THE REVIEW OF
SECURITIES & COMMODITIES REGULATION
AN ANALYSIS OF CURRENT LAWS AND REGULATIONS AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 47 No. 10 May 21, 2014

# THE CFTC'S CROSS-BORDER APPLICATION OF THE DODD-FRANK ACT

*In Interpretive Guidance and a Staff Advisory issued last year, the CFTC took an expansive position on its cross-border jurisdiction over swap transactions under the Dodd-Frank Act. The Advisory caused an outcry and prompted litigation. The Commission then drew back and issued no-action letters granting and extending temporary relief and has requested comments on whether to adopt the Advisory as Commission policy. The authors discuss these "policy gyrations" and the problems raised for swap dealers.*

By Matthew Kluchenek and James Schwartz *

After years of anticipation, the U.S. Commodity Futures Trading Commission in July 2013 issued more than 300 pages of "guidance" ostensibly to assist market participants in understanding the breadth of the extraterritorial application of swap provisions of the Dodd-Frank Act.[1]

The genesis of the CFTC's cross-border guidance – and the Dodd-Frank Act itself – arose out of the swap market reforms agreed to by G20 leaders at their September 2009 summit in Pittsburgh. At that summit, G20 leaders agreed to wholesale reforms of the swap market, which, to that date, had consisted primarily of off-exchange bilateral transactions: the clearing of standardized OTC derivative contracts, the reporting of such transactions, and the trading of such contracts on exchanges or electronic trading platforms, where

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 701–74, 124 Stat. 1376, 1641–802 (2010) (codified as amended in scattered sections of 7, 12 and 15 U.S.C. (2012)). Title VII of the Dodd-Frank Act gives the CFTC jurisdiction over "swaps" and the U.S. Securities and Exchange Commission jurisdiction over "security-based swaps." *Id*. at §§ 722(a), 761(a) (codified at 7 U.S.C. § 2(a)(1), 15 U.S.C. § 78c(a)). The Dodd-Frank Act defines each term, *id.* at §§ 721(a), 722(a), and a joint rulemaking by the CFTC and the SEC has further defined them. *See* Further Definition of

*footnote continued from previous column…*

"Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48,208 (Aug. 13, 2012). Unlike the CFTC, the SEC has not yet finalized many of its rules and its rules are outside the scope of this article.

* *MATTHEW KLUCHENEK is a partner at Baker McKenzie, LLP and leads the firm's North American Derivatives practice group. He can be reached at matt.kluchenek@bakermckenzie.com. JAMES SCHWARTZ is of counsel in the New York office of Morrison & Foerster LLP, where he concentrates his practice on derivatives. He can be reached at jschwartz@mofo.com.*

***IN THIS ISSUE***

***RSCR Publications LLC*** Published 22 times a year by RSCR Publications LLC. Executive and Editorial Offices, 2628 Broadway, Suite 29A, New York, NY 10025-5055. Subscription rates: $1,197 per year in U.S., Canada, and Mexico; $1,262 elsewhere (air mail delivered). A 15% discount is available for qualified academic libraries and full-time teachers. For subscription information and customer service call (866) 425-1171 or visit our Web site at www.rscrpubs.com. General Editor: Michael O. Finkelstein; tel. 212-876-1715; e-mail mofinkelstein@gmail.com. Associate Editor: Sarah Strauss Himmelfarb; tel. 301-294-6233; e-mail shimmelfarb@comcast.net. To submit a manuscript for publication contact Ms. Himmelfarb.  ISSN: 0884-2426. 

appropriate.[2] The details required to reach these broad goals, however, were left to individual member countries (and, with respect to many European countries, the European Union), with a skeletal, but aspirational, institutional framework to harmonize differing rules that might be adopted by different countries. Harmonization of varying rules, of course, is essential, because the swap market is profoundly global – swaps between parties in different jurisdictions are more the rule than the exception. Results of a failure to harmonize rules in different jurisdictions have been well documented and could include fragmented liquidity, regulatory arbitrage, and disproportionate compliance costs for market participants.

