

Chapter 9

The Cross-border Impact of the Dodd-Frank Act

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9.1 Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act)² was signed into law on 21 July 2010 as a response to the financial crisis of 2008 and is widely considered to be the most significant change to financial regulation in the US since the Great Depression. It implements changes that, among other things:

- affect the oversight and supervision of financial institutions;

¹ The views expressed in this chapter are the views of the authors and do not necessarily represent the views of Davis Polk & Wardwell LLP. Nothing in this chapter is meant to comprise, or should be construed as, legal advice. This chapter represents developments as of August 2013. This chapter is meant to be an introduction to the topics presented and is not a comprehensive treatment of such topics. The authors thank Davis Polk law clerk Franca Franz, Davis Polk associates Alexander Young-Anglim, Julie V. Kourie and Scott D. Farbish and Davis Polk summer associates Skawennio Barnes, Paul Connell and Nuveen Dhingra for their invaluable assistance. This chapter draws on memoranda by Davis Polk & Wardwell LLP, many of which are available at <http://www.davispolk.com> [Accessed 10 September 2013].

² Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. 111-203, 124 Stat. 1376, 21 July 2010.

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- effect significant changes in the regulation of the over-the-counter derivatives markets;
- provide for a new resolution procedure for large financial companies;
- create a new agency, the Consumer Financial Protection Bureau, responsible for implementing and enforcing compliance with consumer financial laws;
- introduce more stringent regulatory capital requirements;
- reform the regulation of credit rating agencies;
- implement changes to corporate governance and executive compensation practices;
- prohibit banking institutions and their subsidiaries from engaging in proprietary trading or from sponsoring, investing or having certain other relationships with a “hedge fund” or “private equity fund”;
- require registration of advisers to certain private funds; and
- effect significant changes in the securitization market.

While the Dodd-Frank Act is primarily targeted at US financial institutions and US markets, it will have both a direct and indirect impact on financial institutions and markets outside the US. This chapter outlines the direct effects of the Dodd-Frank Act on non-US financial institutions and markets in two areas for which the extraterritorial impact is both most developed and likely most important: the Volcker Rule and the Dodd-Frank Act's new regulation of the over-the-counter derivatives market. We note at the outset, however, that the cross-border application of the provisions of the Dodd-Frank Act and US financial law more generally remain in flux and is developing rapidly.

9.2 The Volcker Rule

The statutory “Volcker Rule”, codified as s.13 of the Bank Holding Company Act of 1956, generally prohibits any “banking entity” from engaging in proprietary trading or from sponsoring, investing in or having certain other relationships

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with a “hedge fund” or “private equity fund”.³ The Volcker Rule requires five US federal agencies—the Commodity Futures Trading Commission (the CFTC), the Federal Deposit Insurance Corporation (the FDIC), the Board of Governors of the Federal Reserve System (the Federal Reserve), the Office of the Comptroller of the Currency (the OCC) and the Securities and Exchange Commission (the SEC) (collectively, the Volcker Agencies)—to adopt implementing regulations. To date, the Volcker Agencies have proposed implementing regulations but have not finalized them.

The statutory Volcker Rule became effective on 21 July 2012, but compliance with the rule is subject to a “conformance period” that is currently scheduled to last until at least 21 July 2014, subject to the possibility of extension upon application. During this period, market participants must conform their activities with the statutory Volcker Rule and its implementing regulations.⁴

9.2.1 The statutory Volcker Rule

9.2.1.1 Application to “banking entities”

The statutory Volcker Rule applies to any “banking entity.” For this purpose, a “banking entity” is defined as:

“any insured depository institution (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)), any

³ Dodd-Frank Act s.619 (codified as Bank Holding Company Act s.13, 12 USC s.1851) (hereinafter Volcker Rule). The Volcker Rule also requires systemically important nonbank financial companies to carry additional capital and comply with certain other quantitative limits on such activities to the extent required by the Volcker Agencies, at s.13(a).

⁴ See Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities, 76 Fed. Reg. 8265 (14 February 2011). On 19 April 2012, the Federal Reserve issued a policy statement clarifying the obligations of a banking entity during this conformance period. In general, this policy statement requires market participants to make good-faith efforts towards compliance with the Volcker Rule during the conformance period. See Statement of Policy Regarding the Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities, 77 Fed. Reg. 33,949 (8 June 2012).

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company that controls an insured depository institution, or that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of any such entity.”⁵

As a result, subsidiaries and affiliates of US banks or foreign banks with US branches, agencies or certain commercial lending subsidiaries are subject to the Volcker Rule and its implementing regulations.

9.2.1.2 The restriction on “proprietary trading” and the permitted activities

The statutory Volcker Rule prohibits banking entities from engaging in “proprietary trading,” unless pursuant to a “permitted activity.”

The statutory Volcker Rule defines “proprietary trading” as:

“engaging as a principal for the *trading account* of the banking entity . . . in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument [determined by the Volcker Agencies]”,⁶

and defines a “trading account” as:

“any account used for acquiring or taking positions in the securities and instruments described in [the definition of proprietary trading] principally for the purpose of selling in the near term (or otherwise with the intent to resell in

⁵ Volcker Rule at s.13(h)(1). Certain banks that function solely in a trust or fiduciary capacity are excluded from the statutory definition. Volcker Rule at s.13(h)(1)(A)–(D).

⁶ Volcker Rule at s.13(d)(1)(H)(4) (emphasis added).

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order to profit from short-term price movements), and any such other accounts as [determined by the Volcker Agencies]”.⁷

Notwithstanding that a particular activity may be deemed to be “proprietary trading”, the statutory Volcker Rule permits a banking entity to engage in such activity if pursuant to one of the enumerated “permitted activities”. These include:

- market-making-related activities;
- underwriting activities;
- risk-mitigating hedging activities;
- trading in specified government obligations⁸;
- trading on behalf of customers;
- trading by a regulated insurance company; and
- trading “solely outside the United States”.⁹

Even where a “permitted activity” is used, however, a banking entity is not permitted to engage in proprietary trading if the transaction or activity:

- would involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties;
- would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies;
- would pose a threat to the safety and soundness of the banking entity; or
- would pose a threat to the financial stability of the US.¹⁰

⁷ Volcker Rule at s.13(h)(6).

⁸ This refers to US government obligations and does not include foreign government obligations.

⁹ Volcker Rule at s.13(d)(1)(H).

¹⁰ Volcker Rule at s.13(d)(2)(A)(i-iv).

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9.2.1.3 *The restriction on investing in or sponsoring covered funds and the permitted activities*

The Volcker Rule also prohibits a banking entity from acquiring or retaining “as principal” any equity, partnership or other “ownership interest” in, or “sponsoring”, any hedge fund or private equity fund (a covered fund), unless pursuant to a “permitted activity”.

A “covered fund” is defined in the statute as any issuer that would be an investment company under the Investment Company Act of 1940 (the ICA) but for the exceptions listed in s.3(c)(1) or s.3(c)(7)¹¹ of that Act, or such similar funds as the Volcker Agencies may, by rule, determine.¹² It remains unclear to what extent the Volcker Rule restrictions extend to non-US funds that serve similar purposes, such as Undertakings for Collective Investment in Transferable Securities (UCITS) funds.¹³

“Sponsoring” is defined as any of the following actions: serving as a general partner, managing member, or trustee of a fund; in any manner selecting or controlling, or having

¹¹ Section 3(c)(1) of the Investment Company Act provides an exclusion from the definition of “investment company” for any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than 100 persons and which is not making and does not currently propose to make a public offering of its securities. Section 3(c)(7) of the Investment Company Act provides an exclusion for any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities.

¹² Volcker Rule at s.13(h)(2). The proposed implementing regulations expanded this definition to include commodity pools, or any foreign fund that would be a covered fund if organized and offered in the US (e.g. a foreign fund that would typically rely on s.3(c)(1) or s.3(c)(7) or be a commodity pool).

¹³ Foreign banking organizations (FBOs) and others that have commented on the Volcker Rule proposed implementing regulations, discussed *infra*, have identified European investment funds, such as UCITS funds, as vehicles potentially subject to the Volcker Rule—even though economically similar US vehicles may not be subject. Many of these non-US funds have an active public market and are listed on various exchanges, such as the Dublin or Luxembourg Stock Exchange, and therefore have many of the substantive characteristics of US public open-end or closed-end investment funds that are not covered by the Volcker Rule. However, in order to be offered and sold in the US, they would have to rely on an ICA exemption.

