

## E-ALERT | Dodd-Frank Act

January 2, 2013

**CFTC ISSUES FINAL EXEMPTIVE ORDER AND FURTHER PROPOSED GUIDANCE REGARDING CROSS-BORDER APPLICATION OF DODD-FRANK SWAP PROVISIONS**

On December 21, 2012, the U.S. Commodity Futures Trading Commission (“CFTC”) issued a final exemptive order (“Final Exemptive Order”) providing temporary relief from compliance with certain swap regulations and further proposed guidance in the context of the cross-border application of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”).<sup>1</sup>

The CFTC initially proposed the exemptive order on June 29, 2012 (“Proposed Exemptive Order”),<sup>2</sup> contemporaneously with proposed interpretive guidance and a policy statement (“Proposed Guidance”) addressing cross-border issues.<sup>3</sup> The CFTC elected not to finalize the Proposed Guidance at this time. It did, however, include in the Final Exemptive Order proposed further guidance (“Proposed Further Guidance”) regarding the definition of the term “U.S. person” and aggregation requirements for non-U.S. persons. The CFTC requested comment on the Proposed Further Guidance, and also with regard to certain requirements the CFTC is considering for determining whether swaps are entered into with “foreign branches” of U.S. persons. The comment period ends **30 days** after the date of publication of the document in the Federal Register, which is forthcoming. The Final Exemptive Order became effective on the date of approval by the CFTC (December 21, 2012), and it expires on **July 12, 2013**.

This alert sets forth the provisions of the Final Exemptive Order that were modified from the proposed version, then describes the additional new provisions of the Final Exemptive Order and finally describes the Proposed Further Guidance.

**Background**

***Dodd-Frank Act’s Cross-Border Provisions.*** The Dodd-Frank Act amended the CEA to include Section 2(i), which establishes the scope of the CFTC’s authority to apply the requirements of Title VII of the Dodd-Frank Act to cross-border swap activities. Section 2(i) provides that the provisions of Title VII do not apply to activities outside the United States unless those activities have a “direct and significant connection with activities in, or effect on, commerce of the United States” or contravene such rules as the CFTC may prescribe to prevent evasion.

***Proposed Guidance, Proposed Exemptive Order and CFTC Staff No-Action Relief.*** Pursuant to this authority, the CFTC proposed guidance on June 29, 2012 interpreting the scope of Section 2(i), focusing primarily on whether the swap activities of non-U.S. persons would trigger registration as a swap dealer (“SD”) or major swap participant (“MSP”). The Proposed Guidance included a broad

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<sup>1</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

<sup>2</sup> Exemptive Order Regarding Compliance with Certain Swap Regulations, 77 Fed. Reg. 41110 (July 12, 2012).

<sup>3</sup> Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, 77 Fed. Reg. 41213 (July 12, 2012).

definition of “U.S. person,”<sup>4</sup> the principal starting point for determining whether non-U.S. persons are required to register as SDs or MSPs based on their swap transactions with U.S. persons. The Proposed Guidance further addressed how foreign branches, agencies, affiliates, and subsidiaries of U.S. SDs and U.S. branches of non-U.S. SDs should be treated, and included a categorization of Title VII’s substantive requirements into “Entity-Level Requirements”<sup>5</sup> and “Transaction-Level Requirements.”<sup>6</sup> The Proposed Guidance also generally described the policy under which the CFTC may permit compliance with a comparable regulatory requirement of a non-U.S. jurisdiction to substitute for compliance with the requirements of the CEA and CFTC regulations. The Proposed Exemptive Order, which was issued contemporaneously with the Proposed Guidance and utilized its definitions of U.S. person, Entity-Level Requirements and Transaction-Level Requirements, provided for temporary exemptive relief from compliance with certain Entity-Level Requirements and Transaction-Level Requirements, subject to certain conditions.

