

## The CFTC Proposes New Rules Walking Back Its Maximalist Cross-Border Swaps Regulatory Approach

March 4, 2020

### KEY POINTS

- The Commodity Futures Trading Commission (CFTC) has proposed new rules (Proposal) for the cross-border application of certain of its swap regulations.

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- The Proposal includes certain changes relative to the CFTC's existing interpretive guidance and policy statement on this subject. Most notably, the Proposal specifically aims to:
  - establish key definitions, some of which are revised definitions of existing terms and some of which are completely new terms and definitions;
  - address which cross-border swaps must be considered for the purposes of the swap dealer (SD) registration threshold;<sup>1</sup>
  - reclassify the CFTC's swaps requirements—which are currently classified as either entity-level requirements or transaction-level requirements—into three new categories for the purposes of determining when those requirements apply to cross-border transactions and counterparties; and
  - supplant the agency's existing substituted compliance framework with a new one that focuses more on regulatory outcomes as opposed to identical regulatory approaches.

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- This advisory contains a number of useful charts that highlight and explain the Proposal's changes.

The CFTC has recently taken an important step to codify its interpretation of the cross-border application of certain swap provisions in the Commodity Exchange Act (CEA), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), and the CFTC's regulations promulgated thereunder. On December 18, 2019, the CFTC voted to approve the Proposal.<sup>2</sup> If adopted as final, these new rules—including proposed provisions defining which persons constitute “U.S. persons” and other types of entities in which the agency has a strong regulatory interest—would take a less maximalist and controversial stance than is the case

<sup>1</sup> The Proposal also would seek to address which cross-border swaps must be considered for purposes of the major swap participant (MSP) registration tests. Katten has chosen not to discuss the impact of the Proposal on MSPs—including the proposed registration tests—in this advisory since no MSPs are currently registered with the CFTC. The CFTC also acknowledges this fact in the Proposal. See 85 Fed. Reg. at 958 n.63.

<sup>2</sup> Cross-Border Application of the Registration Thresholds and Certain Requirements Applicable to Swap Dealers and Major Swap Participants, 85 Fed. Reg. 952 (Jan. 8, 2020).

under current law. Indeed, some may view the Proposal to be much more amenable to registrants than the current patchwork of swaps cross-border interpretive guidance, CFTC staff advisories and staff no-action relief.

Voting along party lines, three CFTC commissioners (including Chairman Tarbert) voted in favor of re-writing key elements of the agency's 2013 interpretive guidance and policy statement regarding the cross border reach of the agency's swap regulations (Existing Cross-Border Guidance).<sup>3</sup> If adopted as final, the Proposal would also abandon a controversial CFTC staff policy advisory (Staff Policy Advisory) regarding the application of certain compliance obligations to non-U.S. swap dealers' transactions when those dealers use personnel or agents located in the United States to arrange, negotiate or execute a swap with a non-U.S. person (ANE Transactions).<sup>4</sup> Finally, the Proposal officially withdraws a 2016 CFTC rulemaking proposal covering many of the same topics (the 2016 Proposal).<sup>5</sup>

In short, the Proposal suggests that, unlike his predecessors, Chairman Tarbert is positioning the agency to take a much more measured and territorial approach when regulating cross-border swaps transactions and counterparties. In addition, while the Proposal maintains certain interpretations and principles from the Existing Cross-Border Guidance, in several respects the Proposal seeks to more closely align the CFTC's interpretation of its swaps jurisdiction with the Securities and Exchange Commission's (SEC) interpretation of its jurisdiction over security-based swaps. And in other respects, the Proposal seeks to position the CFTC's cross-border swaps regulatory approach in a way that is even more limited than the SEC's approach.

The Proposal's official public comment period ends on March 9. We expect that in their comment letters several industry observers will commend the CFTC's new more territorial and deferential regulatory approach in terms of the way in which the CFTC seeks to oversee cross-border swap transactions and counterparties.

Other industry observers, on the other hand, will likely criticize certain aspects of the Proposal in their comments, arguing that it creates regulatory loopholes in favor of swap dealers. These commenters most certainly will agree with many of the concerns

## Glossary

**U.S. Person** means, subject to certain specific exclusions, "any person that is: (A) a natural person resident in the United States; (B) a partnership, corporation, trust, investment vehicle, or other legal person organized, incorporated, or established under the laws of the United States or having its principal place of business in the United States; (C) an account (whether discretionary or non-discretionary) of a U.S. person; or (D) an estate of a decedent who was a resident of the United States at the time of death." See Section 1 of this Client Alert for more details.

**Non-U.S. Person** means "any person that is not a U.S. Person."

**Other Non-U.S. Person** means "a non-U.S. person that is neither a Guaranteed Entity nor a significant risk subsidiary."

**U.S. Branch** means "a branch or agency of a non-U.S. banking organization where such branch or agency: (i) is located in the United States; (ii) maintains accounts independently of the home office and other U.S. branches, with the profit or loss accrued at each branch determined as a separate item for each U.S. branch; and (iii) engages in the business of banking and is subject to substantive banking regulation in the state or district where located."

**Foreign Branch** means "any office of a U.S. bank that: (i) is located outside the United States; (ii) operates for valid business reasons; (iii) maintains accounts independently of the home office and of the accounts of other foreign branches, with the profit or loss accrued at each branch determined as a separate item for each foreign branch; and (iv) is engaged in the business of banking and is subject to substantive regulation in banking or financing in the jurisdiction where it is located."

