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1. Introduction

On October 11, 2016, the Commodity Futures Trading Commission (the "**CFTC**") released proposed rules and accompanying interpretative guidance setting forth the application of certain requirements under the Commodity Exchange Act and the rules and regulations thereunder to cross-border swap transactions (the "**Proposed Rule**")[1] . The focus of this article is the impact of certain aspects of the Proposed Rule on swap dealer *de minimis* threshold determinations by non-US persons and on the potential consequences for trading activities.

This article will consider the CFTC's current cross-border guidance in the context of conduit affiliates and the use of this classification in the swap dealer *de minimis* threshold determination by non-US persons as well as the proposed approach of the CFTC set out in the Proposed Rule where the conduit affiliate classification has been replaced with the concept of a "Foreign Consolidated Subsidiary."

Specifically, we will highlight concerns with the approach and methodology set forth in the Proposed Rule in respect of determining which swaps a non-US person is required to count to determine whether it is subject to registration as a swap dealer.

2. Background

A. CFTC's Final Cross-Border Guidance

On July 26, 2013, the CFTC issued its final guidance and policy statement regarding the application of certain swap regulations in cross-border and extra-territorial transactions and operations (the "**Final Guidance**")[2] . The Final Guidance was adopted under the authority granted by Section 722(d) of the Dodd-FrankWall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"), which provides as follows:

"The provisions of [the Dodd-Frank Act] wrelating to swaps that were enacted by the Wall Street Transparency and Accountability Act of 2010 (including any rule prescribed or regulation promulgated under that Act), shall not apply to activities outside the United States unless those activities— (1) have a direct and significant

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connection with activities in, or effect on, commerce of the United States; or (2) 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 this Act that was enacted by the Wall Street Transparency and Accountability Act of 2010."

Hence, the CFTC's jurisdiction in the cross-border context should be limited by considerations of direct and significant connection with activities in, or effect on, commerce in the US. The extent of the CFTC's reach must weigh this consequence and effect. In the Final Guidance, as well as in the Proposed Rule, the CFTC has adopted an approach that considers risk to the US financial system and how risk might "flow back to the US" as significant elements in the analysis and the finding of a direct and significant connection or effect.

The Final Guidance addresses several important topics:

i. the final definition of the term "US person," including the treatment of foreign branches of US swap dealers and major swap participants;

ii. introduction and definition of the concepts of Guaranteed Affiliates and Conduit Affiliates (as discussed below);

iii. the determinations of whether a non-US person is engaged in more than a *de minimis* level of swap dealing activity or holds swap positions above any of the major swap participant thresholds; and

iv. compliance obligations (including substituted compliance by non-US persons, foreign branches of US swap dealers and major swap participants) with swap regulations that have been categorized into one of two classifications (either entity-level requirements or transaction-level requirements).

For purposes of determining if a person is required to register as a swap dealer, it is necessary to determine whether or not the person and its counterparties are a US person, Guaranteed Affiliate or Conduit Affiliate.Adescription of the Guaranteed Affiliate and Conduit Affiliate concepts are set out below:

i. "**Guaranteed Affiliate**" refers to a non-US person that is affiliated with and guaranteed by a US person. The CFTC takes the view that any guarantee with recourse, regardless of whether it is "full recourse," is price forming and an integral part of a guaranteed swap.[3]

ii. The concept of a "**Conduit Affiliate**" is used by the CFTC to capture vehicles or conduits that effect swap transactions with third parties on behalf of US persons, but generally do not include swap dealers or affiliates of swap dealers. The CFTC explained in the Final Guidance that Conduit Affiliates are used by large global companies to centralize their hedging or risk-management in one or more affiliates. The Final Guidance does not provide a precise definition and instead sets forth a list of factors that are relevant in determining whether a particular entity is a Conduit Affiliate (although this list of factors is not considered exhaustive, and the CFTC may consider additional relevant factors depending on the facts and circumstances):

   (a) the non-US person is a majority-owned affiliate of a US person;

   (b) the non-US person is controlling, controlled by or under common control with the US person;

   (c) the financial results of the non-US person are included in the consolidated financial statements of the US person; and

   (d) the non-US person, in the regular course of business, engages in swaps with non-US third-parties for the purpose of hedging or mitigating risks faced by, or to take positions on behalf of, its US affiliates and enters into offsetting swaps or other arrangements with its US affiliates in order to transfer the risks and benefits of such swaps with third-parties to its US affiliates.