Subsequent to the issuance of the Proposed Guidance and Proposed Exemptive Order, on October 12, 2012, the effective date of the swap definitional rules, CFTC staff issued a no-action letter to provide a uniform standard regarding which swaps must be included in the relevant calculations under the SD and MSP definitions for determining whether registration is required on a temporary basis through December 31, 2012.<sup>7</sup> For swaps with counterparties that must be included, the letter adopts counterparty criteria – in effect a definition of U.S. person – that is narrower than that contained in the Proposed Guidance and Proposed Exemptive Order.<sup>8</sup> The letter was issued in

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<sup>4</sup> Specifically, as set forth in the Proposed Guidance, the definition of the term “U.S. person” 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 U.S. person;
- (iii) any individual account (discretionary or not) where the beneficial owner is a U.S. 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 U.S. 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 U.S. income tax regardless of source.

<sup>5</sup> Entity-Level Requirements consist of: (1) capital adequacy; (2) chief compliance officer; (3) risk management; (4) swap data recordkeeping; (5) swap data repository (“*SDR*”) reporting; and (6) Large Trader Reporting (“*LTR*”).

<sup>6</sup> Transaction-Level Requirements consist of: (1) clearing and swaps 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.

<sup>7</sup> See CFTC Staff Letter No. 12-22, *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* (Oct. 12, 2012). The document may be viewed by clicking [here](#).

<sup>8</sup> The counterparty criteria under CFTC Staff Letter No. 12-22 were 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;

response to concerns raised by market participants, who as of October 12 needed to begin the calculations necessary for determining whether SD or MSP registration was required, with regard to the number of interpretive issues raised by the definition of U.S. person in the Proposed Guidance and the resulting uncertainty when applying the definition in performing the SD and MSP calculations.

## THE DECEMBER 21, 2012 FINAL EXEMPTIVE ORDER

The Final Exemptive Order provides temporary relief until July 12, 2013, for non-U.S. SDs and MSPs and foreign branches of U.S. SDs and MSPs from certain Dodd-Frank Act regulatory requirements in order to facilitate the transition to the Dodd-Frank Act regulatory regime for these entities.<sup>9</sup> Specifically, the Final Exemptive Order provides that a non-U.S. person that registers as an SD or MSP may delay compliance with certain Entity-Level Requirements, and non-U.S. SDs and MSPs, and foreign branches of U.S. SDs and MSPs, may delay compliance with certain Transaction-Level Requirements, of the Commodity Exchange Act (“CEA”) and CFTC regulations, subject to specified conditions.<sup>10</sup> As with the Proposed Exemptive Order, the Final Exemptive Order does not delay the compliance date for registration as an SD or MSP.

The Final Exemptive Order is similar to the Proposed Exemptive Order, but makes several modifications to its provisions and includes several additions, each of which are described below.

### Modified Provisions

**Relief from Entity-Level Requirements.** As under the Proposed Exemptive Order, the Final Exemptive Order provides that a non-U.S. person who registers with the CFTC as an SD or MSP may delay compliance with respect to Entity-Level Requirements that are in effect as of the effective date of the Final Exemptive Order, with the exception of certain reporting requirements.

With respect to reporting requirements for swaps with non-U.S. counterparties, the relief has been clarified. The Proposed Exemptive Order provided that non-U.S. SDs and non-U.S. MSPs that were not affiliates or subsidiaries of a U.S. SD could delay compliance with the SDR reporting and LTR requirements for swaps with non-U.S. counterparties. In the Final Exemptive Order, the CFTC clarified this relief by providing that it is available only to non-U.S. SDs or MSPs that are not part of an affiliated group in which the ultimate parent entity is a U.S. SD, U.S. MSP, U.S. bank, U.S. financial holding company, or U.S. bank holding company. Thus, swaps with non-U.S. counterparties that are entered into by a non-U.S. registrant the ultimate parent of which is a U.S. registrant will not be entitled to rely on this aspect of the Final Exemptive Order, and will be subject to the SDR reporting and LTR requirements.

With respect to U.S. counterparties, the relief has not been modified. Accordingly, all swaps with U.S. counterparties are subject to SDR reporting and LTR requirements.

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(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 U.S. 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.

<sup>9</sup> The Final Exemptive Order does not provide relief for U.S. persons registered with the CFTC as SDs or MSPs (other than their foreign branches) or for transactions between non-registrants.

<sup>10</sup> The Final Exemptive Order did not change the categorization of Entity-Level Requirements and Transaction-Level Requirements set forth in the Proposed Guidance.