<sup>3</sup> Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45,291 (July 26, 2013).

<sup>4</sup> Applicability of Transaction-Level Requirements to Activity in the United States, Division of Swap Dealer and Intermediary Oversight, CFTC Staff Advisory No. 13-69 (Nov. 14, 2013).

<sup>5</sup> Cross-Border Application of the Registration Thresholds and External Business Conduct Standards Applicable to Swap Dealers and Major Swap Participants, 81 Fed. Reg. 71,946 (Oct. 18, 2016).

expressed by CFTC Commissioners Dan Berkovitz and Rostin Behnam, who both voted against the Proposal and issued scathing statements criticizing it as essentially weakening the CFTC's existing regulatory framework from the risks of cross-border swaps activity.<sup>6</sup>

Chairman Tarbert has publicly stated that he intends to finalize the Proposal by the summer of 2020. The CFTC's issuance of the Proposal, and the Chairman's stated goal, are consistent with our prediction in a September 2019 Katten advisory, "A New Captain at the Helm: The CFTC's 16-Month Regulatory and Enforcement Agenda Under Chairman Tarbert," regarding the CFTC's regulatory agenda under Chairman Heath Tarbert.<sup>7</sup> Furthermore, Chairman Tarbert has publicly committed to advance an ambitious rulemaking agenda, beyond just the Proposal, in the near term, as evidenced by remarks last October to the Futures Industry Association's 35th Annual FIA Expo.<sup>8</sup>

In this advisory, we have summarized the six most significant and noteworthy differences between the Proposal on the one hand and the CFTC's Existing Cross-Border Guidance and Staff Advisory Letter on the other. In particular, this advisory covers the following aspects of the Proposal: (1) the U.S. Person definition and the definitions of other key terms; (2) the CFTC's revised approach towards determining whether collective investment vehicles are U.S. Persons; (3) the narrower treatment of guarantees; (4) differences in SD registration threshold standards; (5) the re-categorization and application of swap requirements (including new standards for substituted compliance determinations); and (6) the handling of ANE Transactions.<sup>9</sup>

## 1. U.S. Person Definition and Other Key Terms

The centerpiece of the proposed rulemaking is the introduction of a formal definition for the term "U.S. Person" that would replace the "interpretation" of that term found in the Existing Cross-Border

**Foreign Counterparty** means "(i) a Non-U.S. Person, except with respect to a swap conducted through a U.S. branch of that non-U.S. person; or (ii) a foreign branch where it enters into a swap in a manner that satisfies the definition of a swap conducted through a foreign branch."

**Foreign-Based Swap** means "(i) a swap by a non-U.S. swap entity, except for a swap conducted through a U.S. branch; or (ii) a swap conducted through a foreign branch."

**Swap Conducted Through a U.S. Branch** means "a swap entered into by a U.S. branch where: (i) the U.S. branch is the office through which the Non-U.S. Person makes and receives payments and deliveries under the swap pursuant to a master netting or similar trading agreement, and the documentation of the swap specifies that the office for the Non-U.S. Person is such U.S. branch; or (ii) the swap is reflected in the local accounts of the U.S. branch."

**Swap Conducted Through a Foreign Branch** means "a swap entered into by a foreign branch where: (i) the foreign branch or another foreign branch is the office through which the U.S. Person makes and receives payments and deliveries under the swap pursuant to a master netting or similar trading agreement, and the documentation of the swap specifies that the office for the U.S. Person is such foreign branch; (ii) the swap is entered into by such foreign branch in its normal course of business; and (iii) the swap is reflected in the local accounts of the foreign branch."

Source: 85 Fed. Reg. at 964 ("Other Non-U.S. Person"), 1002-03 (all other definitions, as included in the proposed amendments to 17 C.F.R. § 23.23).

<sup>6</sup> Comm'r Rostin Behnam, Statement of Dissent Regarding Cross-Border Application of the Registration Thresholds and Certain Requirements Applicable to Swap Dealers and Major Swap Participants (Dec. 18, 2019), <https://www.cftc.gov/PressRoom/SpeechesTestimony/behnamstatement121819>; Comm'r Dan M. Berkovitz, Dissenting Statement Regarding Cross-Border Application of the Registration Thresholds and Certain Requirements Applicable to Swap Dealers and Major Swap Participants (Dec. 18, 2019), <https://www.cftc.gov/PressRoom/SpeechesTestimony/berkovitzstatement121819b>.

<sup>7</sup> Katten Muchin Rosenman LLP, *A New Captain at the Helm: The CFTC's 16-Month Regulatory and Enforcement Agenda Under Chairman Tarbert* 10-11 (Sept. 2019), [https://katten.com/files/675561\\_financial\\_markets\\_and\\_funds\\_-\\_a\\_new\\_captain\\_at\\_the\\_helm\\_sept\\_2019.pdf](https://katten.com/files/675561_financial_markets_and_funds_-_a_new_captain_at_the_helm_sept_2019.pdf).

<sup>8</sup> See Chairman Heath P. Tarbert, CFTC, Remarks to the 35th Annual FIA Expo 2019 (Oct. 30, 2019), <https://www.cftc.gov/PressRoom/SpeechesTestimony/opatarbert2>.