### *Scope of the CFTC's Cross-Border Jurisdiction*

Because of the international nature of the market, to regulate effectively, a regulator must have a certain amount of authority with respect to transactions not occurring wholly within its jurisdiction. The primary U.S. swaps regulator, the CFTC, is empowered to regulate the swaps market under Title VII of the Dodd-Frank Act, which permits the CFTC to exercise authority with respect to activities outside of the United States if those activities "have a direct and significant connection with activities in, or effect on, commerce of the United States" or "contravene such rules or regulations as the [CFTC] may prescribe [] as are necessary or appropriate to prevent the evasion of any provision of [the Dodd-Frank Act]."[3]

This language makes it clear that Congress intended the CFTC to have authority with respect to certain matters outside the U.S. However, particularly with respect to its transactional rules, to date the regulator appears to have had difficulty arriving at a clear and workable delineation of its authority. Moreover, because the CFTC's myriad attempts to state the scope of the application of its transactional rules appear to be inconsistent with other regulators' adopting an approach analogous to the CFTC's own approach, not only has the path toward harmonization been unclear, but at times the CFTC has appeared to lack full credibility.

### *Implementation of a Cross-Border Framework*

The CFTC appears to have been the timeliest regulator in the G20 countries in finalizing and implementing its swaps regulations. In addition to its substantive rules, it has finalized, albeit subject to ongoing litigation,[4] its guidance regarding the application of such rules to non-U.S. parties and transactions with non-U.S. parties. The CFTC's approach to cross-border matters divides its substantive requirements into two separate categories: Transaction-Level Requirements and Entity-Level Requirements,[5] each of which it splits into two subcategories.[6] The Transaction-Level requirements are split into Category A Transaction-Level Requirements (which include the clearing and trade executions reforms contemplated by the G20, among other requirements, such as swap trading relationship documentation and real-time public reporting of swap data) and Category B Transaction-Level Requirements (which consist of the CFTC's external business conduct standards).[7] Similarly, the Entity-Level Requirements are divided into First Category Entity-Level Requirements (which include capital adequacy, chief compliance officer, risk management, and most swap data recordkeeping) and Second Category Entity-Level Requirements (which

[2] Leaders' Statement: The Pittsburgh Summit (September 24-25, 2009), *available at* http://www.treasury.gov/resource-center/international/g7-g20/Documents/pittsburgh_ summit_leaders_ statement_250909.pdf.

[3] Dodd-Frank Act, at § 722(d).

[4] *See Securities Industry and Financial Markets Association, et al. v. United States Commodity Futures Trading Commission*, D.D.C. No. 13-cv-1916, Dk. 1 (Dec. 4, 2013). In their complaint, the plaintiffs allege, among other things, that in the process of adopting its cross-border guidance, the CFTC failed to engage in a required analysis of costs and benefits and to provide interested persons with an opportunity to participate in its rulemaking.

[5] Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45,292, 45,331–40 (July 26, 2013).

[6] *Id.* at 45,335–36.

[7] *Id.* at 45,336.

include, among others, swap data repository reporting and reporting for large traders of swaps linked to certain commodities).[8]

With regard to the Entity-Level Requirements, by means of substituted compliance determinations,[9] the CFTC has taken the pragmatic view that the primary, non-U.S. regulation of non-U.S. swap dealers renders it largely unnecessary for its rules to apply directly to non-U.S. entities.[10] In contrast, however, with regard to the Transaction-Level Requirements, the CFTC to date has been far more insistent on the application of its own rules. Moreover, the CFTC's approach appears to contain incongruities, areas in which conflicts would occur if other, non-U.S. regulators adopted the CFTC's approach.