**Relief from Transaction-Level Requirements.** The relief under the Final Exemptive Order from Transaction-Level Requirements for non-U.S. SDs and MSPs and for foreign branches of U.S. SDs and MSPs generally is the same as that under the Proposed Exemptive Order. With respect to Transaction-Level Requirements as applied to transactions with a non-U.S. counterparty, non-U.S. SDs and non-U.S. MSPs may comply with such requirements only as may be required by the local jurisdiction of such registrants. With respect to U.S. Counterparties, non-U.S. SDs and MSPs must comply with the Transaction-Level Requirements. The Final Exemptive Order clarifies that the relief extends to swaps between non-U.S. SDs and MSPs and foreign branches of U.S. SDs and MSPs (i.e., the non-U.S. SD or MSP may treat such a foreign branch as a non-U.S. person) and expands the relief to swaps between foreign branches of U.S. SDs and MSPs in certain circumstances (i.e., a foreign branch of a U.S. SD or MSP may treat a foreign branch of another U.S. SD or MSP as a non-U.S. person).

For purposes of the relief from the Transaction-Level Requirements for swaps between foreign branches of U.S. SDs and MSPs only, the Final Exemptive Order provides guidance for determining when a swap is entered into with a foreign branch of a U.S. person, as opposed to being with the U.S.-based entity. Under that guidance, a swap is with a foreign branch of a U.S. person when:

- the personnel negotiating and agreeing to the terms of the swap are located in the jurisdiction of the foreign branch;
- the documentation of the swap specifies that the counterparty or “office” for the U.S. person is the foreign branch; and
- the swap is entered into by the foreign branch in its normal course of business.

The CFTC requests comment on additional requirements for making this determination. The Final Exemptive Order proposes the following additional considerations that could be added to the guidance on this point:

- the foreign branch is the location of employment of the employees negotiating the swap for the U.S. person or, if the swap is executed electronically, the employees managing the execution of the swap;
- the U.S. person treats the swap as a swap of the foreign branch for tax purposes;
- the foreign branch operates for valid business reasons and is not simply a representative office of the U.S. person; and
- the foreign branch is engaged in the business of banking or financing and is subject to substantive regulation in the jurisdiction where it is located.

**Compliance Plans Not Required.** The Final Exemptive Order does not require the filing of compliance plans by non-U.S. persons who register with the CFTC as SDs and MSPs, or by foreign branches of registered U.S. SDs or MSPs, which would have been required under the Proposed Exemptive Order. However, in response to commenter concerns that there could be practical or technical limitations or interpretive uncertainty that might need to be resolved before an SD’s or MSP’s full compliance with Dodd-Frank Act requirements is feasible, the Final Exemptive Order contains a statement regarding the CFTC’s intended application of its enforcement authority for failure to comply with Dodd-Frank Act requirements prior to July 12, 2013, when the order expires.<sup>11</sup>

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<sup>11</sup> Specifically, the Final Exemptive Order states that the CFTC does not intend to bring an enforcement action against an SD or MSP 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

**Definition of the term U.S. Person Narrowed.** The Final Exemptive Order includes a narrower definition of U.S. Person than the Proposed Exemptive Order. The Final Exemptive Order defines a U.S. person as:

- (i) A natural person who is a resident of the United States;
- (ii) A corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund or any form of enterprise similar to any of the foregoing, in each case that is (A) organized or incorporated under the laws of a state or other jurisdiction in the United States or (B) effective as of April 1, 2013 for all such entities other than funds or collective investment vehicles, having its principal place of business in the United States;
- (iii) A pension plan for the employees, officers or principals of a legal entity described in (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.

The definition is largely similar to criteria set out in the no-action letter issued by CFTC staff on October 12, 2012, but with modifications that relate to the location of an entity's principal place of business, the treatment of pension plans for foreign employees, the treatment of trusts and estates, and the treatment of joint accounts.