<sup>9</sup> Katten has limited the discussion in this advisory to the most significant changes identified in the Proposal, in its estimation. It should be noted, in particular, that this advisory does not address the discussion in the Proposal around related recordkeeping requirements. See 85 Fed. Reg. at 987.

Guidance. The new definition would eliminate some problematic elements of the interpretation and, most importantly, would be identical to the definition of the same term adopted by the SEC in relation to security-based swaps.<sup>10</sup> The chart below compares the elements of the current interpretation and the proposed definition.<sup>11</sup>

CFTC Interpretation (by prong in the Existing Cross-Border Guidance)	Proposed CFTC Definition (by subsection in new Rule 23.23(a)(22))
(i) Any natural person who is a resident of the United States	(A) A natural person who is a resident of the United States
(ii) Any estate of a decedent who was a resident of the United States at the time of death	(D) An estate of a decedent who was a resident of the United States at the time of death
(iii) 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 (other than an entity described in prongs (iv) or (v), below) (a “legal entity”), in each case that is 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	<p>(B) A partnership, corporation, trust, investment vehicle, or other legal person organized, incorporated, or established under the laws of the United States or having its principal place of business in the United States</p> <p>NOTE: The Proposed Rule provides that:</p> <p>1. “Principal place of business” means the location from which the officers, partners, or managers of the legal person primarily direct, control, and coordinate the activities of the legal person</p> <p>2. With respect to an externally managed investment vehicle, this location is the office from which the manager of the vehicle primarily directs, controls, and coordinates the investment activities of the vehicle</p>
(iv) Any pension plan for the employees, officers or principals of a legal entity	[Not covered separately from subsection (B)]
(v) Any 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	[Not covered separately from subsection (B)]
(vi) Any commodity pool, pooled account, investment fund, or other collective investment vehicle that is not described in prong (iii) and that is majority-owned by one or more persons described in prong (i), (ii), (iii), (iv), or (v), except any commodity pool, pooled account, investment fund, or other collective investment vehicle that is publicly offered only to non-U.S. persons and not offered to U.S. persons	[Not covered separately from subsection (B) (so no U.S. ownership test for commodity pools and investment vehicles)]

<sup>10</sup> See 17 C.F.R. § 3a71-3(a)(4)(i); 85 Fed. Reg. at 959.

<sup>11</sup> Note that, consistent with the SEC’s usage of the same term, the term “U.S. Person” in the Proposal does not include any of the following international organizations: the International Monetary Fund; the International Bank for Reconstruction and Development; the Inter-American Development Bank; the Asian Development Bank; the African Development Bank; the United Nations; any agencies or pension plan of any of the foregoing entities; and any other similar international organization (together with its agencies and pension plans). 85 Fed. Reg. at 961.

CFTC Interpretation (by prong in the Existing Cross-Border Guidance)	Proposed CFTC Definition (by subsection in new Rule 23.23(a)(22))
(vii) Any legal entity (other than a limited liability company, limited liability partnership or similar entity where all of the owners of the entity have limited liability) that is directly or indirectly majority-owned by one or more persons described in prong (i), (ii), (iii), (iv), or (v) and in which such person(s) bears unlimited responsibility for the obligations and liabilities of the legal entity	[Not covered separately from subsection (B) (so no liability test)]
(viii) Any 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 prong (i), (ii), (iii), (iv), (v), (vi), or (vii)	(C) An account (whether discretionary or non-discretionary) of a U.S. person

The Proposal makes another significant change by eliminating the concept of a “Conduit Affiliate” used in the Existing Cross-Border Guidance. Instead, the CFTC is introducing a new category of non-U.S. entity called a “Significant Risk Subsidiary” (SRS) that must be treated like a U.S. Person for regulatory purposes because of the risks it poses to an ultimate and significant U.S. parent entity. The definition of SRS begins with the condition that the entity must have an ultimate U.S. parent that has more than \$50 billion in global consolidated assets, so the scope of the definition is relatively narrow and becomes even narrower when one considers the additional conditions that must be met before an entity falls within its scope. In the CFTC meeting in which the Proposal was approved, Commissioner Berkovitz expressed the opinion that there is no current entity that is an SRS, illustrating his reasoning in a [flow chart](#).<sup>12</sup>

The last noteworthy definitional change in the Proposal is a narrowing of the term “guarantee.” The proposed definition focuses on whether a party to a swap has a legally enforceable right to collect payments from a guarantor as well as from its counterparty, so comfort letters and other informal or indirect arrangements are not covered. The Proposal also clarifies that guarantees from a Non-U.S. Person do not count for U.S. regulatory purposes.

## 2. Collective Investment Vehicles

The Proposal makes certain changes to the U.S. Person definition as it applies to collective investment vehicles, somewhat lessening the potential cross-border reach of the CEA and related CFTC regulations over such entities.

### *Majority-Owned Vehicles*

The Proposal’s amended U.S. Person definition would eliminate the application of such definition to a collective investment vehicle (e.g., a commodity pool, pooled account, investment fund) that is not organized, incorporated, or established under the laws of the United States nor has its principal place of business in the United States but which is majority-owned by persons otherwise generally falling within the U.S. Person definition. Currently, under the Existing Cross-Border Guidance, even if a collective investment vehicle is not organized, incorporated or established under the laws of the United States nor has its principal place of business in the United States, it will nonetheless fall within the U.S. Person definition if it is majority-owned by certain U.S. Persons. Such collective investment vehicles currently, therefore, have to incur significant time and costs in verifying the U.S. Person status of their investors.

