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Final rule: The CFTC clarifies the extraterritorial application of cross-border derivatives regulation – implications for the buy side

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On 14 September 2020, the Commodity Futures Trading Commission (CFTC) published a final rule in the *Federal Register* entitled "Cross-Border Application of the Registration Thresholds and Certain Requirements Applicable to Swap Dealers and Major Swap Participants" (the final rule).[1] The final rule is an important step in the CFTC's efforts to clarify and consolidate the various interpretations of the global reach of its regulatory authority after many years of issuing guidance, no-action letters, and other interpretations, often inconsistent and confusing.

As a result of the final rule, both corporate and fund end users may have to (re)consider their U.S. person status in connection with making representations to swap dealers (SDs) when entering into derivatives transactions or negotiating International Swaps and Derivatives Association (ISDA) Schedules. End users whose derivatives activity is not limited to hedging may also need to reassess whether their swap dealing activity could exceed the SD registration threshold.

CFTC regulation of cross-border swap transactions under the final rule

When transacting with an SD, numerous regulatory requirements apply to the derivatives transaction. Of the regulations that apply to the derivatives transaction, the final rule divides them into two groups: Group B swaps requirements[2] and Group C swaps requirements.[3] Group B swaps requirements include swap trading relationship documentation, portfolio reconciliation and compression, trade confirmation, and daily trading records. Group C swaps requirements include the external business conduct rules that govern the conduct of SDs in dealing with their end user counterparties. The final rule did not address mandatory clearing (including the end user exception), mandatory trade execution, or margin for uncleared swaps.

The applicability of the Group B and Group C swaps requirements to a particular transaction depends on the "U.S. person" status of both the SD and the end user counterparty, and on whether either is acting out of a foreign branch. Importantly, end users do not have an affirmative

[1] The final rule has an effective date of 13 November 2020 and compliance date of no later than 14 September 2021.
[2] Group B swaps requirements mean the requirements set forth in §§ 23.202 and 23.501 through 23.504.
[3] Group C swaps requirements mean CFTC Rules 23.400 through 23.451 and 23.700 through 23.704.

obligation to determine which CFTC regulations apply to a particular transaction or whether the SD will instead avail itself of substituted compliance with non-U.S. regulations.

Determining U.S. person status

It is important for end users to understand whether they are "U.S. person," and if not to determine the applicable category of "non-U.S. person."

"U.S. person"

New CFTC Rule 23.23(a)(23) defines a U.S. person as:

- A natural person resident in the United States.
- A partnership, corporation, trust, investment vehicle, or other legal person organized, incorporated, or established under the laws of the United States or having its principal place of business in the United States.
- An account (whether discretionary or nondiscretionary) of a U.S. person.
- An estate of a decedent who was a resident of the United States at the time of death.

"Principal place of business" means the location from which the officers, partners, or managers of the legal person primarily direct, control, and coordinate the activities of the legal person. With respect to an externally managed investment vehicle, this location is the office from which the manager of the vehicle primarily directs, controls, and coordinates the investment activities of the vehicle.[4] Consistent with the U.S. Securities and Exchanges Commission's (SEC) definition of U.S. person, the CFTC noted that the principal place of business for a collective investment vehicle (CIV) would be in the United States if the senior personnel responsible for the implementation of the CIV's investment strategy are located in the United States, depending on the facts and circumstances that are relevant to determining the center of direction, control, and coordination of the CIV.

Notably, the CFTC dropped the previously used majority ownership by U.S. persons test. In addition, whether a pool, fund, or other CIV is publicly offered only to non-U.S. persons and not offered to U.S. persons is not relevant in determining whether it falls within the scope of the "U.S. person" definition under the final rule.

Non-U.S. person categories

If you are not a "U.S. person," there are further categorizations to consider. The final rule introduces a new type of non-U.S. person, "significant risk subsidiary" (SRS),[5] and sets forth other categories of "Non-U.S. person," such as U.S. branch, guaranteed entity, other non-U.S. person, and SRS end user.