With regard to an entity's principal place of business, the Final Exemptive Order expands the criteria of CFTC Letter No.12-22 to include not only entities that are incorporated under the laws of a state or other jurisdiction in the U.S., but also to include non-U.S. entities with a principal place of business in the U.S. (other than funds or collective investment vehicles) as U.S. persons on a phased-in basis by **April 1, 2013**. For purposes of the Final Exemptive Order, the Commission will construe the term "principal place of business" as referring to the single place where a corporation's officers direct, control, and coordinate the corporation's activities, which typically will be where the corporation maintains its headquarters.

Concerning the treatment of pension plans for foreign employees, CFTC Letter No. 12-22 excluded pension plans for foreign employees from its counterparty criteria plans if they were "exclusively" for such employees; the Final Exemptive Order provides that if such plans are "primarily" for foreign employees, they will not be considered U.S. persons.

With respect to trusts and estates, the Final Exemptive Order eliminates the requirement under CFTC Letter No. 12-22's and the Proposed Guidance's U.S. person definition that the income of the trust or estate be subject to U.S. taxation. The CFTC explained that this determination may depend on factors not relevant for Dodd-Frank purposes. Instead, the Final Exemptive Order's definition relies on the residency of the person within the U.S. at time of death and if the trust is subject to the law of

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requirements, and the SD or MSP is acting reasonably and in good faith to comply with such requirements. This 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 SD's or MSP's senior management for consideration and resolution; and (iv) timely consultation with other industry participants and the CFTC as necessary to seek resolution of any such issues.

a State or other jurisdiction in the U.S. and a U.S. court is able to exercise primary supervision over its administration as determinative of U.S. person status.

Regarding joint accounts, the Final Exemptive Order adds joint accounts (in addition to individual accounts included in CFTC Letter No. 12-22's criteria) where the beneficial owners are entities described in the definition.

In addition to these modifications, the Final Exemptive Order reiterates the position taken by the CFTC in the Proposed Guidance that foreign branches of U.S. persons are U.S. persons (except to the extent provided in the Final Exemptive Order). Moreover, the CFTC makes clear in the Final Exemptive Order that the definition of U.S. person contained therein is solely for purposes of the Final Exemptive Order and not for application of the CEA and CFTC regulations generally.

Note that, as was the case with the October 12, 2012 no-action letter, this definition does not contain the troubling "but not limited to" reference preceding the list of categories that comprise the definition of U.S. person. This is helpful, as commenters have noted that the presence of that language introduces uncertainty as to the scope of the definition. However, the CFTC has not indicated that it intends to remove that language in the final definition once the Final Exemptive Order expires.

### **Additional Provisions**

The Final Exemptive Order also includes several additions to the Proposed Exemptive Order that provide further guidance or relief.

***Due Diligence for Determining U.S. Person Status.*** The Final Exemptive Order includes guidance that a party to a swap may reasonably rely on its counterparty's representation that it qualifies as a U.S. person, absent indications to the contrary. In this regard, the CFTC notes that an SD or MSP cannot rely on a representation and continue to claim the exemptive relief if it has information that would cause a reasonable person to question the accuracy of the representation (in other words, an SD or MSP cannot ignore "red flags").

***Treatment of Transactions with non-US. Persons and Foreign Branches of U.S. Persons under the SD and MSP Definitions.*** The Final Exemptive Order provides that a non-U.S. person, regardless of whether the non-U.S. person's swap obligations are guaranteed by U.S. persons, does not need to include in its calculation of the aggregate gross notional amount of swaps connected with its swap dealing activity for purposes of applying the de minimis test, or in its calculation of whether it is an MSP, any swap where:

- the counterparty is a non-U.S. person, or
- the counterparty is a foreign branch of a U.S. person that is registered or intends to register as an SD by **March 31, 2013**, or
- it is not a party because the swap is entered into by a central booking entity affiliated with the non-U.S. person.

***Aggregation Rules for Affiliates under the SD De Minimis Calculation.*** The Final Exemptive Order provides relief from the requirement that a person include, in determining whether its swap dealing activities exceed the de minimis threshold of the SD definition (thus requiring registration), the aggregate notional value of swap dealing transactions entered by its affiliates under common control. Specifically under the Final Exemptive Order:

- a non-U.S. person that is currently engaged in swap dealing activities with U.S. persons is not required to include the swap dealing transactions of any of its U.S. affiliates in its de minimis calculation; and
- a non-U.S. person, if it is an affiliate of a registered SD, is not required to include in its de minimis calculation the swap dealing transactions of any of its non-U.S. affiliates, so long as each excluded affiliate is either currently engaged in swap dealing activities with U.S. persons or is registered as an SD.