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A US person is required to include all swap dealing activity, whether with US or non-US counterparties. In addition, a Guaranteed Affiliate or Conduit Affiliate must also count all swap dealing activity, whether with US or non-US counterparties. However, a non-US person (that is not a Guaranteed Affiliate or Conduit Affiliate) is not required to count swaps transactions with other non-US persons and need only count swaps transactions with (i) US persons and (ii) subject to certain exceptions specified below, Guaranteed Affiliates, but does not need to include swaps with Conduit Affiliates. A non-US person (that is not a Guaranteed Affiliate or Conduit Affiliate) may also exclude swaps with (a) a foreign branch of a US swap dealer, (b) a Guaranteed Affiliate that is a swap dealer, (c) a Guaranteed Affiliate that is not a swap dealer and itself engages in *de minimis* swap dealing activity and is affiliated with a swap dealer and (d) a Guaranteed Affiliate that is, or is guaranteed by, a non-financial entity. In addition, a non-US person that is not a Guaranteed Affiliate or Conduit Affiliate may exclude any swaps that are entered into anonymously on a registered designated contract market, swap execution facility or foreign board of trade and such swaps are cleared. Furthermore, if a non-US person that is not a Guaranteed Affiliate or Conduit Affiliate clears a swap through a derivatives clearing organization, the resulting novated swap need not be counted for purposes of the swap dealer *de minimis* threshold.

For a few years following the adoption of the Final Guidance in 2013, market participants in the US and abroad focused significant efforts on ensuring compliance with the CFTC's rules and guidance as they were understood to apply in the cross-border context. Considerable resources were allocated by each market participant to understand how the various definitions in the Final Guidance were to be interpreted and how they were to be applied in the context of their existing trading relationships - evaluating the consequences to relationships where the rules and guidance applied and where they did not, and ensuring compliance with the requirements of the rules and guidance that did apply. Internal policies and procedures were established or updated to conform with the rules and guidance, and dealers active in the swaps market had to decide whether to register or not and, where multiple entities within the same corporate group were possibly above the swap dealer de mininis registration threshold, deciding which entity or entities should be registered.

Among the entities that have worked to ensure compliance with the Final Guidance are non-US banks and brokers engaged in swap dealing activity in non-US markets where these entities also concurrently look to the deeper liquidity found in the New York and London markets to hedge their local client facing swaps. These non-US banks or brokers may be located in any number of markets around the globe. These entities regularly enter into swaps with counterparts in their domestic markets. Assuming, for purposes of this article, that the regularity and nature of this business constitutes swap dealing activity, swaps entered into in order to hedge risk and exposure from this local market activity would also be included in the swap dealing activity of the non-US bank or broker. In short, two swaps are entered into: a client facing swap in the local market and a second swap, a hedge, with a bank in a larger market, such as London or New York. Both are likely within the scope of what the CFTC would consider to be "swap dealing activity."[4] We will refer to this trading pattern below in discussing the consequences of the proposed changes to the cross-border framework of the CFTC in the Proposed Rule.

B. Concerns with the Definition of Conduit Affiliate and its Use in the Final Guidance

Many market participants raised a number of issues with the definition of Conduit Affiliate and its use in the Final Guidance. Since its initial proposal in the CFTC's cross-border proposed guidance through its adoption in the Final Guidance, the CFTC explained that its inclusion in the framework is important because of the relationship between the conduit and the US person. The US person is directly exposed to risks from and incurred by the Conduit Affiliate as a result of this relationship. Also, the CFTC further indicated that it was concerned that US swap dealers would utilize Conduit Affiliates to conduct swaps outside the Dodd-Frank Act regulatory framework.

