50 percent or more of the equity or voting interests in the collective investment vehicle, (ii) similar to the alternative prong (ii)(B) discussed above, the collective investment vehicle’s place of organization or incorporation would not be determinative of its status as a US person, (iii) a pool, fund, or other collective investment vehicle that is publicly traded will be deemed a US person only if it is offered, directly or indirectly, to US persons. This alternative proposed prong (iv) is intended to capture collective investment vehicles that are created for the purpose of pooling assets from US investors and channeling these assets to trade or invest in line with the objectives of the US investors, regardless of the place of the vehicle’s organization or incorporation.

Transitional Relief for Swap Dealer and Major Swap Participant Determinations

The Proposed Guidance provided direction on how non-US market participants must consider swap transactions and counterparty relationships in the determination of whether a non-US person is engaged in more than a *de minimis* level of swap dealing or holds swap positions above any of the major swap participant thresholds.

The Commission revisited and modified this guidance in the Final Order. For purposes of the transitional relief under the Final Order, in determining whether a non-US person is engaged in more than a *de minimis* level of swap dealing or holds swap positions above any of the major swap participant thresholds, a non-US person—whether guaranteed or not by a US person—may exclude and not consider the aggregate notional value of:

- any swap where the counterparty is a non-US person; and
- any swap where the counterparty is a foreign branch of a US person that is registered as a swap dealer or that represents that it intends to register with the Commission as a swap dealer by March 31, 2013; and
- for purposes of swap dealer registration only, any swap to which it is not a party because the swap is entered into by an affiliated central booking entity.

The Final Order also revises the aggregation rules for purposes of the swap dealer *de minimis* calculation. Under the transitional relief of the Final Order, in determining whether a non-US person is engaged in more than a *de minimis* level of swap dealing, a non-US person that is engaged in swap dealing activities with US persons as of the effective date of the Final Order is not required to include and may exclude and not consider the aggregate notional value of:

- any swap dealing transaction of its US affiliates under common control; and

- any swap dealing transactions of its non-US affiliates under common with other non-US persons; and
- if any of its affiliates under common control is registered as a swap dealer, any swap dealing transaction of any of its non-US affiliates that (i) is engaged in swap dealing activities with US persons as of the effective date of the Final Order or (ii) is registered as a swap dealer.

The definition of US person in the Final Order is relevant for determining whether a person is a swap dealer or major swap participant. A person that does not satisfy any of the prongs of the US person definition is a non-US person for the purposes of these determinations.

The exclusion from aggregation in the event that one of a non-US person’s commonly controlled affiliates is a registered swap dealer (even if the aggregate amount of swap dealing amongst all the unregistered non-US affiliates is above the *de minimis* threshold) has been provided as limited transitional relief. The exclusion is not available if a non-US affiliate begins to engage in swap dealing activity with US persons after the effective date of the Final Order. The Commission’s view is that this exception from aggregation is appropriate only for the limited time during which the Final Order will be in effect.

In cases where an entity operates a “central booking system” pursuant to which swaps are booked into a single legal entity, whether or not such entity is a counterparty to the swap, the Proposed Guidance stated that the entity that books the swaps would be subject to any applicable swap dealer registration requirement, as if the booking entity had entered into such swaps directly. This was the case regardless of whether such entity is a US person or whether the booking entity is a counterparty to a swap (has booked the swap directly) or has booked a swap indirectly by way of a back-to-back swap or other arrangement with an affiliate. Many market participants sought clarification around the Commission’s interpretation of a “central booking model” and its consequences. In the Final Order, the Commission clarified that a non-US person should not be required to include in its calculation of the aggregate gross notional amount of swaps connected with its swap dealing activity any swap to which it is not a party because the swap is entered into by an affiliated central booking entity.

Further Proposed Guidance—Aggregation of Affiliates’ Swaps for the De Minimis Test

In connection with the Final Order, the Commission has also proposed an alternative interpretation of the aggregation requirement and has requested comment on the proposed alternative approach.

Under this alternative, a non-US person would be required, in determining whether its swap dealing transactions exceed the *de minimis* threshold, to include the aggregate notional value of swap dealing transactions entered into by all its affiliates under common control (i.e., both non-US affiliates and US affiliates), but would not be required to include in such determination the aggregate notional value of swap dealing transactions of any non-US affiliate under common control that is registered as a swap dealer. Also, under this alternative, a non-US person would not be required to include the aggregate notional value of swap dealing transactions of any of its non-US affiliates under common control where the counterparty to such affiliate is also a non-US person.

The Commission explained that this alternative was offered further to comments received, which underscored that the aggregation rule of swap dealer determination could impose significant regulatory burdens upon non-US affiliates of non-US swap dealers without necessarily advancing significant regulatory interests of the Commission.

Entity-Level and Transaction-Level Requirements

In the Proposed Order, the Commission classified the various swap provisions to which market participants (particularly swap dealers and major swap participants) are subject as entity-level requirements and transaction-level requirements⁴. It stated, however, that it intends to reconsider any reclassification of the requirements in connection with further guidance on cross-border issues.