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employees, officers, directors or agents who constitute, a majority of the directors, trustees or management of a fund; or sharing with a fund, for corporate, marketing, promotional, or other purposes, the same name or a variant of the same name.

The statute permits a banking entity to sponsor or acquire or retain an ownership interest in a “covered fund” if pursuant to one of the “permitted activities”. These include:

- asset management, including a three per cent permitted co-investment;
- market-making-related activities;
- underwriting activities;
- risk-mitigating hedging activities;
- regulated insurance company investments; and
- sponsoring or acquiring or retaining an ownership interest “solely outside the United States”.¹⁴

The Volcker Rule also prohibits a banking entity from entering into certain “covered transactions”, as defined in s.23A of the Federal Reserve Act, with “covered funds” sponsored or advised by the banking entity or its affiliates, a prohibition often referred to as “Super 23A”. Specifically, no banking entity or its affiliate that serves, directly or indirectly, as the investment adviser, investment manager or sponsor to a covered fund, or that organizes and offers a covered fund pursuant to the asset management exception, may enter into a transaction with the covered fund, or any other covered fund controlled by such covered fund, that would be a “covered transaction”.

“Covered transactions” include loans or other extensions of credit to the covered fund; purchases of or an investment in securities issued by the covered fund other than ownership interests pursuant to a permitted activity; purchases of assets, including assets subject to a repurchase agreement, from a

¹⁴ Volcker Rule at s.13(d). The proposed implementing regulations proposed several additional permitted activities and declined to extend certain statutory permitted activities—such as market-making and underwriting—to the funds portion of the Volcker Rule. The ultimate scope of the permitted funds activities will not be known until final implementing regulations are issued.

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covered fund, except certain real estate assets; acceptance of securities issued by the covered fund as collateral security for a loan or extension of credit to any person or company; issuances of guarantees, acceptances or letters of credit, including an endorsement or standby letter of credit, on behalf of the covered fund; any credit exposure to the covered fund arising from a derivative transaction, repurchase agreement, reverse repurchase agreement, securities lending transaction or securities borrowing transaction with the covered fund.

9.2.1.4 The cross-border reach of the statutory Volcker Rule

As noted above, the statutory Volcker Rule applies to any “banking entity”, regardless of whether that banking entity is established or incorporated in the US. Despite this worldwide reach, the statutory Volcker Rule includes language, in both the proprietary trading section and the funds section, that permits banking entities to engage in otherwise prohibited activities without, or with substantially reduced, restriction if conducted “solely outside the United States.” Specifically, s.13(d) of the Bank Holding Company Act, which enumerates the Volcker Rule permitted activities, states:

- “(d) PERMITTED ACTIVITIES— (1) IN GENERAL. . . . to the extent permitted by any other provision of Federal or State law, and subject to . . . any restrictions or limitations that the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission, may determine, the following activities . . . are permitted. . . .
- (H) Proprietary trading conducted by a banking entity . . . provided that the trading occurs solely outside of the United States and that the banking entity is not directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States. . . .
- (I) The acquisition or retention of any equity, partnership, or other ownership interest in, or the sponsorship of, a hedge fund or a private equity fund by a

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banking entity . . . solely outside of the United States, provided that no ownership interest in such hedge fund or private equity fund is offered for sale or sold to a resident of the United States and that the banking entity is not directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States".¹⁵

9.2.2 *The Volcker Rule Proposed Implementing Regulations*

Section 13(b)(2) of the statutory Volcker Rule tasks the Volcker Agencies with adopting rules to implement the statutory Volcker Rule.¹⁶ On 11 October 2011, the federal banking agencies (the OCC, the Federal Reserve and the FDIC) and the SEC proposed such implementing regulations (the Volcker Proposal).¹⁷ The CFTC did not join the Volcker Proposal at that time but issued a substantively similar proposal on 11 January 2012.¹⁸ The Volcker Proposal, among other things:

- further defines the covered financial positions to which the proprietary trading prohibition applies;
- outlines three tests for what constitutes a trading account for purposes of the proprietary trading prohibition;
- defines "covered fund";

¹⁵ Volcker Rule at s.13(d).

¹⁶ Section 13(b) of the statutory Volcker Rule required two additional relevant actions. Section 13(b)(1) of the Bank Holding Company Act directed the Financial Stability Oversight Council (the FSOC), newly created by the Dodd-Frank Act, to conduct a study and issue recommendations on implementation of the Volcker Rule's provisions by 21 January 2011. The FSOC published its study on 18 January 2011. See Financial Stability Oversight Council, Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds (January 2011). Section 13(b) of the Bank Holding Company Act also directed the Federal Reserve to adopt rules regarding the Volcker Rule conformance period. The Federal Reserve adopted these rules on 9 February 2011, and issued an additional policy statement on conformance period on 8 June 2012. See Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities, 76 Fed. Reg. 8265 (14 February 2011); Statement of Policy Regarding the Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities, 77 Fed. Reg. 33,949 (8 June 2012).

¹⁷ 76 Fed. Reg. 68,846 (7 November 2011) (hereinafter Volcker Rule Proposed Regulations).

¹⁸ 77 Fed. Reg. 8332 (14 February 2012).

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- establishes detailed requirements for each of the permitted activities;
- enumerates a set of quantitative metrics that banking entities must report to regulators with respect to trading activity; and
- creates compliance obligations.

As of the date of this chapter, the Volcker Agencies have not adopted final implementing regulations.

9.2.2.1 The proposed "solely outside the United States" permitted activity

The Volcker Proposal establishes detailed requirements for each of the permitted activities, including the "solely outside the United States" permitted activities. In doing so, the Volcker Proposal provides significant insight into the impact of the Volcker Rule on non-US institutions.

Under the Volcker Proposal, in order to rely on the "solely outside the United States" permitted activity for both the proprietary trading and covered funds provisions of the Volcker Rule, a banking entity must satisfy requirements related to both the banking entity itself and to the specific transaction or investment in question. With respect to the banking entity, the "solely outside the United States" permitted activity is available only if:

- the banking entity is not itself, and is not directly or indirectly controlled by an entity that is, organized under US law;
- where the banking entity is an FBO, it is conducting the activity in compliance with subpart B of the Federal Reserve's Regulation K; and
- where the banking entity is not an FBO, it meets at least two of the following tests:
 - total assets held outside the US exceed total assets held inside the US;

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- total revenues derived from business outside the US exceed total revenues derived from business in the US; and
- total net income derived from business outside the US exceeds total net income derived from business in the US.¹⁹

With respect to the specific transaction or investment, the “solely outside the United States” permitted activity is only available if:

- no party to the transaction is a “resident of the United States”;
- no personnel or affiliate of the banking entity involved in the activity—other than those engaged in purely administrative, clerical or ministerial functions²⁰—are physically located or incorporated in the US; and
- the purchase or sale is executed wholly outside of the US.²¹

For this purpose, the Volcker Proposal defines a “resident of the United States” as:

- any natural person resident in the US;
- any partnership, corporation or other business entity organized or incorporated under the laws of the US or any State;
- any estate of which any executor or administrator is a resident of the US;
- any trust of which any trustee, beneficiary or, if the trust is revocable, any settlor is a resident of the US;
- any agency or branch of a foreign entity located in the US;
- any discretionary or nondiscretionary account or similar account (other than an estate or trust) held by a dealer or fiduciary for the benefit or account of a resident of the US;

¹⁹ Volcker Rule Proposed Regulations at 68,949, s.6(d)(1)–(2); 68,953–68,954, s.13(c)(1)–(2).

²⁰ Volcker Rule Proposed Regulations at 68,881 n.182.

²¹ Volcker Rule Proposed Regulations at 68,949, s.6(d)(3); 68,954, s.13(c)(3).

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- any discretionary account or similar account (other than an estate or trust) held by a dealer or fiduciary organized or incorporated in the US, or (if an individual) a resident of the US; and
- any person organized or incorporated under the laws of any foreign jurisdiction formed by or for a resident of the US principally for the purpose of engaging in one or more transactions described in the “solely outside the United States” permitted activity.²²

This definition of “resident of the US” is similar to in many ways to the definition of “US person” under the SEC’s Regulation S,²³ but it is more expansive in that it includes discretionary accounts held for a US person by a non-US dealer or fiduciary and omits certain exclusions in Regulation S, including for offshore branches and agencies of US entities and discretionary accounts held for the benefit of a non-US person by a US person or fiduciary.