<sup>12</sup> Significant Risk Subsidiary Test Flow Chart, <https://katten.com/webfiles/Significant%20Risk%20Subsidiary%20Test%20Flow%20Chart.pdf>. CFTC, Comm’r Dan M. Berkovitz, CFTC to Hold an Open Commission Meeting on December 10, YouTube 1:30:07 (Dec. 19, 2020), <https://www.youtube.com/watch?v=CUy97DkydU>.



The Proposal identifies as its two primary objectives in limiting the Existing Cross-Border Guidance's current scope of the U.S. Person definition are to harmonize the definition with that of the SEC and reduce undue compliance costs for market participants. Amending the U.S. Person definition to eliminate the obligation of a collective investment vehicle to obtain the U.S. Person status of its investors is in-line with those two objectives. Collective investment vehicles not otherwise falling under the U.S. Person definition have found it costly and time consuming to have to look through to determine the U.S. Person status of their investors. Additionally, the Proposal's U.S. Person definition is identical to the SEC's U.S. person definition.<sup>13</sup>

The Proposal notes that requiring collective investment vehicles to assess the U.S. Person status of their investors would be likely to impose additional "programmatic" costs in complying with the applicable U.S. regulatory requirements, especially in the case of fund-of-funds and master-feeder structures, while not significantly increasing "programmatic" benefits. The Proposal observes that the U.S. Person status of any investor should not have a significant impact on the amount of risk a collective investment vehicle poses to the U.S. financial system. The Proposal also notes that while the default of a collective investment vehicle's swap counterparty could significantly harm any underlying U.S. investors, the size of any U.S. Person investor's loss would be limited to the amount of their investment. Additionally, systemic risk would be mitigated by any margin obligations imposed on a collective investment vehicle in a foreign jurisdiction.

#### ***Vehicles Publicly Offered Only to Non-U.S. Persons and Not Offered to U.S. Persons***

The Proposal confirmed that the Existing Cross-Border Guidance's exemption from the U.S. Person definition for collective investment vehicles publicly offered only to non-U.S. persons and not offered to U.S. persons would be maintained.

#### ***Principal Place of Business***

The Proposal's U.S. person definition includes any collective investment vehicle with its "principal place of business" in the United States. The Proposal, as does the Existing Cross-Border Guidance, defines "principal place of business" to be the location from which the manager "primarily directs, controls, and coordinates the investment activities of the vehicle."<sup>14</sup> The Existing Cross-Border Guidance includes an additional prong of the principal place of business definition, extending its reach to the location of the senior personnel responsible for the "formation and promotion of the collective investment vehicle." The Proposal would eliminate this additional prong.<sup>15</sup>

### **3. Redefining Guarantees**

Under the CEA, as amended by the Dodd-Frank Act, additional rules and obligations can apply to counterparties when entering into a swap with a Non-U.S. Person that has a guarantee from a U.S. Person than to a Non-U.S. Person without a U.S. Person guarantee. Moreover, non-U.S. counterparties with a U.S. Person guarantee are required to count all of their dealing swaps towards the SD *de minimis* registration threshold, and Non-U.S. Persons must count all swap dealing activity with a Non-U.S. Person with a U.S. Person guarantee towards their SD *de minimis* registration threshold. The definition of "guarantee," therefore, is critical in determining the cross-border reach of the CEA and related CFTC regulations.

The Proposal narrows the definition of guarantee from the Existing Cross-Border Guidance to be consistent with the definition provided in the SEC's security-based swap rules and the CFTC's rules relating to cross-border margin (Cross-Border Margin Rules).<sup>16</sup> Under the Proposal, the term guarantee would be limited to "an arrangement, pursuant to which one part to a swap has rights of recourse against a guarantor, with respect to its

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<sup>13</sup> See *supra* note 10.

<sup>14</sup> 85 Fed. Reg. at 960.

<sup>15</sup> *Id.*

<sup>16</sup> Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants-Cross-Border Application of the Margin Requirements, 81 Fed. Reg. 34,817 (May 31, 2016).

counterparty's obligations under the swap."<sup>17</sup> A party to a swap would have rights of recourse against a guarantor if it either has a conditional or unconditional legally enforceable right to receive or otherwise collect payments from the guarantor with respect to its counterparty's obligations under the swap. The term guarantee also would include any arrangement pursuant to which the guarantor itself has a conditional or unconditional legally enforceable right to receive or otherwise collect, in whole or in part, payments from any other guarantor with respect to the counterparty's obligations under the swap.

A guarantee does not have to be in writing or included within the swap documentation, provided that the swap counterparty has legally enforceable rights (conditional or unconditional) under the laws of the relevant jurisdiction to collect from the U.S. Person with respect to the Non-U.S. Person's swap obligations. Additionally, the term guarantee includes any arrangement whereby a swap counterparty has the right of recourse against at least one U.S. Person (individually, jointly, and/or severally with others) for the Non-U.S. Person's obligations under the swap. Thus, a non-U.S. entity that has a guarantee from a non-U.S. entity with respect to its swap obligations, which are in turn guaranteed by a U.S. entity, would be deemed to have a guarantee from a U.S. Person. The definition of guarantee is not dependent upon whether the guarantor is an affiliate of the Non-U.S. Person.