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Commenters on the CFTC's proposed cross-border guidance expressed concerns with a few elements of the definition of Conduit Affiliate, including the following:

i. the broad scope of the definition, adding that it was too vague;

ii. the uncertainties with the trading patterns, and the regularity thereof, required to satisfy the definition;

iii. the risks of arbitrary competitive disparities;

iv. whether there exists the appropriate level of connection or nexus to US activity or commerce to regulate transactions with these entities as is proposed; and

v. ownership requirements.

Some of these issues were addressed with revisions to the definition that were adopted in the Final Guidance, though the definition was largely retained as proposed. The CFTC reasoned that, although the conduit is located outside the US, it remains owned and controlled by a US person, and that the conduit's swaps should be attributed to the US entity. The CFTC considers that its approach recognizes the economic reality of the situation, which is not altered by the non-US location of the Conduit Affiliate—that is, these swaps are undertaken for the benefit of, and at the economic risk of, the broader corporate group owned and controlled by the US person affiliate. As a result, the direct and significant requirement is satisfied in the view of the CFTC.

However, market participants have since continued to raise questions and compliance issues with the use of the Conduit Affiliate classification, including the open ended way in which it is defined, because factors beyond those enumerated in the Final Guidance may also be relevant for the determination. Its use has raised many questions by those who have to represent to swap dealers whether or not they are a Conduit Affiliate. Any uncertainty around the scope of the term is borne by these entities in making representations. Without speculating as to all the reasons for a move away from the term Conduit Affiliate in the Proposed Rules, the CFTC dropped the definition of Conduit Affiliate and replaced it with the concept of a "Foreign Consolidated Subsidiary."

The term "Foreign Consolidated Subsidiary" captures any covered swap entity (see below) that is not a US person in which an ultimate parent entity that is a US person has a controlling interest, in accordance with US GAAP, such that the ultimate parent entity includes the non-US covered swap entity's operating results, financial position and statement of cash flows in its consolidated financial statements, in accordance with US GAAP.

This definition is the same as that used in the CFTC Final Cross-Border Margin Rules and, therefore, the use and consequences of this term in the margin context (as further discussed in the next section) are instructive in analyzing its proposed use in the CFTC's broader cross-border framework.

C. Use of "Foreign Consolidated Subsidiary" in the CFTC's Cross-Border Margin Rules

On December 16, 2015, the CFTC released final rules and accompanying interpretive guidance that set forth the CFTC's initial and variation margin requirements applicable to uncleared swaps (the "**CFTC Final Margin Rules**")[5]. On May 24, 2016, the CFTC released final rules and accompanying interpretative guidance setting forth the application of the CFTC Final Margin Rules to cross-border swap transactions (the "**CFTC Final Cross-Border Margin Rules**")[6] .

Under the CFTC Final Cross-Border Margin Rules, the application of the CFTC Final Margin Rules to a swap dealer or major swap participant that is not prudentially regulated (termed a covered swap entity, or ***CSE***, under the rules) will depend on that entity's classification as well as the classifications of its counterparties. The relevant classifications include, among others, "Foreign Consolidated Subsidiary." As mentioned above, the definition of this term is the same as that proposed under the Proposed Rule, although we note that under the CFTC Final Cross-Border Margin Rules (i) a party that is not a CSE cannot be a Foreign Consolidated Subsidiary, even if it is consolidated with a US ultimate parent entity and (ii) substituted compliance is potentially broadly available to a Foreign Consolidated Subsidiary to the same extent as any other non-US CSE.