9.3 Title VII: swaps regulation

9.3.1 Basic introduction to Dodd-Frank’s regulation of swaps and security-based swaps

In response to the lack of regulatory oversight over the over-the-counter derivatives, or “swaps”, markets and to a general perception that these markets contributed to the spread of the 2008 financial crisis, Congress adopted Title VII of the Dodd-Frank Act. Among other provisions, Title VII:

- defines the term “swap”,²⁴ which includes (but is not limited to) interest rate swaps, currency swaps, energy and metal swaps, agricultural swaps, commodity swaps, foreign exchange options, nondeliverable foreign exchange forwards, nondeliverable foreign exchange swaps,²⁵ swaps

²² Volcker Rule Proposed Regulations at 68,945, s.2(t).

²³ 17 C.F.R. ss.230.901–230.905

²⁴ Commodity Exchange Act (CEA) s.1a(47).

²⁵ As permitted under the Dodd-Frank Act, the Treasury Department issued a final

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- on US government securities, swaps on multiple loans and swaps on broad-based indices of securities, and subjects these instruments to primary oversight by the CFTC²⁶;
- defines the term “security-based swap”,²⁷ which includes swap instruments that are based on a single security or loan (excluding US Treasuries and other government securities), a narrow-based security index or the occurrence, nonoccurrence or extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index, provided that such event directly affects the financial statements, financial condition or financial obligations of the issuer, and subjects these instruments to primary oversight by the SEC;
 - defines the term “mixed swap”,²⁸ which include security-based swaps that also have attributes of swaps, and subjects those instruments to the joint jurisdiction of both the CFTC and the SEC;
 - prohibits swap, security-based swap and mixed swap transactions with non-“eligible contract participants” other than on an exchange;
 - defines a class of “swap dealers” and “security-based swap dealers” (SBSDs) based on the type and scope of an institution’s activities and requires swap dealers to register with the CFTC and SBSBs to register with the SEC;

determination providing that certain deliverable foreign exchange forwards and deliverable foreign exchange swaps should not be regulated as swaps under the CEA for most purposes, including registration, mandatory clearing and trade execution and margin. See Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 77 Fed. Reg. 69,694 (20 November 2012). Such instruments are, however, subject to certain requirements including swap data repository trade reporting, external business conduct, swap documentation, portfolio reconciliation and portfolio compression rules. The Treasury Department’s determination does not extend to other foreign exchange derivatives, including nondeliverable forwards.

²⁶ There are a number of significant exceptions to the definition of “swap”, “security-based swap” and “mixed swaps,” including for futures transactions and options on securities. See Further Definition of “Swap”, “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48,208 (13 August 2012).

²⁷ See Exchange Act s.3(a)(10).

²⁸ See CEA s.1a(47)(D).

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- defines a class of “major swap participants” (MSPs) and “major security-based swap participants” (MSBSPs) that are not swap dealers or SBSDs, respectively, but that pose, through their swap or security-based swap activities, substantial risk to the US financial system;
- subjects swap dealers, SBSDs, MSPs and MSBSPs to a comprehensive regulatory regime that includes capital, margin, collateral segregation, risk management, conflict of interest, external business conduct, swap trading relationship documentation, portfolio reconciliation, portfolio compression and other requirements;
- mandates reporting of information about executed swaps, security-based swaps and mixed swaps to registered swap data repositories and the public dissemination of certain anonymised data by those swap data repositories in “real time”;
- requires the central clearing of standardized swaps, security-based swaps and mixed swaps, with limited exceptions; and
- requires exchange or exchange-like trading of certain swaps, security-based swaps and mixed swaps subject to the clearing requirement.

As with the Dodd-Frank Act more generally, the statutory text provides an outline of the desired regime but leaves the details to regulatory rulemaking.

9.3.2 *Statutory territorial scope of Title VII*

The Dodd-Frank Act includes two provisions that define the territorial scope of the swap and security-based swap provisions of Title VII.

Section 722 of the Dodd-Frank Act defines the territorial scope of the provisions of the Dodd-Frank Act added to the Commodity Exchange Act, the statute that governs the CFTC. Section 722 provides that:

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“The provisions of this Act relating 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 connection with activities in, or effect on, commerce of the United States; or
- (2) contravene such rules and 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”.²⁹

Section 772 of the Dodd-Frank Act defines the territorial scope of the provisions of the Dodd-Frank Act added to the Securities Exchange Act of 1934, one of the statutes that governs the SEC. Section 772 provides that:

“No provision of this title that was added by the Wall Street Transparency and Accountability Act of 2010, or any rule or regulation thereunder, shall apply to any person insofar as such person transacts a business in security-based swaps without the jurisdiction of the United States, unless such person transacts such business in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate to prevent the evasion of any provision of this title that was added by the Wall Street Transparency and Accountability Act of 2010. This subsection shall not be construed to limit the jurisdiction of the [SEC] under any provision of this title, as in effect prior to the date of enactment of the Wall Street Transparency and Accountability Act of 2010”.³⁰

As a result of these statutory provisions, it is clear that the US swap and security-based swap regulatory regimes apply to any relevant transaction between US persons and generally does not apply to a swap or security-based swap between two

²⁹ Dodd-Frank Act s.722(d)(i).

³⁰ Dodd-Frank Act s.772(c).

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non-US persons that has no nexus to the US. The applicability of these regulations to situations that fall between these two extremes is unsettled and less clear. This “cross-border” or “extraterritoriality” issue is the subject of substantial debate as well as releases by the CFTC and SEC, as described in the following sections.

9.3.3 Basic CFTC and SEC Cross-Border Approaches

In light of the ambiguity created by the statutory cross-border provisions, both the CFTC and SEC have undertaken to provide market participants with additional clarity regarding the cross-border impact of the Title VII regulatory scheme. On 12 July 2013, the CFTC adopted final guidance regarding the cross-border application of its swap regulatory regime (the CFTC Guidance).³¹ On 1 May 2013, the SEC proposed rules governing the application of Title VII's security-based swap provisions to cross-border activities in security-based swaps (the SEC Proposal).³² To date, the SEC Proposal has not been finalised.

At a high level, both the CFTC Guidance and the SEC Proposal:

- classify swap counterparties, including as “US persons”, as described in Section 9.3.4 below;

³¹ Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45,292 (26 July 2013) (hereinafter CFTC Guidance). At the same time, the CFTC adopted a phase-in compliance schedule. Exemptive Order Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 43,785 (22 July 2013) (hereinafter Exemptive Order). The Exemptive Order extends, with material changes, the cross-border exemptive order issued by the CFTC in January 2013. Final Exemptive Order Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 858 (7 January 2013). In some cases, the Exemptive Order extends the phase-in period for compliance as late as 22 December 2013. This chapter does not discuss the timing of applicability of requirements in the Exemptive Order; as a result, some of the requirements discussed herein may not apply until at least 22 December 2013.

³² Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, 78 Fed. Reg. 30,968 (23 March 2013) (hereinafter SEC Proposal).

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- provide for “substituted compliance” with local regulation where the relevant regulator deems such local regulation to be comparable, as described in Section 9.3.5 below;
- address the methodology through which a non-US person must determine whether it must register as a swap dealer, SBSB, MSP or MSBSP, as described in Section 9.3.6 below; and
- apply regulatory requirements to market participants based on their classification, as described in Section 9.3.7 below.

The CFTC’s and SEC’s cross-border approaches are similar in a number of important ways. Both rely heavily on the classification of market participants as “US persons”. Both generally apply all Title VII requirements to transactions involving “US persons” and provide special treatment to non-U.S. branches of US persons registered as swap dealers, SBSBs, MSPs and MSBSPs. Both provide for substituted compliance in limited circumstances where the relevant regulator has deemed local rules comparable to their own.