The Proposal's changes to the definition of guarantee would no longer extend the definition to other formal arrangements that support the non-U.S. Person's ability to pay or perform its swap obligations, as had been covered under the Existing Cross-Border Guidance. Such arrangements include keepwells and liquidity puts, certain types of indemnity agreements, master trust agreements, and liability or loss transfer or sharing arrangements. In narrowing the scope of the term guarantee, the Proposal notes that it intends both to create a more workable regulatory framework and to align the definition with the one detailed in the Cross-Border Margin Rules, as noted above. Although the Proposal acknowledges that the narrower definition of guarantee could lead to certain Non-U.S. Persons counting fewer swaps towards their SD *de minimis* registration threshold, the Proposal suggests that this risk would be mitigated to the degree such non-U.S. persons fall within the definition of a SRS.

A Non-U.S. Person with a guarantee from a U.S. Person is defined as a "Guaranteed Entity." The Proposal clarifies that a Non-U.S. Person could be a Guaranteed Entity with respect to some counterparties but not with respect to others, depending upon whether its swaps were guaranteed by a U.S. Person.

#### 4. SD Registration Threshold

The Proposal changes some of the current methodology under the Existing Cross-Border Guidance for determining which swaps are counted for a particular counterparty towards its SD *de minimis* registration threshold. Under the CFTC rules, a counterparty will not be required to register with the CFTC as a SD provided that the aggregate gross notional amount of its swaps connected with swap dealing activity when aggregated with the aggregate gross notional amount of the swaps of its affiliates under common control connected with swap dealing activity during the preceding 12 months is below \$8 billion (USD) across all counterparties, or \$25 million (USD) for swaps with pension plans, municipalities or other "Special Entities."<sup>18</sup>

##### **U.S Person**

Under the Proposal, a U.S. Person would count all of its swap dealing swaps with any type of counterparty toward the SD *de minimis* threshold, as is currently the case under the Existing Cross-Border Guidance. A U.S. Person

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<sup>17</sup> 85 Fed. Reg. at 963.

<sup>18</sup> A "Special Entity" is defined to include: "any U.S. Federal agency; a U.S. state, state agency, city, county, municipality, other political subdivision of a State, or any instrumentality, department, or a corporation of or established by a State or political subdivision of a State; any employee benefit plan subject to Title I of the Employee Retirement Income Security Act of 1974 (ERISA); any governmental plan, as defined in Section 3 of ERISA; any endowment, including an endowment that is an organization described in Section 501(c)(3) of the Internal Revenue Code of 1986; or any employee benefit plan defined in Section 3 of ERISA, not otherwise defined as a Special Entity, that elects to be a Special Entity by notifying a swap dealer or major swap participant of its election prior to entering into a swap with the particular swap dealer or major swap participant." 17 C.F.R. § 23.401(c).

must include in its calculation all of the swap dealing swaps of any of its foreign branches, as such branches are part of the same legal person.

### ***Guaranteed Entity or SRS***

A Guaranteed Entity and a SRS also would be required under the Proposal to count all of their swaps dealing swaps (including those of any foreign branch) with any type of counterparty toward the SD *de minimis* threshold, in the same manner in which a U.S. Person would be required to do so.

### ***Other Non-U.S. Persons***

An “Other Non-U.S. Person” would be required under the Proposal to count the following swaps toward its SD *de minimis* threshold: (1) dealing swaps with a U.S. Person, except for swaps conducted through a foreign branch of a registered SD; and (2) dealing swaps with a Guaranteed Entity, except when (a) the Guaranteed Entity is registered as a SD or (b) the Guaranteed Entity’s swaps are subject to a guarantee by a U.S. Person that is a non-financial entity.

An Other Non-U.S. Person, however, would not be required to count toward its SD *de minimis* threshold any swaps it has entered into anonymously on a designated contract market, a registered or exempt swap execution facility, or a registered foreign board of trade which swaps were also cleared through a registered or exempt derivatives clearing organization.

## **5. New Categorization and Application of Swap Requirements**

The Proposal makes significant changes to the cross-border application of swap dealer compliance requirements, including the introduction of a new approach to substituted compliance as well as several new exemptions for qualifying SDs when transacting in “foreign-based swaps.”<sup>19</sup> Notably, however, the Proposal does not address all of the legacy compliance obligations set out in the Existing Cross-Border Guidance; the compliance consequences for SDs with respect to these obligations remains unclear.

### ***New Classification Scheme***

The Existing Cross-Border Guidance established a taxonomy of SD compliance obligations distinguishing between so-called “entity-level” and “transaction-level” requirements. These two sets of requirements were then further sub-divided: entity-level requirements were allocated between “first” and “second” categories,<sup>20</sup> whereas transaction-level requirements were split between “Category A” and “Category B” requirements.<sup>21</sup>

The Proposal reclassifies these compliance obligations into Groups A, B and C. Group A requirements are classified together on the basis that it would be “impractical” to apply these requirements only to specific transactions or counterparty relationships, and it is therefore most appropriate to apply these requirements across an entire enterprise.<sup>22</sup> By contrast, the Proposal indicates that Group B requirements can be applied on a bifurcated basis between U.S. and non-U.S. transactions or counterparty relationships; in particular, that approach would grant the CFTC “greater flexibility” in applying these requirements to non-U.S. swap entities and foreign branches of U.S. swap entities.<sup>23</sup>

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<sup>19</sup> 85 Fed. Reg. at 1002 (§ 23.23(a)(4)).