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A few commenters expressed support for the Foreign Consolidated Subsidiary concept in the proposed cross-border margin rules. Some said it was a "logical and reasonable approach" and an "effective remedy to evasion," suggesting that because of its inclusion in the same consolidated financial statements, a Foreign Consolidated Subsidiary has a direct financial impact on its US ultimate parent entity, even absent a direct recourse guarantee. Also, some commented on how the proposed Foreign Consolidated Subsidiary definition addressed indirect ownership issues and would foreclose the possibility of a non-US CSE having multiple parent entities.

The CFTC considered the classification of a Foreign Consolidated Subsidiary to be a clear and objective standard for the application of margin requirements. The classification of a Foreign Consolidated Subsidiary, the CFTC explained, captures how the fact that an entity is included in the consolidated financial statements of another entity is an indication of potential risk to the other entity. The CFTC further explained that, "as a result of the Foreign Consolidated Subsidiary's direct connection to, and the possible negative impact of its swap activities on, its US ultimate parent entity and the US financial system, a Foreign Consolidated Subsidiary raises a more substantial supervisory concern in the United States relative to other non-US CSEs."[7]

3. The Proposed CFTC Cross-Border Rule's Adoption of the Foreign Consolidated Subsidiary Concept

In the fall of 2016, the CFTC issued the Proposed Rule to continue its codification efforts of the cross-border framework. Although the Proposed Rule only deals with the cross-border application of the swap and major swap participant *de minimis* registration thresholds and certain external business conduct standards of swap dealers and major swap participants as well as related definitions, the CFTC stated that it expects to address how other substantive Dodd-Frank Act requirements would apply to cross-border transactions in subsequent rulemakings. The Proposed Rule along with any such other future rulemaking would supersede the Final Guidance with respect to the matters covered by such rules.

The Proposed Rule addresses the cross-border application of the *de minimis* registration thresholds for determining whether a person would be required to register with the CFTC as a swap dealer or major swap participant. Counting towards the swap dealer *de minimis* threshold depends on a person's classification under the Proposed Rule, as well as the classification of its counterparty. The relevant classifications are: (i) US person, (ii) Foreign Consolidated Subsidiary, (iii) non-US person whose swaps are guaranteed by a US person (a "US Guaranteed Entity") and (iv) non-US person that is neither a Foreign Consolidated Subsidiary nor a US Guaranteed Entity (an "Other Non-US Person"). Each term is defined in the Proposed Rule, and the term Foreign Consolidated Subsidiary is the same as the definition of such term in the CFTC Final Cross-Border Margin Rules (as discussed above).

The CFTC said the following of its adoption of the Foreign Consolidated Subsidiary concept in the Proposed Rule:[8]

"The [CFTC] believes that the [Foreign Consolidated Subsidiary] definition appropriately encompasses those entities within this consolidated group that are subject to the financial control, and directly impact the financials, of the U.S. ultimate parent entity. First, consolidation under U.S. GAAP is predicated on the financial control of the reporting entity. Therefore, an entity within a financial group that is consolidated with its parent entity for accounting purposes in accordance with U.S. GAAP is subject to the financial control of that parent entity. Second, as the [CFTC] previously stated, by virtue of consolidation with its parent entity's financial statement under U.S. GAAP, [a Foreign Consolidated Subsidiary's] swap activity creates direct risk to the U.S. parent. That is, as a result of consolidation, the financial position, operating results, and statement of cash flows of [a Foreign Consolidated Subsidiary] are included in the financial statements of its U.S. ultimate parent and therefore affect the financial condition, risk profile, and market value of the parent. Because of that relationship, risks taken by [Foreign Consolidated Subsidiaries] can have a direct effect on the U.S. ultimate parent entity. Furthermore, the [Foreign Consolidated Subsidiary's] counter-parties generally look to both the [Foreign Consolidated Subsidiary] and its U.S. ultimate parent for fulfillment of the [Foreign Consolidated Subsidiary's] obligations under the swap, even without any

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explicit guarantee. In many cases, the [CFTC] believes that the counterparty would not enter into the transaction with the subsidiary (or would not do so on the same terms), and the subsidiary would not be able to engage in a swaps business, absent this close relationship with the parent entity."