However, there are a number of significant differences between the two approaches. For example, while both the CFTC Guidance and the SEC Proposal look to the status of counterparties in determining the application of Title VII requirements, the SEC Proposal would also apply security-based swap regulatory requirements to any “transaction conducted within the United States”, as described in Section 9.3.4.2.3 below. This fundamental difference results in a number of distinctions between the CFTC’s and SEC’s approaches, including the significantly broader and more complex “US person” definition adopted by the CFTC. As another example, the CFTC Guidance and the SEC Proposal differ significantly in the relevance of guarantees of a non-US person’s obligation by a US person, with the CFTC applying many rules if such a guarantee is present and the SEC finding the guarantee relevant for fewer purposes.

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9.3.4 Counterparty classification

Both the CFTC Guidance and the SEC Proposal apply Title VII requirements based, in large part, on the classification of counterparties to transactions, including whether one or both of the counterparties are "US persons". This section describes the counterparty classifications used by both agencies in their cross-border application.

9.3.4.1 CFTC approach

9.3.4.1.1 US person

The CFTC Guidance defines a "US person" generally to include, but not be limited to:

- i. any natural person who is a resident of the US;
- ii. any estate of a decedent who was a resident of the US 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 US or having its principal place of business in the US³³;
- iv. any pension plan for the employees, officers or principals of a legal entity described in prong (iii), unless the pension plan is primarily for foreign employees of such entity;

³³ The CFTC provided extensive guidance on how to determine a business's "principal place of business." Relying on the Supreme Court's 2010 decision in *Hertz Corp v Friend* No.08-1107, the CFTC suggested that the principal place of business "should normally be where the corporation maintains its headquarters—provided that the headquarters is the actual center of direction, control and coordination, i.e. the 'nerve center,' and not simply an office where the corporation holds its board meetings". See CFTC Guidance at 45,309 (citing *Hertz*, No.08-1107).

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- v. any trust governed by the laws of a state or other jurisdiction in the US, if a court within the US is able to exercise primary supervision over the administration of the trust;
- vi. any commodity pool, pooled account, investment fund or other collective investment vehicle³⁴ 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-US persons and not offered to US persons³⁵;
- 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; and
- 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).³⁶

The CFTC Guidance explicitly states that the prongs of the US person definition are not exhaustive. A market participant that is not captured by one of the above prongs is required to look to relevant facts and circumstances in determining whether it is a “US person” which include:

- the strength of the connections between the person’s swap-related activities and US commerce;
- the extent to which such activities are conducted in the US;
- the importance to the US (as compared to other jurisdictions where the person may be active) of regulating the person’s swap-related activities;

³⁴ See CEA s.1(a)(10) (providing a new definition of “collective investment vehicle”).

³⁵ See CFTC Guidance at 45,313–45,314.

³⁶ CFTC Guidance at 45,316–45,317.

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- the likelihood that including the person within the interpretation of "US person" could lead to regulatory conflicts; and
- considerations of international comity.³⁷

Prong (iii) of the US person definition provides that any corporation, partnership, limited liability company, fund or similar form of enterprise (other than a pension plan or a trust) is a US person if it is organized or incorporated under the laws of the US *or* if it has its principal place of business in the US. For legal entities other than funds, the CFTC states that it would normally consider an entity's principal place of business to be the place where the entity maintains its headquarters, provided that the headquarters is the actual centre of direction, control and coordination. The CFTC generally will consider the principal place of business of a collective investment vehicle to be in the US if the senior personnel responsible for either: (1) the formation and promotion of the vehicle; or (2) the implementation of the vehicle's investment strategy are located in the US, depending on the facts and circumstances that are relevant to determining the centre of direction, control and coordination of the vehicle.³⁸

Prong (vi) of the US person definition includes as a US person a fund or other collective investment vehicle that is majority-owned by one or more US persons. The CFTC Guidance states that, generally, funds would not need to look through to their *indirect* owners, except that a fund would need to look through to the beneficial owners of any other legal entity invested in the fund that is controlled by or under common control with the fund.³⁹ For example, a master fund would need to look to the US person status of the investors in its feeder funds, where the master and feeder funds are under common control. The Final Guidance contains an exemption from the US person definition

³⁷ CFTC Guidance at 45,316. The CFTC also states that it is helpful to consider how the person (and in particular its swap activities) is currently regulated and whether such regulation encompasses the person's swap activities as they related to US commerce.

³⁸ See CFTC Guidance at 45,309–45,312.

³⁹ See CFTC Guidance at 45,312–45,315.

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for funds and other collective investment vehicles that are publicly offered only to non-US persons and not offered to US persons.⁴⁰

A branch or agency of an entity is deemed to have the same US person status as the entity itself. Foreign affiliates and subsidiaries of US persons are not, by virtue of that fact alone, US persons.

9.3.4.1.2 Foreign branches of US swap dealers and MSPs

Under the CFTC Guidance, in general, a non-US branch of a US person is considered to be part of the US person, and a US branch of a non-US person is considered to be part of the non-US person. However, as described in greater detail below, the CFTC Guidance provides special treatment in certain cases for swap transactions involving non-US branches of US swap dealers or MSPs that meet specified criteria (Non-US Branches). In order to qualify as a Non-US Branch for this purpose, a branch of a registered swap dealer must:

- be a “foreign branch”, as defined in the applicable banking regulation, of a US bank that is subject to Regulation K or the FDIC International Banking Regulation;
- maintain 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
- be subject to substantive regulation in banking or financing in the jurisdiction where it is located.⁴¹

The CFTC will also consider other relevant facts and circumstances in determining whether a non-US branch of a US swap dealer or MSP should be classified as a Non-US Branch for these purposes.

⁴⁰ See CFTC Guidance at 45,314.

⁴¹ See CFTC Guidance at 45,328–45,329.

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In addition, in order for a specific swap to be deemed to be “with” such a Non-US Branch, the CFTC will consider factors including whether:

- the employees negotiating and agreeing to the terms of the swap (or, if the swap is executed electronically, managing the execution of the swap), other than employees with functions that are solely clerical or ministerial, are located in such branch or in another non-US branch of the US bank;
- the branch or another non-US branch is the office through which the US bank makes and receives payments and deliveries under the swap on behalf of the branch pursuant to a master netting or similar trading agreement, and the documentation of the swap specifies that the office for the US bank is such branch;
- the swap is entered into by such branch in its normal course of business;
- the swap is treated as a swap of the branch for tax purposes; and
- the swap is reflected in the local accounts of the branch.⁴²

According to the CFTC Guidance, the booking location of the swap is not the determinative factor in the analysis of whether a transaction is with a Non-US Branch. However, if material terms of the swap are negotiated or agreed to by employees of the US bank located in the US, the swap should be considered to be with the US bank rather than a Non-US Branch.

9.3.4.1.3 US branches of non-US swap dealers and MSPs

Under the CFTC Guidance, for most purposes, a US branch of a non-US swap dealer or MSP is considered to be part of the non-US swap dealer or MSP. However, fn.513 of the CFTC Guidance states that “the Commission takes the view that a US branch of a non-US swap dealer or MSP would be subject to Transaction-Level requirements, without substituted compliance available”.⁴³ The precise meaning of this footnote in light

⁴² See CFTC Guidance at 45,329–45,331.

⁴³ CFTC Guidance at 45,350 n.513.

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of other statements in the CFTC Guidance is the subject of continuing debate and analysis.

9.3.4.1.4 Guaranteed and conduit affiliates

The CFTC Guidance divides non-US persons into “guaranteed affiliates,” “conduit affiliates” and non-US persons that are neither guaranteed affiliates nor conduit affiliates. The application of certain swap regulatory requirements differs depending on this categorization.

Under the CFTC Guidance, a “guaranteed affiliate” is a non-US person that is an affiliate of a US person and that is guaranteed by a US person.⁴⁴ For this purpose, the CFTC interprets the term “guarantee” broadly to include both traditional guarantees and other formal arrangements that support the non-US person’s ability to perform its swap obligations.⁴⁵

The CFTC Guidance does not provide a definition of “conduit affiliate” but, instead, includes factors the CFTC considers relevant in determining whether a non-US person is a conduit affiliate. These factors include whether:

- the non-US person is a majority-owned affiliate of a US person;
- the non-US person is controlling, controlled by or under common control with the US person;
- the financial results of the non-US person are included in the consolidated financial statements of the US person; and
- 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.⁴⁶

⁴⁴ CFTC Guidance at 45,318.