### Proposed Further Guidance

The Final Exemptive Order includes Proposed Further Guidance that addresses two topics: (i) the aggregation requirements for purposes of SD registration and (ii) the definition of the term “U.S. person;” and requests comment on this Proposed Further Guidance.

**Aggregation Requirements.** In addition to the revised relief under the CEA’s aggregation rule contained in the Final Exemptive Order (described above), the CFTC proposed an alternative interpretation of the aggregation requirement. Under this interpretation, a non-U.S. person would be required to include the swap dealing transactions of all its affiliates under common control (i.e., both non-U.S. affiliates and U.S. affiliates), but would not be required to include the swap dealing transactions of any non-U.S. affiliate that is registered as an SD in determining whether its swap dealing transactions exceed the de minimis threshold. The CFTC requests comment on all aspects of this alternative interpretation.

**Definition of the Term U.S. Person.** The CFTC is proposing two alternative prongs to the definition of the term U.S. person contained in the Proposed Guidance. The first, prong (ii)(B), addresses U.S. owners that are responsible for the liabilities of non-U.S. entities.<sup>12</sup> The second, prong (iv), addresses collective investment vehicles.<sup>13</sup>

In contrast to the prong (ii)(B) contained in the Proposed Guidance, the alternative would only include unlimited liability corporations in which U.S. persons have a majority ownership interest. The CFTC clarifies that it would not cover a legal entity organized or domiciled in a non-U.S. jurisdiction simply because the entity’s swap obligations are guaranteed by a U.S. person.

Alternative prong (iv) regarding collective investment vehicles differs from that in the Proposed Guidance in that the collective investment vehicle will be deemed a U.S. person only if its directly or indirectly majority-owned (beneficial ownership of 50% or more) by one or more persons or entities that meet prongs (i) and (ii) of the definition of the term “U.S. person,” and would clarify that a

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<sup>12</sup> Alternative prong (ii)(B) as set forth in the Proposed Further Guidance is 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).

<sup>13</sup> Alternative prong (iv) as set forth in the Proposed Further Guidance is 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 U.S. persons.

collective investment vehicle that is “publicly traded” will be deemed a U.S. person only if it is offered, directly or indirectly, to a U.S. person.

In the case of both proposed alternative prongs (ii)(B) and (iv), the place of organization or incorporation would not be determinative of status as a U.S. person.

The CFTC seeks comment on these issues. It is not yet clear whether the Proposed Further Guidance will become final guidance, or will be embodied in definitive rulemaking, and in either case whether such action will be coordinated with the expiration of the Final Exemptive Order on July 12, 2013. It is also possible that the Final Exemptive Order could be replaced by definitive guidance, rulemaking or a new order that is not time-limited upon expiration of the Final Exemptive Order. We note that the relatively short (30-day) comment period for the Proposed Further Guidance suggests that the CFTC may attempt to implement some version of this guidance in conjunction with the expiration of the Final Exemptive Order. It is, however, not yet possible to predict how the CFTC will proceed.

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If you have any questions concerning the material discussed in this client alert, please contact the following lawyers:

<b>Bruce Bennett</b>	212.841.1060	<a href="mailto:bbennett@cov.com">bbennett@cov.com</a>
<b>Julian Hammar</b>	202.662.5628	<a href="mailto:jhammar@cov.com">jhammar@cov.com</a>
<b>Keith Noreika</b>	202.662.5497	<a href="mailto:knoreika@cov.com">knoreika@cov.com</a>
<b>Ira Palgon</b>	212.841.1250	<a href="mailto:ipalgon@cov.com">ipalgon@cov.com</a>
<b>William Massey</b>	202.662.5322	<a href="mailto:wmassey@cov.com">wmassey@cov.com</a>
<b>Kerry Burke</b>	202.662.5297	<a href="mailto:kburke@cov.com">kburke@cov.com</a>

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