<sup>20</sup> The “first” category includes capital adequacy, chief compliance officer, risk management, and swap recordkeeping (other than customer complaints and marketing materials). The “second” category includes swap data repository reporting, swap recordkeeping for customer complaints and marketing materials, and large trader reporting. See 78 Fed. Reg. at 45,331.

<sup>21</sup> Category A includes clearing and swap processing, margin and segregation for uncleared swaps, trade execution, swap trading relationship documentation, portfolio reconciliation and compression, real-time public reporting, trade confirmations, and daily trading records. Category B includes external business conduct standards. See 78 Fed. Reg. at 45,333.

<sup>22</sup> 85 Fed. Reg. at 980.

<sup>23</sup> 85 Fed. Reg. at 981.



Finally, the Group C requirements—which are limited to a SD’s external business conduct standards—represent obligations that are directed more towards customer protection, rather than systemic or market protection issues. Consequently, the CFTC intends to defer to the applicable customer protection rules of the local regulatory regime applicable to a non-U.S. SD or the foreign branch of a U.S. SD.

The chart below sets out the Proposal’s reclassification of SD compliance requirements. Note in particular that antitrust issues, which were absent from the Existing Cross-Border Guidance, have been added to the Group A requirements.

CFTC Requirement	Prior Classification	New Classification
Chief Compliance Officer	Entity-Level / First	Group A
Risk Management	Entity-Level / First	Group A
Swap Data Recordkeeping (except marketing / complaints)	Entity-Level / First	Group A
Swap Data Recordkeeping (marketing / complaints)	Entity-Level / Second	Group A
Antitrust	Absent	Group A
STRD	Transaction-Level / A	Group B
Portfolio Reconciliation / Compression	Transaction-Level / A	Group B
Trade Confirmations	Transaction-Level / A	Group B
Daily Trading Records	Transaction-Level / A	Group B
External Business Conduct	Transaction-Level / B	Group C

### ***Substituted Compliance***

The Proposal further develops the current substituted compliance program for those non-U.S. swap entities and foreign branches of U.S. entities that are subject to a comparable regulatory regime in their respective home jurisdictions. The Proposal’s new approach would apply with respect to Group A and Group B requirements only. For Group A requirements, which cannot be effectively applied on a fragmented basis across a single entity, a non-U.S. SD would be allowed to comply solely with its local, comparable regulations without regard to the identity of the counterparty (i.e., both when transacting with U.S. and non-U.S. counterparties). On the other hand, for Group B requirements, which can be applied on a transaction-by-transaction or relationship-specific basis, the Proposal would permit non-U.S. SDs (unless acting through a U.S. branch), as well as U.S. SDs acting through a foreign branch, to comply with applicable comparable local regulations only when transacting with foreign counterparties.<sup>24</sup>

<sup>24</sup> Should an entity rely on substituted compliance with respect to Group A and/or Group B requirements, the Proposal emphasizes that a swap entity would still remain subject to the CFTC’s examination and enforcement authority.

The chart below sets out the Proposal's approach to substituted compliance.

CFTC Requirement	Substituted Compliance		
	Available?	For which swap entities?	For which swaps?
Chief Compliance Officer	Yes	Non-U.S. Swap Entity	All swaps
Risk Management	Yes	Non-U.S. Swap Entity	All swaps
Swap Data Recordkeeping	Yes	Non-U.S. Swap Entity	All swaps
Antitrust	Yes	Non-U.S. Swap Entity	All swaps
Swap Trading Relationship Doc.	Yes	Non-U.S. Swap Entity* / Foreign Branch of U.S. Swap Entity	Non-U.S. swaps only
Portfolio Reconciliation / Compression	Yes	Non-U.S. Swap Entity* / Foreign Branch of U.S. Swap Entity	Non-U.S. swaps only
Trade Confirmations	Yes	Non-U.S. Swap Entity* / Foreign Branch of U.S. Swap Entity	Non-U.S. swaps only
Daily Trading Records	Yes	Non-U.S. Swap Entity* / Foreign Branch of U.S. Swap Entity	Non-U.S. swaps only
External Business Conduct	No	N/A	N/A

\* Unless such Non-U.S. Swap Entity is transacting through a U.S. branch.

The Proposal also contains a more flexible standard of review when making substituted compliance determinations. Specifically, the Proposal would permit the CFTC to consider any factor it deems appropriate when performing its review, with the express intent to take an “even more holistic review” than prior outcomes-based determinations.<sup>25</sup> Among other factors, the Commission would consider: (1) the scope and objectives of the relevant foreign jurisdiction's regulatory standards; (2) whether, despite differences, a foreign jurisdiction's regulatory standards achieve comparable regulatory outcomes to the CFTC's corresponding requirements; (3) the ability of the relevant regulatory authority or authorities to supervise and enforce compliance with the relevant foreign jurisdiction's regulatory standards; and (4) whether the relevant foreign jurisdiction's regulatory authorities have entered into a memorandum of understanding or similar cooperative arrangement with the CFTC regarding the oversight of swap entities.