The Final Order provides some relief for entity-level and transaction-level requirements for non-US swap dealers and major swap participants and foreign branches of US swap dealers and major swap participants for so long as the Final Order is in effect.

Non-US Swap Dealers and Major Swap Participants

A non-US swap dealer or non-US major swap participant may delay compliance with respect to entity-level requirements that are in effect as of the effective date of the Final Order, subject to the following conditions:

- non-US swap dealers and non-US major swap participants shall be required to comply with the swap data repository (“SDR”) reporting and large trader reporting requirements for all swaps with US counterparties, upon their respective compliance dates; and

- non-US swap dealers and non-US major swap participants that are part of an affiliated group in which the ultimate parent entity is a US swap dealer, US major swap participant, US bank, US financial holding company, or US bank holding company shall be required to comply with the swap data reporting and large trader reporting requirements for swaps with non-US counterparties, upon their respective compliance dates.

However, during the pendency of the Final Order, non-US swap dealers and non-US major swap participants that are not part of an affiliated group in which the ultimate parent entity is a US swap dealer, US major swap participant, US bank, US financial holding company or US bank holding company may delay compliance with the swap data reporting and large trader reporting requirements for swaps with non-US counterparties.

With respect to transaction-level requirements as applied to transactions with a non-US counterparty, non-US swap dealers and non-US major swap participants may comply with such requirements only as may be required by the local jurisdiction of such registrants. However, such registrants must comply with transaction-level requirements that are in effect for all swaps with US counterparties.

US Swap Dealers and Major Swap Participants

US persons must apply to register as a swap dealer or major swap participant by the date such registration is required and shall comply with all applicable entity-level and transaction-level requirements that are in effect, except that:

- with respect to transaction-level requirements as applied to swaps with a non-US counterparty (including a non-US swap dealer or non-US major swap participant), a foreign branch of a US swap dealer or US major swap participant may comply with those requirements only as may be required by the local jurisdiction of such branches; and
- with respect to transaction-level requirements as applied to swaps between foreign branches of US swap dealers or foreign branches of US major swap participants, such foreign branches may comply with those requirements only as may be required by the local jurisdiction of such foreign branches.

4. The entity-level requirements classification of the Proposed Order included the following: (1) capital adequacy; (2) chief compliance officer; (3) risk management; (4) swap data recordkeeping; (5) swap data repository reporting; and (6) large trader reporting. The entity-level requirements apply to registered swap dealers and major swap participants across all their swaps without distinctions as to the counterparty or the location of the swap.

The transaction-level requirements classification of the Proposed Order included the following: (1) clearing and swap processing; (2) margining and segregation for uncleared swaps; (3) trade execution; (4) swap trading relationship documentation; (5) portfolio reconciliation and compression; (6) real-time public reporting; (7) trade confirmation; (8) daily trading records; and (9) external business conduct standards.

No-Action Relief in Respect of Dodd-Frank Requirements

The Proposed Order required entities that sought relief thereunder to submit to the National Futures Association a compliance plan addressing how it plans to comply with applicable requirements under the CEA and related regulation. The Commission has determined that the submission of a compliance plan should not be necessary in connection with phasing in compliance with the Dodd-Frank Act requirements in the cross-border context during the limited time frame in which the Final Order will be in effect. Therefore, the Final Order does not require submission of a compliance plan.

Also, to address practical and technical concerns as well as interpretive uncertainty raised by market participants, the Commission provided guidance around its intention for the exercise of its enforcement authority. Specifically, the Commission stated that it “does not intend to bring an enforcement action against a swap dealer or major swap participant for failing to fully comply with applicable Dodd-Frank Act requirements prior to July 12, 2013, provided that there is a practical or technical impediment to compliance that results in an inability to comply with relevant compliance deadlines, or uncertainty in interpreting, particular Dodd-Frank Act requirement(s) and the swap dealer or major swap participant is acting reasonably and in good faith to fully comply with the applicable Dodd-Frank Act requirements, which would include, at a minimum, (i) material progress toward timely implementation and compliance; (ii) identification of any implementation or interpretive issue as soon as reasonably possible; (iii) timely elevation of such issue(s) to the swap dealer’s or major swap participant’s senior management for consideration and resolution; and (iv) timely consultation with other industry participants and the Commission as necessary to seek resolution of any such issue(s).”

The Commission cautions, however, that this expression of intent does not confer upon any party any rights or defenses in any investigation or in any action that may be brought by the Commission. As always, the Commission “will weigh all facts and circumstances in determining whether to commence an enforcement action.”⁵

Scope of the Relief of the Final Order

The time-limited relief provided in the Final Order: (A) does not affect, with respect to any swap within the scope of the Final Order, the applicability of any other CEA provision or Commission regulation; (B) shall not limit the applicability of any CEA provision or Commission regulation to any person, entity or transaction except as provided in the Final Order; (C) shall not affect the applicability of any provision of the CEA or Commission regulations to futures contracts, or options on future contracts; and (D) shall not affect any effective or compliance date set forth in any Dodd-Frank Act rulemaking by the Commission.

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5. See page 56 of the Final Order.