⁴⁵ See, e.g., CFTC Guidance at 45,320 n.267.

⁴⁶ CFTC Guidance at 45,458–45,459.

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Swap dealers and their affiliates generally will not be deemed to be conduit affiliates.

9.3.4.2 *SEC approach*

9.3.4.2.1 US person

The SEC Proposal would define a “US person” to include:

- any natural person resident in the US;
- any partnership, corporation, trust or other legal person organized or incorporated under the laws of the US or having its principal place of business in the US; or
- any account (whether discretionary or nondiscretionary) of a US person.⁴⁷

The “US person” definition includes a foreign branch, agency or office of a US person, but it excludes foreign central banks and international multilateral organizations such as the World Bank Group, the International Monetary Fund, the United Nations and similar organizations or their agencies and pension plans.⁴⁸

9.3.4.2.2 Foreign Branch

Like the CFTC Guidance, the SEC Proposal would provide differential treatment to non-US branches of US banks meeting certain criteria (a Foreign Branch). A non-US branch of a US bank is considered to be a Foreign Branch for these purposes if the branch:

- is located outside the US;
- operates for valid business reasons; and

⁴⁷ SEC Proposal at 31,207 (proposed Exchange Act Rule 3a71-3(a)(7)).

⁴⁸ Both the CFTC and SEC provide special treatment, in certain circumstances, to foreign central banks and international multilateral organizations. Such treatment is beyond the scope of this chapter.

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- is engaged in the business of banking and is subject to substantive banking regulation in the jurisdiction where located.⁴⁹

A transaction would be considered to be conducted through such a Foreign Branch if the Foreign Branch is a counterparty to the security-based swap and the security-based swap is not solicited, negotiated or executed by a person within the US on behalf of the Foreign Branch or its counterparty.⁵⁰

9.3.4.2.3 Transactions “conducted within the United States”

As noted above, the SEC considers whether a transaction is “conducted within the United States”, in addition to the classification of the counterparty, in determining the application of Title VII security-based swap requirements. For this purpose, a “transaction conducted within the US” would include any security-based swap that is solicited, negotiated, executed or booked within the US by or on behalf of either counterparty to the transaction.⁵¹ Clearing, reporting or engaging in collateral management for a security-based swap within the US would not cause a transaction to be considered to be “conducted within the US”.⁵² A security-based swap transaction conducted through a Foreign Branch of a US bank would not be considered a transaction conducted within the US solely by virtue of being conducted through such a Foreign Branch.

9.3.5 *Substituted compliance*

9.3.5.1 *CFTC approach*

In recognition of the international nature of the swaps markets and the fact that jurisdictions worldwide have initiated the process of reforming the swaps markets, the CFTC Guidance contemplates a system of “substituted compliance” with local

⁴⁹ SEC Proposal at 31,206 (proposed Exchange Act Rule 3a71-3(a)(1)).

⁵⁰ SEC Proposal (proposed Exchange Act Rule 3a71-3(a)(4)).

⁵¹ SEC Proposal at 31,206 (proposed Exchange Act Rule 3a71-3(a)(5)).

⁵² SEC Proposal at 31,000.

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law in certain cases where it deems foreign law to be comparable to its own requirements.⁵³ The ability to apply to comply with local law through “substituted compliance” depends on the type of market and the specific requirement, as described further below.

In order to request that the CFTC engage in a comparability analysis, a non-US person or group of non-US persons from the same jurisdiction, or a foreign regulator, may submit an application for substituted compliance in connection with an application of a person to register as a swap dealer or MSP. The application must state with specificity the factual basis for the request to recognize the non-US law as comparable. Generally, the CFTC would expect that an application would, at a minimum:

- state the basis for requesting that the CFTC find that a particular set of foreign laws and regulations is comparable to, and as comprehensive as, particular Dodd-Frank Act requirements;
- include all applicable legislation, rules and policies;
- provide an assessment of whether the objectives of the two regulatory regimes are comparable and comprehensive; and
- if the applicant is a registered swap dealer or MSP, provide an explanation of the capacity in which it is licensed in its home country and whether the applicant is in good standing.

The CFTC indicates that the bar for obtaining a comparability determination will be high. In reviewing a request for a substituted compliance determination, the CFTC generally will consider the objectives of a foreign jurisdiction’s swap regulations and will base its analysis on a comparison of specific foreign requirements against CEA provisions and CFTC regulations in 13 categories of regulatory obligations. The CFTC may determine that a foreign jurisdiction’s swap regulatory requirements are comparable in some, all or none of these categories.

⁵³ See CFTC Guidance at 45,340–45,346.

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The CFTC expects that, in connection with a determination that substituted compliance is appropriate, it would enter into supervisory memoranda of understanding or other arrangements that provide for information-sharing and cooperation in the context of supervising swap dealers and MSPs, such as procedures for confirming continuing oversight activities, access to information, on-site visits and notification procedures in certain situations.

The Final Guidance provides that, even where substituted compliance is not available, a market participant could be deemed to be in compliance with CFTC rules where it complies with requirements in its home jurisdiction that are “essentially identical” to US requirements. The Final Guidance provides little detail on how “essentially identical” determinations will be made. However, almost contemporaneously with issuing the Final Guidance, the CFTC staff issued a no-action letter finding that risk mitigation rules implemented by the European Union under the European Market Infrastructure Regulation (EMIR) are essentially identical to the CFTC’s rules relating to confirmation, portfolio reconciliation and compression, and valuation and dispute resolution, with certain exceptions. Under this no-action letter, for a swap that is subject to concurrent jurisdiction under US and EU risk mitigation rules, compliance under EMIR constitutes compliance under US rules, subject to conditions. The CFTC staff also issued a no-action letter allowing market participants that are clearing members to meet CFTC clearing requirements by through two European clearinghouses, neither of which are registered with the CFTC or exempt from registration.⁵⁴

⁵⁴ See *No-Action Relief for Registered Swap Dealers and Major Swap Participants from Certain Requirements under Subpart I of Part 23 of Commission Regulations in Connection with Uncleared Swaps Subject to Risk Mitigation Techniques under EMIR*, CFTC Letter No.13-45 (11 July 2013); *No-Action Relief with Regard to Sections 5b(a) and 2(h)(1)(A) of the Commodity Exchange Act and Implementing Regulations Thereunder*, CFTC Letter No.13-43 (11 July 2013), available here; *No-Action Relief with Regard to Sections 5b(a) and 2(h)(1)(A) of the Commodity Exchange Act and Implementing Regulations Thereunder*, CFTC Letter No.13-44 (11 July 2013).

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Like the CFTC Guidance, the SEC Proposal would allow security-based swap market participants to satisfy some US security-based swap regulations by complying with foreign regulatory requirements if the SEC has made a determination that the foreign jurisdiction's rules are comparable. The SEC Proposal includes standards that would govern the SEC's process for making such comparability determinations.⁵⁵

When considering a substituted compliance request, the SEC would evaluate whether the foreign security-based swap regime achieves regulatory outcomes in a particular area comparable to the relevant US requirements. It would also take into account factors such as the scope and objectives of the relevant foreign regulatory requirements, the effectiveness of the foreign supervisory compliance scheme and the enforcement authority exercised by the foreign regulatory authority. In most cases, the SEC would need to enter into a supervisory and enforcement memorandum of understanding with the relevant foreign jurisdiction before issuing a comparability determination.

Foreign regulatory requirements would not need to be identical to US requirements for the SEC to make a comparability determination, and the SEC would not anticipate engaging in a rule-by-rule analysis in coming to such a determination. The SEC Proposal contemplates that the SEC may provide substituted compliance for specific requirements in a particular jurisdiction, even if substituted compliance is not deemed appropriate on a regime-wide basis.

A foreign SBSB would be able to request that the SEC make a substituted compliance determination that could apply to entity- and transaction-level requirements if the SBSB or group of dealers:

- is directly supervised by the relevant foreign financial regulatory authority or authorities; and

⁵⁵ See SEC Proposal at 31,207–31,208 (proposed Exchange Act Rule 3a71–5).

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- provides an opinion of counsel confirming that the SEC can have prompt access to its books and records and conduct on-site inspections and examinations.

Though MSBSPs are generally subject to the same requirements as SBSDs, substituted compliance would not be available for MSBSPs.