### ***Proposed Exemptive Relief***

Under the Proposal, the CFTC would not provide any exceptions from Group A requirements. However, the Proposal includes four new exemptions from some or all of the Group B and Group C requirements when transacting in foreign-based swaps. Specifically, exceptions would be provided for: (1) certain exchange-traded and cleared foreign-based swaps; (2) certain foreign-based swaps with foreign counterparties; (3) certain non-U.S. swap entities for certain foreign-based swaps with specified foreign counterparties; and (4) foreign-based swaps of foreign branches of U.S. swap entities with certain foreign counterparties, subject to limitations including a quarterly cap on the total gross notional amount of such swaps.

<sup>25</sup> 85 Fed. Reg. at 986.

The chart below summarizes the material terms of each of these exemptions.

Proposed Exception	Criteria		
	Eligibility	Counterparties	Conditions of Relief
Exchange-Traded Exception (Group B* and Group C)	Non-U.S. Swap Entity / Foreign Branch of U.S. Swap Entity	Any	Trading must be: <ul style="list-style-type: none"> <li>• anonymous</li> <li>• on a DCM, registered or exempt SEF, or registered FBOT</li> <li>• cleared on a registered or exempt DCO</li> </ul>
Foreign Swap Exception (Group C)	Non-U.S. Swap Entity / Foreign Branch of U.S. Swap Entity	Foreign counterparty	Not available for trades with U.S. Persons** or U.S. branches of Non-U.S. Persons
Non-U.S. Swap Entity Exception (Group B)	Non-U.S. Swap Entity that is an Other Non-U.S. Person	Foreign counterparty that is an Other Non-U.S. Person	None stated
Foreign Branch Exception (Group B)	Foreign Branch of U.S. Swap Entity	Foreign counterparty that is an Other Non-U.S. Person	Not available if substituted compliance is available  Capped at 5% total gross notional swaps in a given quarter

\* Except with respect to daily trading records requirements.

\*\* Other than a foreign branch of a U.S. Person where the swap is conducted through such foreign branch.

### Legacy Compliance Obligations

As noted above, the Proposal does not address all of the SD compliance obligations set out in the Existing Cross-Border Guidance. In particular, the Proposal does not address the following: capital adequacy; clearing and swap processing; mandatory trade execution; swap data repository reporting; large trader reporting; margining of uncleared swaps; and real-time public reporting. The Proposal recognizes this disparity and notes its intention to “separately address” the cross-border application of these requirements.<sup>26</sup>

For certain compliance obligations, such as capital adequacy and margining of uncleared swaps, the relevant CFTC rulemakings include detailed provisions on the cross-border application of their provisions.<sup>27</sup> For the other legacy compliance obligations, the practical consequences are less clear, and non-U.S. SDs may encounter challenges in implementing an only partial migration of their compliance framework from the Existing Cross-Border Guidance to the terms of the Proposal.

<sup>26</sup> 85 Fed. Reg. at 979 n.254.

<sup>27</sup> See id. Footnote 254 of the Proposal only mentions the CFTC’s ongoing capital adequacy rulemaking process. Although not expressly stated, in our view, the absence of any reference to margin requirements for uncleared swaps in footnote 254 of the Proposal suggests that the CFTC believes that the relevant cross-border issues have already been addressed in the relevant rulemakings.

The chart below summarizes the treatment of these legacy compliance obligations.

CFTC Requirement	Prior Classification	Treatment Under Existing Guidance	Commentary
Capital Adequacy	Entity-Level / First	Substituted compliance applicable (where available) for trades with U.S. and Non-U.S. Persons	Subject to separate rulemaking proposal, see 84 Fed. Reg. 69664
SDR Reporting	Entity-Level / Second	Substituted compliance applicable (where available) for trades with Non-U.S. Persons*	To be addressed separately
Large Trader Reporting	Entity-Level / Second	No substituted compliance available	To be addressed separately
Margin / Seg for Uncleared Swaps	Transaction-Level / A	N/A	See CFTC Rule 23.160**
Swap Clearing / Processing	Transaction-Level / A	See Exhibit 5 of Prior Katten Client Advisory	To be addressed separately
Mandatory Trade Execution	Transaction-Level / A	See Exhibit 5 of Prior Katten Client Advisory	To be addressed separately
Real-Time Trade Reporting	Transaction-Level / A	See Exhibit 5 of Prior Katten Client Advisory	To be addressed separately

\* The CFTC also requires access to foreign SDR data, which has not occurred in practice.

\*\* See *supra* note 27.

## 6. ANE Transactions

Arguably, the most controversial aspect of the CFTC's interpretation of its cross-border swaps authority is its view that a non-U.S. SD's swap transactions with Non-U.S. Persons are subject to CFTC transactional requirements when the SD's U.S. personnel arrange, negotiate or execute those transactions. Through the Proposal, however, the CFTC seeks to largely abandon its interpretation regarding ANE Transactions for certain swap requirements—and distinguish its regulatory approach with respect to these transactions from the SEC's approach.