Under the Proposed Rule, a Foreign Consolidated Subsidiary would include all its swap dealing transactions in its swap dealer *de minimis* threshold calculation, without exception. The CFTC explained that it believes that the swap dealing transactions of a Foreign Consolidated Subsidiary should be treated in the same manner as the swap dealing transactions of a US person (and US Guaranteed Entity) for purposes of the swap dealer *de minimis* threshold calculation. The CFTC's view is that the nature of the relationship between the Foreign Consolidated Subsidiary and its US ultimate parent entity are such that to do otherwise is to expose US markets to risk. In this respect, as it concerns swap dealer *de minimis* threshold determinations, Foreign Consolidated Subsidiaries and US persons are equivalent in the CFTC's view; any counterparty trading with the Foreign Consolidated Subsidiary presents the same risks to the US financial system as would result from a direct trade with a US person. Without expressing a view as to whether this equivalence is appropriate, we believe the consequences and the application of this paradigm should be reconsidered and weighed against the potential effect for the broader market. This will be discussed below.

An Other Non-US Person[9] would generally include in its *de minimis* calculation all swap dealing transactions with US counterparties, US Guaranteed Entities and with non-US persons that are Foreign Consolidated Subsidiaries, subject to certain exceptions for swaps executed anonymously on trading facilities and cleared. The CFTC has explained its view by saying that:[10]

"A credit event, including funding and liquidity problems, downgrades, default or insolvency at an Other Non-U.S. Person [swap dealer] could therefore have a direct adverse impact on its U.S. counterparties, which could in turn create the risk of disruptions to the U.S. financial system. A credit event, including funding and liquidity problems, downgrades, default or insolvency at an Other Non-U.S. Person [swap dealer] could therefore have a direct adverse impact on its U.S. counterparties, which could in turn create the risk of disruptions to the U.S. financial system."

Therefore, the CFTC considers that "the default or insolvency of an Other Non-US Person could have a direct adverse effect on a Foreign Consolidated Subsidiary, which through the interconnection to its US ultimate parent, could have knock-on effects, potentially leading to disruptions to the US financial system . . . [and] believes that such risk would be significant to the extent that the Other Non-US Person's dealing activities with Foreign Consolidated Subsidiaries, US persons and US Guaranteed Entities exceed the *de minimis* threshold."[11]

4. Discussion

As outlined above, a non-US person (that is not a Guaranteed Affiliate or a Conduit Affiliate) is not required to include in its swap dealer *de minimis* threshold determination under the requirements of the Final Guidance a swap with a counterparty that is a Conduit Affiliate. This remains the case even if the non-US person is a bank or broker entering into the swap with the Conduit Affiliate to hedge exposure from another swap entered into in its local market as part of its swap dealing activity and, thus, where both swaps are within the scope of the non-US person's swap dealing activity.

The result is different, however, under the Proposed Rule, which would to require the non-US person to count the swap with the Foreign Consolidated Subsidiary toward the swap dealer *de minimis* threshold (to the extent such swap is part of the non-US person's swap dealing activity).

Faced with a possibility of having to register as a swap dealer, it is highly likely that a good many of these entities will establish policies and procedures simply to prevent entering into swap transactions with Foreign Consolidated Subsidiaries. Although they will acknowledge the risk might be remote, the consequences of registration are significant. If the Proposed Rule is adopted as proposed, non-US banks and brokers will likely implement clear policies

and procedures preventing the execution of a swap with a Foreign Consolidated Subsidiary and also a US Guaranteed Entity (other than perhaps in very specific circumstances). These policies would be an extension of existing policies that allow non-US persons to transact only with certain counterparties or branches to ensure these institutions are not required to register as a swap dealer before they are prepared to do so. This would further bifurcate markets and draw lines to delineate liquidity pools in which only certain non-US persons would participate. Others would look to the liquidity offered by market participants that do not include Foreign Consolidated Subsidiaries and US Guaranteed Entities. All these measures would be to ensure continued operation as a dealer in swaps in their local non-US market, perhaps subject to applicable local rules or even European rules in respect of swaps executed to hedge local market risk, but never to face registration as a swap dealer ahead of a proper decision and preparation to register with the CFTC.