9.3.6 Registration thresholds

9.3.6.1 Swap dealer and security-based swap dealer

One of the pillars of the Title VII swap regulatory regime is the registration and regulation of market intermediaries including “swap dealers” and “security-based swap dealers”. Persons that meet these definitions are subject to a robust regulatory regime that includes capital, margin, risk management, conflict-of-interest, documentation, confirmation and external business conduct requirements, among many others.

Section 1a(47) of the CEA defines a “swap dealer” as a person who:

- holds itself out as a dealer in swaps;
- makes a market in swaps;
- regularly enters into swaps with counterparties as an ordinary course of business for its own account; or
- engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.⁵⁶

A swap dealer includes a person that

“[r]egularly enters into swaps with counterparties as an ordinary course of business for its own account but does not include a person that enters into swaps for such person’s own account, either individually or in a fiduciary capacity, but not as a part of regular business.”

⁵⁶ CEA s.1a(47).

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In addition, the definition of “swap dealer” includes a de minimis threshold of swap-dealing activity, discussed below.

The definition of “security-based swap dealer” in s.3(a)(71) of the Exchange Act is substantively similar.⁵⁷

As required by the Dodd-Frank Act, the CFTC and the SEC have adopted rules further defining “swap dealer” and “security-based swap dealer”.⁵⁸ Among many other provisions, these rules further define the indicia of dealing activity that gives rise to the need to register as a swap dealer or SBSB. In addition, these rules establish initial thresholds for the de minimis exclusion from swap dealer registration requirements at:

- for registration as a swap dealer:
 - \$8 billion in notional amount of swaps connected with dealing activity effected in a 12-month period; or
 - \$25 million in notional amount of swaps connected with dealing activity with “special entities”⁵⁹ effected in a 12-month period; and
- for registration as an SBSB:
 - \$8 billion in notional amount of credit default swaps that are security-based swaps connected with dealing activity effected in a 12-month period;
 - \$400 million for other security-based swaps connected with dealing activity effected in a 12-month period; or
 - \$25 million in notional amount of security-based swaps connected with dealing activity with “special entities” effected in a 12-month period.⁶⁰

⁵⁷ Exchange Act s.3(a)(71).

⁵⁸ See Further Definition of “Swap Dealer”, “Security-Based Swap Dealer”, “Major Swap Participants”, “Major Security-Based Swap Participant” and “Eligible Contract Participant”, 77 Fed. Reg. 30,1596 (23 May 2012) (hereinafter Entity Definition Rules).

⁵⁹ “Special entities” include federal agencies, states, state agencies, cities, counties, municipalities, other political subdivisions of a state, any ERISA s.3 employee benefit plan or governmental plan and any endowment.

⁶⁰ Swap and security-based swaps entered into on or before 12 October 2012 do not count toward the swap dealer or SBSB de minimis thresholds.

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An entity becomes a swap dealer or an SBSB two months after the end of the month in which one of the thresholds above is breached.

An entity is not required to count toward its calculations of swap dealer and SBSB de minimis activity:

- swaps and security-based swaps not connected to dealing activity;
- swaps and security-based swaps entered into with a person's majority-owned affiliates; and
- swaps entered into by insured depository institutions with counterparties in connection with loans to those counterparties.

As described further below, the CFTC's and SEC's rules require market participants to aggregate swap and security-based swap-dealing positions with those of certain of their affiliates in determining whether it is necessary to register as a swap dealer or an SBSB.

9.3.6.1.1 CFTC approach

The CFTC Guidance provides rules for determining which swaps must be counted toward the swap dealer de minimis threshold described above.⁶¹

Under the CFTC Guidance, US persons (including through their Non-US Branches), guaranteed affiliates and conduit affiliates are required to count all swaps entered into in a dealing capacity, regardless of counterparty. Non-US persons that are not guaranteed or conduit affiliates are required to count transactions with:

- US persons, other than Non-US Branches; and
- guaranteed affiliates, except where the guaranteed affiliate:
 - is registered as a swap dealer;

⁶¹ See CFTC Guidance at 45,318–45,327.

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- is not a swap dealer but engages in de minimis swap dealing activity and is affiliated with a swap dealer; or
- is guaranteed by a nonfinancial entity.

A non-US person that is not a guaranteed affiliate or conduit affiliate is not required to count towards its swap dealer de minimis threshold swaps entered into anonymously on a registered designated contract market (DCM), swap execution facility (SEF) or foreign board of trade (FBOT) and cleared. In addition, the CFTC Guidance clarifies that only the initial execution of a subsequently cleared swap, and not the novation to the clearinghouse, is required to be counted toward the swap dealer de minimis threshold for a cleared swap entered into by a non-US person that is neither a guaranteed affiliate nor a conduit affiliate.

For purposes of determining whether a person falls under the de minimis threshold, the CFTC's final definition of "swap dealer" and the CFTC Guidance require that an entity (whether a US person or a non-US person) aggregate swap-dealing positions that it counts toward the swap dealer de minimis threshold with those of all of its US and non-US affiliates that it controls, is controlled by or is under common control with, except that swaps of an affiliate that is a registered swap dealer may be excluded from this calculation. In practice, this means that a group of affiliated entities that are not registered as swap dealers may enter into up to \$8 billion of swap-dealing activity over a 12-month period (or \$25 million with special entities) before at least one entity in the group must register as a swap dealer.

9.3.6.1.2 SEC approach

The SEC Proposal clarifies which security-based swap dealing transactions of US and non-US persons, and their affiliates, would be counted toward the SBSB de minimis thresholds for registration.⁶²

⁶² SEC Proposal at 31,207 (proposed Exchange Act Rule 3a71-3(b), 3a71-4).

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A US person would need to count all of its security-based swap-dealing transactions with US and non-US counterparties toward the SBSB de minimis thresholds, including transactions conducted through a Foreign Branch. A non-US person would only be required to count security-based swap dealing transactions with:

- US persons (other than Foreign Branches), regardless of where the transaction is conducted; and
- non-US persons and Foreign Branches, to the extent the transaction is conducted within the US.

A non-US person would not need to count security-based swap transactions with a Foreign Branch that are not conducted within the US as long as the Foreign Branch is the named counterparty to the transaction and no person within the US is directly involved in “soliciting, negotiating, executing, or booking” the transaction on behalf of the Foreign Branch.

The SEC Proposal would require any person to aggregate, together with its own security-based swap-dealing transactions, all security-based swap-dealing transactions engaged in by any of its affiliates, regardless of whether that affiliate is a US person, a non-US person or a US person conducting the transaction through a Foreign Branch, to the extent the affiliate would need to count the transaction toward its own de minimis threshold. A US person would not need to aggregate the security-based swap-dealing activities of an affiliate that is an SEC-registered SBSB that is “operationally independent”.⁶³

⁶³ The security-based swap activities of an entity would be considered “operationally independent” from that of an affiliated registered SBSB if the affiliates maintain separate: sales and trading functions; operations (including separate back offices); and risk management with respect to any security-based swap activity of either affiliate that is counted toward either affiliate’s de minimis thresholds. If any of the previously mentioned functions are jointly managed—including being managed at a central booking location within the affiliate group—with respect to security-based swap activity of either affiliate, the exclusion from the de minimis thresholds for security-based swaps entered into by the affiliated registered SBSB would not be available.

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9.3.6.2 Major swap participant and major security-based swap participant

Persons that meet the definition of “major swap participant” or “major security-based swap participant” must register with the CFTC or SEC, respectively, and are subject to requirements substantially similar to those that apply to swap dealers and SBSBs.

Section 1a(33) of the CEA defines an MSP as any person who is not a swap dealer and:

- who maintains a substantial position in swaps for any of the major swap categories, excluding positions held to “hedge or mitigate commercial risk” and certain hedging positions held by an “employee benefit plan” (as defined in the Employee Retirement Security Act of 1974, as amended (ERISA));
- whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the US banking system or financial markets; or
- who is a highly leveraged financial entity that is not subject to capital requirements established by a federal banking agency who maintains a substantial position in outstanding swaps of any major category.⁶⁴

Section 3(a)(67) of the Exchange Act provides a substantively similar definition of “major security-based swap participant” with respect to activities in security-based swaps.⁶⁵

As required by the Dodd-Frank Act, the CFTC and SEC have adopted regulations further defining the terms “major swap participant” and “major security-based swap participant”.⁶⁶ These definitions employ two building blocks for calculating the three statutory prongs for determining whether an entity is an MSP or MSBSP: a “current uncollateralized exposure”

⁶⁴ CEA s.1a(33).