As noted above, in November 2013, the CFTC's Division of Swap Dealer and Intermediary Oversight (DSIO) issued the Staff Policy Advisory.<sup>28</sup> Concurrently, with the issuance of the Staff Policy Advisory, DSIO also issued no-action relief that CFTC staff has extended several times (most recently in No-Action Letter No. 17-36), delaying the effect of the Staff Policy Advisory.<sup>29</sup> No-Action Letter No. 17-36 is currently in effect and will remain so pending finalization of further rules or guidance clarifying the scope of CFTC swaps requirements applicable to ANE Transactions.

<sup>28</sup> See *supra* note 5.

<sup>29</sup> The initial no-action relief was extended in CFTC Staff Letter No. 13-71, No-Action Relief: Certain Transaction-Level Requirements for Non-U.S. Swap Dealers (Nov. 26, 2013). In addition to CFTC Letter No. 17-36, CFTC staff extended such relief in CFTC Letter Nos. 14-01, 14-74, 14-140, 15-48, and 16-64.

The CFTC's 2016 Proposal sought to codify the Staff Policy Advisory's interpretation of the application of the CFTC's Dodd-Frank Act transactional requirements to ANE Transactions.<sup>30</sup> In 2018, former CFTC Chairman J. Christopher Giancarlo wrote a white paper suggesting that the CFTC adopt that same interpretation.<sup>31</sup>

If adopted as final, however, the Proposal would supersede the Staff Policy Advisory's interpretation only with respect to those requirements that are covered in the Proposal (i.e., certain business conduct standards).<sup>32</sup> In particular, the Proposal would not apply certain swap transactional requirements to ANE Transactions so long as neither non-U.S. counterparty to the transactions is an SRS or guaranteed by a U.S. Person. As a result, the Proposal would apply those requirements to ANE Transactions in the same manner as other transactions between two non-U.S. counterparties under the Existing Cross-Border Guidance.

Under the Proposal, however, persons engaging in any aspect of swap transactions within the United States would remain subject to the CFTC's anti-fraud and anti-manipulation authority under the CEA and CFTC regulations.<sup>33</sup> With respect to this point, the CFTC reiterated that it still maintains a significant interest in deterring fraudulent or manipulative conduct occurring within the United States notwithstanding where a swap is entered into by two Non-U.S. Persons.<sup>34</sup>

This approach is notably divergent with the SEC's approach with respect to ANE Transactions of security-based swaps.<sup>35</sup> In his statement of support for the Proposal, Chairman Tarbert best explained the reason for the divergence for swaps. Specifically, he noted that "key differences in the markets for swaps and security-based swaps are dispositive. The swap market is far more global than the security-based swaps market. [...] Because security-based swaps can affect the price and liquidity of the underlying security, the SEC has a legitimate interest in requiring these transaction to be reported. By contrast, because commodities are traded throughout the world, there is less need for the CFTC to apply its swaps rules to ANE Transactions."<sup>36</sup>

Interestingly, the Proposal makes clear that it would supersede the Staff Policy Advisory only with respect to those requirements covered in the Proposal.<sup>37</sup> As discussed above, the Proposal does not cover certain other CFTC swaps requirements such as mandatory clearing, mandatory trade execution, and real-time public reporting. Thus, these requirements would remain subject to the Staff Policy Advisory and No-Action Letter No. 17-36 pending further CFTC action. It is unclear how and whether the CFTC will address these other transactional requirements, and these requirements are the ones about which many market participants are most concerned.

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<sup>30</sup> See *supra* note 6.

<sup>31</sup> See J. Christopher Giancarlo, Chairman, CFTC, Cross-Border Swaps Regulation Version 2.0: A Risk-Based Approach with Deference to Comparable Non-U.S. Regulation (White Paper, Oct. 1, 2018).

<sup>32</sup> See *supra* Section 5 for a list of the various requirements covered by the Proposal.

<sup>33</sup> See, e.g., 7 U.S.C. § 9(1); 17 C.F.R. § 180.1.

<sup>34</sup> See 85 Fed. Reg. at 978.

<sup>35</sup> The SEC applies a very expansive approach to regulating ANE Transactions. Not only does it apply certain security-based swap requirements to ANE Transactions (similar to the approach in the Staff Policy Advisory), it also counts ANE Transactions towards applicable security-based swap dealer registration thresholds. See Final Rules, Cross-Border Application of Certain Security-Based Swap Requirements, SEC Release No. 34-87780 (Dec. 18, 2019).

<sup>36</sup> Chairman Heath P. Tarbert, CFTC, Statement in Support of the Cross-Border Swaps Proposal (Dec. 18, 2019), <https://www.cftc.gov/PressRoom/SpeechesTestimony/tarbertstatement121819>.

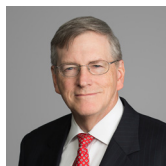
<sup>37</sup> See 85 Fed. Reg. at 958 n.65 ("The treatment of the [CFTC]'s other Title VII Requirements under [No-Action Letter No. 17-36] would not be affected by the finalization of the Proposal.").



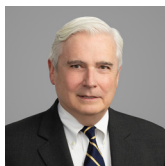
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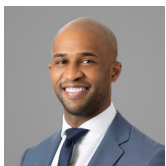
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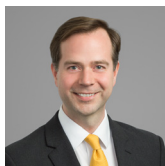
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