The CFTC has taken the broad position that (with certain exceptions for U.S. swap dealers acting through foreign branches, subsidiaries, or affiliates) its Transaction-Level Requirements will apply to any swap to which a U.S. Person[11] is a party.[12] However, it is not clear why, in a swap involving two parties located in two jurisdictions, the CFTC's transactional requirements should necessarily apply and not those of the other jurisdiction. If another jurisdiction were to take a position parallel to that of the CFTC and require the application of its own rules to a transaction involving a swap dealer based on its jurisdiction, then the transaction would be governed by both U.S. and the non-U.S. rules, and any material differences between these two sets of rules could be a significant issue for the parties and, by extension, the market as a whole.[13]

The CFTC's stance with regard to swaps with non-U.S. Persons located within the U.S. appears to present a similar incongruity. In a footnote in its cross-border guidance, the CFTC stated that it "takes the view that the U.S. branch of a non-U.S. swap dealer … would be subject to Transaction-Level requirements, without substituted compliance available."[14] Although a branch does not have a separate legal identity and therefore a

---

[8] *Id.* at 45,335-36.

[9] Under the CFTC's cross-border guidance, in certain circumstances, certain market participants may substitute compliance with the requirements of a non-U.S. jurisdiction for compliance with the CFTC's own requirements. *See generally* James Schwartz, The CFTC's Cross-Border Guidance for Swaps and Substituted Compliance Regime, 4 Harv. Bus. L. Rev. Online 52 (2013), http://www.hblr.org/?p=3676. For this substitution to be permissible, the CFTC must make a determination to the effect that the foreign jurisdiction's requirements "are comparable with and as comprehensive as the corollary area(s) of regulatory obligations encompassed by the Entity- and Transaction-Level Requirements." Interpretive Guidance, *supra* note 5 at 45,342.

[10] With regard to many Entity-Level Requirements, the CFTC has made broad substituted compliance determinations for relevant jurisdictions. *See* Comparability Determinations for Certain Entity-Level Requirements for Australia, 78 Fed. Reg. 78,864; Canada, *id.* at 78,839; the European Union, *id.* at 78,923; Hong Kong, *id.* at 78,852; Japan, *id.* at 78,910; and Switzerland, *id.* at 78,899 (all issued December 27, 2013).

[11] The CFTC's cross-border guidance defines a U.S. Person "generally to include, but not be limited to: (i) Any 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 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

*footnote continued from previous column…*

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; (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; (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; (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; (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)." Interpretive Guidance, *supra* note 5 at 45,316–17.

[12] *Id*. at 45369, apps. D and E.

[13] James Schwartz, *supra* note 9 at 52.

[14] Interpretive Guidance, *supra* note 5 at 45,350 n.513.

U.S. branch of a non-U.S. swap dealer is part of a non-U.S. Person, "the Commission recognizes its strong supervisory interest in regulating the dealing activities that occur within the United States, irrespective of the counterparty."[15]

Perhaps paradoxically, however, the CFTC did not recognize (or perhaps rejected) an equally strong interest of non-U.S. regulators in regulating the dealing activities of branches of U.S. swap dealers located in their jurisdictions. With respect to transactions entered into by U.S. swap dealers acting through non-U.S. branches, the CFTC stated that if such branches faced a U.S. Person (other than the foreign branch of another U.S. swap dealer) in a swap, then the CFTC's own Transaction-Level Requirements would apply.[16] Further, with respect to the Category A Transaction-Level requirements, the CFTC stated that even if a non-U.S. branch of a U.S. swap dealer were facing a non-U.S. Person in a swap, then substituted compliance would apply,[17] meaning that the CFTC's own rules would apply unless the CFTC determined that the analogous foreign rules were sufficiently comprehensive and comparable to its own rules.[18] Once again, if a foreign regulator were to take a position parallel to that of the CFTC – in this case requiring that the branches of swap dealers within its geographical jurisdiction adhere to the foreign regulator's rules – then a transaction could be governed by both U.S. and non-U.S. rules.