⁶⁵ Exchange Act s.3(a)(67).

⁶⁶ See Entity Definition Rules.

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component and a “potential future exposure” component. To determine whether an entity is an MSP or MSBSP, the “current uncollateralized exposure” and “potential future exposure” calculations are combined in different ways corresponding to the three statutory MSP and MSBSP tests and compared to thresholds in the rule. Safe harbours are also available. In certain cases, guaranteed positions are required to be counted towards the guarantor’s MSP or MSBSP thresholds.

9.3.6.2.1 CFTC approach

Under the CFTC Guidance, in determining whether it is required to register as an MSP⁶⁷:

- a US person must count all swaps, regardless of the US person status of its counterparty;
- a guaranteed affiliate or conduit affiliate must count all swaps, regardless of the US person status of its counterparty;
- a non-US person that is not a guaranteed affiliate and is a financial entity is required to count transactions with:
 - US persons (other than Non-US Branches); and
 - Non-US Branches and guaranteed affiliates, unless the counterparty is (i) a registered swap dealer and (ii) the swap is cleared or the documentation of the swap requires the Non-US Branch or guaranteed affiliate to collect daily variation margin, with no threshold, on its swaps with the non-US person (and the position is addressed in the swap dealer’s risk management program); and
- a non-US person that is not a guaranteed affiliate and is not a financial entity is only required to count transactions with US persons (other than Non-US Branches).

The CFTC Guidance also includes complex attribution rules, which generally require a swap to be attributed to the guarantor for purposes of its MSP calculations subject to a

⁶⁷ See CFTC Guidance at 45,318–45,327.

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number of exceptions, including where the guaranteed entity fits within certain regulatory categories.

9.3.6.2.2 SEC approach

Under the SEC Proposal, in determining whether it is required to register as an MSBSP⁶⁸:

- a US person:
 - must count all outstanding security-based swaps, regardless of the counterparty; and
 - must include any security-based swaps it guarantees; and
- a non-US person:
 - must count outstanding security-based swaps with US person counterparties, including Foreign Branches;
 - must include any security-based swaps for which it guarantees a US person's performance; and
 - must include security-based swaps for which it guarantees a non-US person's performance if the guaranteed entity's counterparty is a US person.

In all cases, for both US persons and non-US persons, a guarantor is not required to include positions it guarantees if the entity it guarantees is subject to capital regulation by the SEC or the CFTC or is subject to Basel capital standards.

9.3.7 Application of substantive requirements in the cross-border context

The CFTC Guidance and SEC Proposal describe how substantive Title VII requirements are applied to market participants based on the counterparties to the transaction in question.

⁶⁸ See SEC Proposal at 31,030–31,035; 31,206 (proposed Exchange Act Rule 3a67–10).

*The Cross-border Impact of the Dodd-Frank Act**9.3.7.1 CFTC approach**9.3.7.1.1 Division into entity-level and transaction-level requirements*

The CFTC Guidance distinguishes between requirements that are “entity-level”,⁶⁹ which apply to the firm as a whole, and those that are “transaction-level”,⁷⁰ which apply to the individual transaction or trading relationship.⁷¹

The entity-level requirements are divided into two categories for purposes of determining where substituted compliance may potentially apply. The First Category entity-level requirements include:

- capital adequacy requirements;
- risk-management and chief compliance officer requirements; and
- swap data recordkeeping, except rules relating to customer complaints and sales and marketing materials.

The Second Category entity-level requirements include:

- swap data reporting to swap data repositories (SDRs), including historical swap reporting;
- swap recordkeeping requirements relating to customer complaints and sales and marketing materials; and
- large trader reporting.

The transaction-level requirements are divided into two categories for purposes of determining where substituted compliance may potentially apply. Category A includes:

- clearing and swap processing;
- margining and segregation for uncleared swaps;
- trade execution;

⁶⁹ CFTC Guidance at 45,331–45,338.

⁷⁰ CFTC Guidance at 45,338–45,340.

⁷¹ A substantive discussion of these requirements is beyond the scope of this chapter.

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- swap trading relationship documentation;
- portfolio reconciliation and compression;
- real-time public reporting;
- trade confirmation; and
- daily trading records.

Category B includes only the CFTC's external business conduct standards.

9.3.7.1.2 Application to swap dealers and major swap participants

The CFTC Guidance requires all swap dealers and MSPs to comply with all entity-level requirements.⁷² Substituted compliance is potentially available for non-US persons that are swap dealers or MSPs for the First Category entity-level requirements only, regardless of the US person status of the counterparty to a swap. With respect to Second Category entity-level requirements:

- for SDR reporting, substituted compliance is potentially available for non-US swap dealers and MSPs only where the counterparty is a non-US person and is not a guaranteed or conduit affiliate and the CFTC has direct electronic access to the swap data stored at the foreign trade repository;
- for swap data recordkeeping requirements relating to customer complaints and sales and marketing materials, substituted compliance is potentially available for non-US swap dealers and MSPs only where the counterparty is a non-US person; and
- for large trader reporting, substituted compliance is not available.

The application of the Category A transaction-level requirements to a swap dealer or MSP depends on the status of its counterparty as follows⁷³:

⁷² CFTC Guidance at 45,348–50.

⁷³ CFTC Guidance at 45,350–45,359.

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Application of Category A Transaction-Level Requirements					
Swap dealer or MSP is:	Counter-party is:	US person (other than a Non-US Branch)	Non-US branch	Guaranteed or conduit affiliate	Non-US person that is not a guaranteed or conduit affiliate
US swap dealer or MSP (other than through a Non-US Branch)		Apply	Apply	Apply	Apply
Non-US Branch		Apply	Apply, substituted compliance potentially available	Apply, substituted compliance potentially available	Apply, substituted compliance potentially available. 5% exemption also potentially available, as described below.
Non-US swap dealer or MSP*		Apply	Apply, substituted compliance potentially available	Apply, substituted compliance potentially available	Do not apply

*As described in Section 9.3.4.1.3 above, there remains ambiguity surrounding the treatment of US branches of non-US swap dealers in light of fn.513 of the CFTC Guidance. The CFTC Guidance does not discuss when a swap would be considered to be “with a US branch” of a non-US swap dealer or MSP.

In addition, the CFTC Guidance provides that Category A transaction-level requirements are generally deemed satisfied for a swap between a non-US person and a US person that is executed anonymously on a DCM, SEF or FBOT and cleared, though the exact scope of this exception is unclear.

For swaps between a Non-US Branch and a non-US person that is not a guaranteed affiliate or a conduit affiliate, if the transaction takes place in a foreign jurisdiction other than Australia, Canada, the EU, Hong Kong, Japan and Switzerland (the Six Jurisdictions), parties may comply with the local law of the Non-US Branch if:

- the aggregate notional value of the swaps of all the US swap dealer’s Non-US Branches in foreign jurisdictions

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other than the Six Jurisdictions does not exceed five per cent of the aggregate notional value, measured quarterly, of all of the swaps of the US swap dealer; and

- the US person maintains records with supporting information to verify that the five per cent test is satisfied, as well as to define and address risks that may arise from the nonapplication of the transaction-level requirements.

The Category B transaction-level requirements—the external business conduct standards applicable to swap dealers and MSPs—apply to the cross-border swap activities of swap dealers and MSPs as follows⁷⁴:

Application of Category B Transaction-Level Requirements (External Business Conduct Standards)					
Swap dealer or MSP is:	Counter-party is:	US person (other than a Non-US Branch)	Non-US Branch	Guaranteed or conduit affiliate	Non-US person that is not a guaranteed or conduit affiliate
US swap dealer or MSP (other than through a Non-US Branch)		Apply	Apply	Apply	Apply
Non-US Branch		Apply	Do not apply	Do not apply	Do not apply
Non-US swap dealer or MSP*		Apply	Do not apply	Do not apply	Do not apply

*See above footnote to the table titled “Application of Category A Transaction-Level Requirements”.

