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GLOBAL CONNECTION

September 2011

Issues Regarding the Extraterritorial Reach of U.S. Swap Regulation

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Title VII — the Wall Street Transparency and Accountability Act of 2010—of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") contains a variety of provisions that regulate or require agency action to regulate swaps and the swap markets, generally through amendments to the Commodities Exchange Act (the "CEA") and the Securities Exchange Act of 1934 (the "Exchange Act"). In very broad terms, a typical swap is an agreement between counterparties to exchange payments on regular future dates, with the payments of each party calculated on a different basis. In an interest rate swap, for example, one party may agree to make payments based on a fixed interest rate and the other based on a floating rate. This allows the parties to

hedge against exposure to fluctuating interest rates or to speculate on such fluctuations. The Dodd-Frank Act includes a definition of swap that is much broader than this typical scenario, however, and is intended to cover the entire spectrum of derivatives trading. A security-based swap is generally defined as a swap that is based on a security or loan or a narrow-based security index or the occurrence or non-occurrence of an event relating to an issuer of a security or the issuers of a narrow-based security index.

Swap dealer and major swap participant status (as well as security-based swap dealer and major security-based swap participant status) are concepts created under the Dodd-Frank Act. Generally, swap dealers and security-based swap dealers are entities that make a market in swaps or security-based swaps, subject to de minimis exceptions, while major swap participants and major security-based swap participants are entities whose activities in the swap or security-based swap markets could pose a high degree of risk to the U.S. financial system. Section 712(d) of the Dodd-Frank Act requires rulemaking by the Commodity Futures Trading Commission (CFTC) and the Securities Exchange Commission (SEC) to, among other things, further define relevant terminology, including swap, security-based swap, swap dealer, security-based swap dealer, major swap participant and security-based swap participant. The CFTC and SEC have issued multiple proposals to address these definitions but have not yet issued final rules. The final definitions are fundamental to the entire regulatory scheme, however, as persons who are swap dealers, security-based swap dealers, major swap participants or major security-based swap participants may be subject to significant regulation, including requirements for, among other things, registration, margin, capital, recordkeeping, risk management and other business conduct.

Title VII contains several provisions that limit the Dodd Frank Act's extraterritorial reach. Section 722(d), for example, provides that the provisions of the CEA relating to swaps that were enacted by Title VII and rules promulgated under such provisions shall not apply to activities outside the U.S. unless 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 or promulgate as are necessary or appropriate to prevent the evasion of any provision of the CEA enacted by Title VII. Section 772(c) amends the Exchange Act to provide for a similar limitation. Other provisions direct regulators to consider foreign regulation or consult with foreign regulators in implementing certain provisions of Title VII. See e.g., Section 725(b) and Section 113(f).

In response to requests for comment on various definitional and rulemaking proposals to implement the required swap regulatory regime, foreign banks and other foreign entities have argued that U.S. regulation of foreign entities and transactions under the Dodd-Frank Act should be extremely limited. For example, in one comment letter, three major Japanese banks noted that regulators in a variety of foreign countries are currently working to set high, internationally consistent, coordinated and non-discriminatory

requirements for the derivatives markets. They expect that by December 31, 2012, Japanese banks engaged as swap dealers will be subject to comprehensive regulation under Japanese law extending to all branches engaging in swap dealing activities, including their U.S. branches. This has the potential to render U.S. overlapping regulation superfluous and potentially conflicting. They seek at least a deferral of U.S. regulation of foreign entities, including U.S. branches of foreign banks, until December 31, 2012 to facilitate coordination among national authorities in the U.S., Japan and other relevant jurisdictions. These banks also argue that U.S. agencies should not regulate a home country-regulated foreign swap dealer whose activities in the U.S. are restricted to transactions with U.S. based swap dealers because regulation of the U.S. entity alone will be sufficient to achieve the desired reduction of systemic risk to the U.S. financial system.

In another comment letter, an investment management division of a European bank expressed concerns about principles of international comity, the interests of foreign regulators in the regulation of their home markets and practical limitations on the ability of the U.S. regulators to monitor activity and enforce U.S. laws and standards outside the United States. This entity argued that non-U.S. based swap market participants who engage in swap transactions outside the U.S. in jurisdictions with their own derivatives' regulatory schemes, even transactions with branches and affiliates of U.S. banks and other U.S. entities, should be subject only to local laws in jurisdictions where the transactions are effected in order to avoid creating competing and potentially contradictory regulation and confusion among market participants and competitive disadvantage to U.S. banks and dealers in foreign markets.

Various commenters have argued that the regulators should exclude positions with non-U.S. entities for purposes of substantial position and counterparty credit exposure calculations for determining major swap participant and major security-based swap participant status and that subsidiaries and affiliates of U.S. banks should not fall within the definitions of swap dealer, security-based swap dealer, major swap participant and major security-based swap participant merely because of such affiliations to the extent that their operations take place with non-U.S. persons outside of the United States. Foreign banks have argued that the CFTC and SEC will need to establish regulatory categories and regimes that are acceptable to foreign prudential regulators who may be concerned with how the U.S. regulators would apply their regulatory authority to overseas activities. Various banks have suggested different approaches containing more or less specificity. Generally, however, they argue that the reach of Title VII should only apply to a well-defined U.S. subpart of a foreign bank’s global derivatives business.

Whatever definitional and registration boundaries are ultimately set for foreign entities, the most critical goal is to clarify the jurisdictional reach of U.S. swap regulation as early as possible to allow foreign entities the long lead time necessary to establish the systems and procedures for compliance with the developing regulatory regimes in the

U.S. and home country jurisdictions and to restructure their global swaps business activities to allow such compliance.

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