In a particularly noteworthy fashion, the CFTC appeared to take one step further to underscore its interest in regulating dealing activities occurring within the United States by issuing an advisory (i.e., an advisory on top of guidance) last November 14,[19] which is now subject to no-action relief [20] and a request for public comment.[21] In the advisory, the CFTC's Division of Swap Dealer and Intermediary Oversight ("DSIO") took the position that because of the "strong supervisory interest in swap dealing activities that occur within the United States," even where a swap is between a non-U.S. branch of a non-U.S. swap dealer and another non-U.S. Person, the CFTC's Transaction-Level Requirements will apply to the swap if it is "arranged, negotiated, or executed by personnel or agents of the non-U.S. [swap dealer] located in the United States."[22] As "persons regularly arranging, negotiating, or executing swaps for or on behalf of [a swap dealer] are performing core, front-office activities of that [swap dealer's] dealing business," the DSIO was of the view that a non-U.S. swap dealer "regularly using personnel or agents located in the U.S. to arrange, negotiate, or execute a swap with a non-U.S. person generally would be required to comply with the Transaction-Level Requirements," even where the swap was "between a non-U.S. [swap dealer] and a non-U.S. person [and] booked in a non-U.S. branch of the non-U.S. [swap dealer]."[23] Immediately upon its release, the advisory caused an outcry among U.S. and non-U.S. dealers and market participants and ultimately prompted litigation by the swap dealers.

A subsequent CFTC no-action letter, issued a short time later, gave broad, temporary relief in relation to the November 14 advisory. A second no-action action letter extended that temporary relief. The divisions issuing the letter extending the relief [24] stated that with minor exceptions in relation to dealer-to-dealer swaps, until September 15 of this year, they would not recommend enforcement action in relation to a non-U.S. swap

[15] *Id.*

[16] Interpretive Guidance, *supra* note 5 at 45,369, apps. D and E.

[17] *Id.* Substituted compliance does not apply with respect to the external business conduct rules that constitute the Category B Transaction-Level Requirements. *Id.* at 45,369 app. E. This may be partly because such rules, which require dealers in certain transactions to provide pre-trade and daily mid-market marks and, upon request, scenario analyses, are not expected to have analogs in many non-U.S. jurisdictions. *See generally* Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties, 77 Fed. Reg. 9,734 (February 17, 2012).

[18] *See supra* note 9.

[19] CFTC Staff Advisory 13-69, Division of Swap Dealer and Intermediary Oversight Advisory: Applicability of Transaction-Level Requirements to Activity in the United States (November 14, 2013).

[20] CFTC Letter No. 14-01, Extension of No-Action Relief: Transaction-Level Requirements for Non-U.S. Swap Dealers (January 3, 2014) (extending relief previously given in CFTC Letter No. 13-71, No-Action Relief: Certain Transaction-Level Requirements for Non-U.S. Swap Dealers (November 26, 2013)).

[21] Request for Comment on Application of Commission Regulations to Swaps Between Non-U.S. Swap Dealers and Non-U.S. Counterparties Involving Personnel or Agents of the Non-U.S. Swap Dealers Located in the United States, 79 Fed. Reg. 1347 (January 8, 2014).

[22] CFTC Staff Advisory 13-69, *supra* note 19 at 1.

[23] *Id.* at 2.

[24] Such divisions included not only the DSIO but also the Division of Clearing and Risk and the Division of Market Oversight. CFTC Letter No. 14-01, *supra* note 20.

dealer's failure to comply with the Transaction-Level Requirements in connection with a swap with a non-U.S. Person not connected to the U.S. by virtue of being a guaranteed affiliate[25] or an affiliate conduit,[26] even if the swap were in fact arranged, negotiated, or executed by personnel or agents of the non-U.S. swap dealer located within the U.S.[27] Moreover, the CFTC's request for comment as to "whether the Commission should adopt" the advisory "as Commission policy, in whole or in part," appears to indicate that the CFTC intends to reconsider whether to adhere to the advisory.[28] While the no-action relief and request for comment represent only a step sideways, upon their release market participants seemed to exhale a collective, if cautious, sigh of relief.