"Guaranteed entity" refers to a non-U.S. person whose swaps are guaranteed by a U.S. person, but only with respect to the swaps that are so guaranteed. Importantly, a non-U.S. person may be a guaranteed entity with respect to its swaps with certain counterparties (but not others)

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[4] See CFTC Rule 23.23(a)(23)(ii). The CFTC notes its interpretation is consistent with the Supreme Court's decision in *Hertz Corp. v. Friend*, which described a corporation's principal place of business, for purposes of diversity jurisdiction, as the "place where the corporation's high level officers direct, control, and coordinate the corporation's activities." (559 U.S. 77, 80 (2010)). We note further that the CFTC stated it may amend the definition of cross-border margin rule, which currently considers activities such as the formation of the CIV as relevant to its U.S. person status.

[5] "Significant risk subsidiary" means any non-U.S. significant subsidiary of an ultimate U.S. parent entity where the ultimate U.S. parent entity has more than US$50 billion in global consolidated assets, as determined in accordance with U.S. Generally Accepted Accounting Principles at the end of the most recently completed fiscal year, but excluding non-U.S. subsidiaries that are subject to consolidated regulation by U.S. bank regulators or comparable oversight in their home country, including capital and margin requirements for uncleared swaps that the CFTC has found comparable.

depending on the nature of the trading relationships. "Other Non-U.S. person" means a non-U.S. person that is neither a guaranteed entity nor an SRS.

Depending on an entity's corporate structure and financial relationships, a single entity could be both a guaranteed entity and an SRS and it could be a guaranteed entity for certain of its swaps and an other non-U.S. person for others. "SRS end user" is an SRS that is neither an SD nor a guaranteed entity.

Requirement to obtain each counterparty's U.S. person status

If you have already made a "U.S. person" or "guarantee" status representation to an SD, the SD is permitted to continue to rely on that representation until **31 December 2027**. Reliance on prior representations is only permitted for representations obtained prior to 13 November 2020 (the final rule effective date).

Nevertheless, the CFTC stated that "best practice is to obtain updated representations as soon as practicable."[6] Accordingly, it is possible that SDs will be proactive in contacting end users to obtain updated U.S. person status representations. End users should be prepared to provide SDs with updated U.S. person representations, as well as new representations for documentation entered into after 13 November 2020 in accordance with the final rule. There is not yet a market-standard form of representation that corresponds to the final rule's definition, so forms of request may vary by SD.[7]

The new SRS category does not have an analogue in any of the CFTC's previous cross-border regulations. The CFTC acknowledged that this new definition may result in SDs having to re-document whether their counterparties are significant risk subsidiaries and that this could lead to an additional ISDA protocol.

Registration implications for cross-border swap dealing activity

For end users whose swap activity is not limited to hedging, the final rule is also relevant for determining which cross-border transactions count toward the registration threshold for SD registration. Commodity Exchange Act section 1a(49) defines the term "swap dealer" to include any person that: (1) holds itself out as a dealer in swaps; (2) makes a market in swaps; (3) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or (4) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps, known as swap dealing activity.[8] The definition of "swap dealer" in CFTC Rule 1.3 provides that a person shall not be deemed to be an SD as a result of its swap dealing activity involving counterparties unless, during the preceding 12 months, the aggregate gross notional amount of the swaps connected with those dealing activities exceeds the de minimis threshold of US$8 billion (except with regard to swaps with special entities for which the threshold is US$25 million).

While all swap dealing activity of a U.S. person counts toward the de minimis threshold, whether a non-U.S. person needs to include a swap in its de minimis threshold calculation depends on the non-U.S. person's categorization, the status of its counterparty, and, in some cases, the jurisdiction in which the non-U.S. person is regulated. For example, all swap dealing activity of a guaranteed entity or SRS counts toward the de minimis threshold. When an other non-U.S. person enters into swaps executed anonymously on a registered or exempt swap execution

[6] See e.g., 85 FR 178 at 56938.

[7] ISDA, who often creates market-standard forms of representation letters, has publicly stated that this timing gives "derivatives users and third-party service providers insufficient time to make the necessary changes to their systems" and has called on the CFTC to provide relief.

facility, designated contact market, or registered foreign boards of trade, such transactions do not count toward the de minimis threshold.

What should I do now?

- Determine the U.S. person status of entities in your corporate group that engage in derivatives activities.
- For end users whose derivatives activity is not limited to hedging, begin to quantify whether the final rule's revised counting methodology affects your reliance on the de minimis exemption to SD registration.

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