9.3.7.1.3 Application to Non-Registrants

The CFTC’s swap clearing, trade execution, real-time reporting, large trader reporting, SDR reporting and swap data recordkeeping requirements apply to swap transactions between market participants that are not registered as swap

⁷⁴ CFTC Guidance at 45,359–45,361.

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dealers or MSPs (Non-Registrants). The following table summarizes the application of these requirements (the Non-Registrant Requirements)⁷⁵:

Application of Non-Registrant Requirements				
Counter-party B is:	Counter-party is:	US person	Guaranteed or conduit affiliate	Non-US person that is not a guaranteed or conduit affiliate
US person		Apply	Apply	Apply
Guaranteed or conduit affiliate		Apply	Apply, substituted compliance potentially available (except that substituted compliance is not available for large trader reporting)	Do not apply, except for large trader reporting
Non-US person that is not a guaranteed or conduit affiliate		Apply	Do not apply, except for large trader reporting	Do not apply, except for large trader reporting

The CFTC Guidance notes that if one of the counterparties elects the interaffiliate clearing exemption for the swap, the CFTC generally would expect the parties to the swap to comply with the conditions of the interaffiliate clearing exemption.

9.3.7.2 *SEC Approach*

9.3.7.2.1 Entity-Level and Transaction-Level Requirements

Like the CFTC Guidance, the SEC Proposal classifies security-based swap regulatory requirements into “entity-level” and “transaction-level” requirements and defines how these requirements would apply to US and foreign SBSs and MSBSPs.⁷⁶ However, unlike the CFTC Guidance, these classifications only apply to requirements specific to SBSs and

⁷⁵ CFTC Guidance at 45,361–45,364.

⁷⁶ A substantive discussion of these requirements is beyond the scope of this chapter.

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MSBSPs; they do not apply to reporting, clearing and trade execution requirements, which potentially apply to all market participants.

The SEC's entity-level requirements include⁷⁷:

- capital;
- margin;
- risk management, including trade acknowledgment and verification, and trade documentation requirements;
- recordkeeping and reports to regulators;
- internal systems and controls;
- diligent supervision;
- conflicts of interest;
- chief compliance officer;
- inspection and examination; and
- licensing requirements and statutory disqualification requirements.

The SEC's transaction-level requirements include⁷⁸:

- external business conduct standards (other than diligent supervision); and
- segregation of assets.

9.3.7.2.2 Application to SBSs and MSBSPs

The SEC Proposal would require all SBSs and MSBSPs, whether US or foreign, to comply with the SEC's entity-level requirements. Non-US SBSs would be eligible for substituted compliance for entity-level requirements.

The SEC Proposal would require a US SBS or MSBSPs to comply with transaction-level requirements for all transactions, regardless of the counterparty. However, a US SBS that is a US bank would not be subject to the business conduct standards with respect to security-based swaps entered into by a Foreign Branch with a non-US person or another Foreign

⁷⁷ See SEC Proposal at 31,011–31,016.

⁷⁸ See SEC Proposal at 31,010–31,011.

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Branch, as long as the security-based swap is not “conducted within the United States”, the Foreign Branch is the named counterparty to the transaction and no person within the United States is directly involved in soliciting, negotiating, execution or booking the transaction on behalf of the Foreign Branch.

An SBSB that is a non-US person would be required to comply with the external business conduct requirements, other than for security-based swaps with non-US persons and Foreign Branches that are not “conducted within the United States”. Non-US SBSBs would be eligible for substituted compliance from the external business conduct requirements where they apply.

An SBSB that is a non-US person would be required to comply with the segregation requirements if the SBSB is also registered with the SEC as a broker-dealer. If the SBSB is not registered with the SEC as a broker-dealer, it would be required to comply with the segregation requirements for security-based swaps with US person counterparties and, if the SBSB is not a foreign bank with a branch or agency in the US, for security-based swaps with non-US person counterparties as long as the SBSB receives assets from at least one US person counterparty. A foreign SBSB would need to provide any US person counterparty with written disclosure relating to the applicability of the segregation requirements to that counterparty’s assets, which would need to contain a discussion of the potential treatment of the assets under the particular laws that would govern the insolvency or resolution of the dealer. Non-US SBSBs would be eligible for substituted compliance.

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9.3.7.2.3 Reporting

The SEC Proposal treats reporting outside of the entity-level and transaction-level requirements described above.⁷⁹ Specifically, the SEC Proposal would require regulatory reporting to a security-based SDR of any security-based swap transaction where:

- the transaction is conducted within the US;
- one or both of the direct counterparties is a US person;
- one or both of the direct counterparties has a US person guarantor for its obligations under the security-based swap (an indirect counterparty);
- one or both of the direct or indirect counterparties is an SBSB or MSBSP (whether US or foreign); or
- the transaction is cleared through a clearing agency having its principal place of business in the US.

Specified data about a security-based swap would be subject to public dissemination in real time, with a delay for dissemination of block trade information, if:

- the transaction is conducted within the US;
- both sides of the transaction have a US person that is either a direct or an indirect counterparty;
- at least one direct counterparty to the transaction is a US person other than a Foreign Branch;
- one side of the transaction includes a US person as a direct or indirect counterparty, and the other side includes a direct or indirect counterparty that is a foreign SBSB; or
- the transaction is cleared through a clearing agency having its principal place of business in the US.

The SEC Proposal states that substituted compliance with security-based swap reporting is potentially available to any market participant when engaging in cross-border security-based swap transactions in which:

⁷⁹ See SEC Proposal at 31,215 (proposed Exchange Act r.908).

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- at least one direct counterparty to the security-based swap is a non-US person or a Foreign Branch; and
- the security-based swap is not solicited, negotiated or executed by a person within the US on behalf of the non-US person or Foreign Branch counterparty.

To make a substituted compliance determination, the SEC must find that: (1) the foreign regulatory regime has comparable requirements concerning the data elements that must be reported and the timing and manner of reporting and public dissemination; (2) it has direct electronic access to the security-based swap data held by the trade repository or foreign regulatory authority to which the data is reported; and (3) the trade repository or foreign regulatory authority is subject to comparable requirements concerning data collection and maintenance, systems capacity, resiliency, security and recordkeeping.

9.3.7.2.4 Clearing and trade execution

The SEC Proposal also treats the clearing⁸⁰ and trade execution⁸¹ requirements differently from the entity-level and transaction-level requirements described above. Specifically, the SEC Proposal would apply the security-based swap mandatory clearing and trade execution requirements to any security-based swap transaction if:

- the transaction is conducted within the US, unless:
 - both counterparties to the transaction are non-US persons;
 - neither counterparty is a foreign SBSB; and
 - neither counterparty is guaranteed by a US person; or
- the transaction is not conducted within the US, but at least one counterparty to the transaction is a US person or is a non-US person whose performance under the security-based swap is guaranteed by a US person, unless:

⁸⁰ SEC Proposal at 31,208 (proposed Exchange Act r.3Ca-3).

⁸¹ SEC Proposal at 31,208-31,209 (proposed Exchange Act r.3Ch-1).

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- one counterparty to the transaction is a Foreign Branch or a non-US person whose performance under the security-based swap is guaranteed by a US person; and
- the other counterparty to the transaction is a non-US person whose performance is not guaranteed by a US person and who is not a foreign SBSB.

The SEC Proposal would permit a security-based swap transaction that is subject to mandatory clearing to be cleared through a clearinghouse that is not registered with the SEC or is exempt from registration as a clearing agency, upon a substituted compliance determination for the clearinghouse. This would be the case even where the underlying counterparties are US persons. The SEC proposes that it could make such a substituted compliance determination for a clearinghouse if:

- the clearinghouse has no US person members or activities in the US (and thus would not be required to register or seek an exemption from registration as a clearing agency); and
- the SEC finds the clearinghouse to be subject to comparable foreign regulation.

The SEC Proposal would allow a counterparty to a security-based swap transaction that is subject to the mandatory trade execution requirement to satisfy that requirement by executing the security-based swap transaction on a security-based swap market that is not registered or is exempt from registration with the SEC, upon a substituted compliance determination for the security-based swap market. The SEC proposal would allow the use of substituted compliance determination for trade execution where:

- at least one counterparty to the security-based swap is a non-US person or a Foreign Branch; and
- the security-based swap is not solicited, negotiated or executed by a person within the US on behalf of the non-US person or Foreign Branch counterparty.