The CFTC's focus on the risk and the potential of entities located abroad to disrupt US market is appropriate. These concerns underlie the concept of Foreign Consolidated Subsidiaries and Conduit Affiliates. However, this risk may be addressed in a variety of ways and its existence does not necessarily mean that a Foreign Consolidated Subsidiary needs to be treated for all purposes as a US person. Distinctions, in fact, were made in the CFTC Final Cross-Border Margin Rules. There, Foreign Consolidated Subsidiaries may benefit from full or partial substituted compliance where US persons may not do so, or not in the same circumstances.

Further, Foreign Consolidated Subsidiaries could continue to count all dealing swaps, whether with US persons or non-US persons, just as Conduit Affiliates are currently required under the Final Guidance. As such, they would be obligated to register with the CFTC as swap dealers once the notional amount of their dealing swaps exceeds the *de minimis* threshold. Once registered, their swap dealing business would be regulated by the CFTC and they would be subject to the CFTC Final Cross-Border Margin Rules.

Extending the reach of the CFTC to require the registration of Other Non-US Persons wherever they may be located based upon trading activity with non-US persons that are Foreign Consolidated Subsidiaries, who are themselves required to register once all their dealing swaps exceeds the *de minimis* threshold, stretches the exercise of jurisdiction by the agency to market participants with a more attenuated nexus to the US markets. Any risk to US trade or business presented by these entities in these circumstances could be addressed through margin requirements imposed upon the Foreign Consolidated Subsidiary following its own registration as a swap dealer.

5. Conclusion

Before the Proposed Rules are finalized, the impact of requiring Other Non-US Persons to count all their dealing swaps with any Foreign Consolidated Subsidiary to their *de minimis* threshold, particularly where they are hedging local market swaps, should be reconsidered. The extended reach of the CFTC in this context should be weighed against any adverse potential impact on trading patterns and the creation of bifurcated liquidity pools. It should also be considered against alternatives (such as reliance on margin requirements) that may adequately address the risks these Other Non-US Persons present to US markets without taxing the resources of the CFTC to regulate these non-US persons as swap dealers or otherwise adversely altering trading patterns.

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Endnotes

1 Cross-Border Application of the Registration Thresholds and External Business Conduct Standards Applicable to Swap Dealers and Major Swap Particpants, 81 FR 71946 (October 18, 2016).

2 Interpretive Guidance and Policy Statement Regarding ComplianceWith Certain Swap Regulations, 78 FR 45292 (July 26, 2013).

3 In addition to traditional guarantees, the CFTC also views other formal agreements or arrangements in which one party commits to provide a financial back stop or funding against potential losses that may be incurred by the other party, either from specific contracts or more generally, as guarantees for purposes of Section 2(i) of the CEA. The CFTC will focus on the substance, rather than the form of the arrangement, in determining whether or not a financial arrangement constitutes a "guarantee" for purposes of the term Guaranteed Affiliate.

4 See Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 FR 30596 (May 23, 2012).

5 Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 FR 635 (January 6, 2016).

6 Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants—Cross-Border Application of the Margin Requirements, 81 FR 34817 (May 31, 2016).

7 See id. at 34826.

8 Proposed Rule, 81 FR 71946 at 71950.

9 The classification of Other Non-US Persons would include, from our working example, the non-US bank or broker that engages in swap dealing activity in its local non-US market and enters into off-setting swaps with a money center bank in London or New York.

10 Proposed Rule, 81 FR 71946 at 71955.

11 See id. at 71956.