Then, a month later, in a further indication of a shift in CFTC policy, CFTC staff in February 2014 issued no-action letters[29] together clarifying, among other things, the conditions upon which staff would not recommend enforcement action against (i) a multilateral trading facility ("MTF") overseen by "competent authorities" within the European Union for failure to register with the CFTC as a swap execution facility ("SEF") and (ii) parties executing a swap on an MTF for failure to comply with the Dodd-Frank Act's trade execution mandate.[30] The no-action letters appear to recognize the value of the EU's regulatory framework to a greater extent than the CFTC was willing to do only months ago. In tandem with the issuance of the no-action letters, the CFTC and the European Commission issued a joint statement outlining a renewed effort to collaborate on cross-border policy and providing an update on the implementation of the "path forward" statement released in July 2013.[31] The CFTC staff's no-action letters were encouraging to swap market participants because they appeared to reflect both the general terms of the "path forward" statement and the spirit of cooperation that characterized that statement.

## CONCLUSION

Over the past year, swaps market participants grappling with understanding the cross-border application of the Dodd-Frank Act have been subjected to a level of policy gyration not seen with respect to other Dodd-Frank Act rulemakings. Nonetheless, while the CFTC's cross-border policy may have stoked fear in market participants by shifting backwards and sideways, a more clear and reasonable CFTC policy appears attainable – one that portends to represent a positive and responsible step forward. ■

[25] A "guaranteed affiliate" is a "non-U.S. person that is an affiliate of a U.S. person and that is guaranteed by a U.S. person." Interpretive Guidance, *supra* note 5 at 45,318.

[26] The CFTC has not precisely defined "affiliate conduit" but has stated that certain factors are relevant to the consideration of whether a non-U.S. Person constitutes an affiliate conduit. *Id.* at 45,369 app. D n.1. Such factors include "whether (i) the non-U.S. person is majority-owned, directly or indirectly, by a U.S. person; (ii) the non-U.S. person controls, is controlled by, or is under common control with the U.S. person; (iii) the non-U.S. person, in the regular course of business, engages in swaps with non-U.S. third party(ies) for the purpose of hedging or mitigating risks faced by, or to take positions on behalf of, its U.S. affiliate(s), and enters into offsetting swaps or other arrangements with such U.S. affiliate(s) in order to transfer the risks and benefits of such swaps with third party(ies) to its U.S. affiliates; and (iv) the financial results of the non-U.S. person are included in the consolidated financial statements of the U.S. person." *Id.*

[27] CFTC Letter No. 14-01, *supra* note 20 at 2-3.

[28] Request for Comment, *supra* note 21 at 1348.

[29] CFTC Letter 14-15, Time-Limited No-Action Relief with respect to Swaps Trading on Certain Multilateral Trading Facilities Overseen by Competent Authorities Designated by European Union Member States (February 12, 2014); CFTC Letter No. 14-16, Conditional No-Action Relief with respect to Swaps Trading on Certain Multilateral Trading Facilities Overseen by Competent Authorities Designated by European Union Member States (February 12, 2014).

[30] The Dodd-Frank Act amended the Commodity Exchange Act to provide that swaps that the CFTC subjects to mandatory clearing must be executed on either a SEF or a designated contract market, unless no swap execution facility or designated contract market makes the swap available to trade. Dodd-Frank Act at § 723(a)(8); 7 U.S.C. § 2(h)(8).

[31] Cross-Border Regulation of Swaps/Derivatives Discussions between the Commodity Futures Trading Commission and the European Union – A Path Forward, July 11, 2013, *available at* www.cftc.gov/PressRoom/PressReleases/pr6640-13.