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K&L Gates LLP
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—By Cary J. Meer, Lawrence B. Patent, and Leeron Avnery

Recent CFTC Guidance Regarding Cross-Border Swaps Relating to Collective Investment Vehicles

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) amended the Commodity Exchange Act (CEA) to establish comprehensive regulation of swaps by the Commodity Futures Trading Commission (CFTC).[1] On July 12, 2013, the CFTC adopted interpretive guidance regarding the cross-border application of the swaps provisions of Dodd-Frank (Guidance).[2] Among other things, the Guidance provides a definition of the term "U.S. person," effective as of October 9, 2013, to be used in the context of Section 2(i) of the CEA.[3] This column focuses on the Guidance's definition of U.S. person as it relates to collective investment vehicles.[4]

I. Definition of U.S. Person

The Guidance provides an eight-prong definition of the term U.S. person, of which prongs (iii) and (vi) are most relevant to collective investment vehicles. Prong (iii) includes vehicles organized or incorporated, or having their principal place of business, in the United States, and prong (vi) includes those that are majority owned by other U.S. persons, with one exception discussed below.

A. Principal Place of Business

With respect to a collective investment vehicle, the Guidance states that the determination of its principal place of business (or "nerve center") should focus upon the location of the senior personnel responsible either for (1) formation and promotion, or (2) implementation of investment strategy, each of which is considered a key function of the vehicle.[5] This applies without regard to the senior personnel's employment arrangements with the vehicle[6] and regardless of the location or nationality of the investors in the vehicle.[7]

B. Majority Owned by U.S. Persons

The other element of the U.S. person definition relevant to collective investment vehicles, prong (vi), involves the ownership of the vehicle in question. Under this factor, any collective investment vehicle that is majority-owned by one or more U.S. persons would be a U.S. person.[8] "Majority-owned" is defined in the Guidance as the beneficial ownership of more than 50 percent of the equity or voting interests in the collective investment vehicle.[9] Whether the vehicle is majority-owned by

U.S. persons is first determined by whether its direct beneficial owners are U.S. persons, as described in other prongs of the definition.[10] Second, there must be a "look through" to the beneficial ownership of any other legal entity invested in the vehicle that is controlled by or under common control with the vehicle.[11] This "look through" requirement applies in the case of a registered investment company's controlled foreign corporation and in any registered or unregistered collective investment vehicle's master-feeder fund structure.[12] However, this requirement does not apply to entities that are not controlled by or under common control with the collective investment vehicle, so it should not apply to an offshore affiliate of a U.S. foundation or endowment or an unaffiliated fund of funds.[13]

The Guidance specifically provides an exception to the majority ownership test to exclude, from the definition of U.S. person, publicly-offered funds that are not offered in the United States, as opposed to publicly-traded, collective investment vehicles.[14] Thus, a collective investment vehicle that is publicly offered to non-U.S. persons, but not offered, publicly or privately, to U.S. persons (that is, most UCITS funds), generally would not be considered a U.S. person.[15] This exclusion was intended to respond to comments that publicly-traded funds are only a subset of non-U.S. regulated collective investment vehicles and that verifying ownership would be challenging for pools, funds, and other collective investment vehicles that are publicly offered.[16] Furthermore, a collective investment vehicle that is publicly offered only to non-U.S. persons and not offered, publicly or privately, to U.S. persons generally would not be considered a U.S. person.[17]

II. Significance of the Guidance

The definition of U.S. person contained in the Guidance may have a significant impact on collective investment vehicles that trade cross-border swaps. Primarily, because transactions with U.S. persons count against a swap dealer's (SD) *de minimis* threshold,[18] if a counterparty on the sell side of a transaction would like to avoid SD classification under Dodd-Frank, the counterparty may request a representation that the collective investment vehicle is not a U.S. person under the CEA. If the collective investment vehicle is a U.S. person, then Dodd-Frank transaction level requirements will apply.[19]

The following scenarios are discussed in the Guidance and are particularly relevant to collective investment vehicles:

- If the collective investment vehicle is a *U.S. person*, and the counterparty to the transaction is a SD or major swap participant (MSP), whether a U.S. or non-U.S. person, Dodd-Frank applies. However, concurrent with the Guidance, CFTC's Division of Swap Dealer and Intermediary Oversight (DSIO) issued No-Action Letter No. 13-45[20] to permit an SD or the foreign branch of a US SD located in the EU and subject to the European Market Infrastructure Regulation (EMIR) to follow certain provisions of EMIR deemed to be "essentially identical" to US law.[21]
- If the collective investment vehicle is a *U.S. person*, and the counterparty to the transaction is a non-SD or non-MSP, whether a U.S. or non-U.S. person, only certain requirements would apply, including: clearing, trade execution, real-time public reporting, large trader reporting, swap transaction data reporting to the SDR, and swap data recordkeeping.[22] The collective investment vehicle may wish to avoid entering into swaps with a non-U.S. non-SD/MSP, because, as the only U.S. person involved, the collective investment vehicle would be the reporting party for the swap transaction data and real-time reporting.
- If the collective investment vehicle is a *non-U.S. person*, swaps with a U.S. SD or MSP are subject to CFTC transaction level requirements, but the collective investment vehicle would generally only have recordkeeping and, if applicable, large trader reporting requirements, because the SD or MSP would be the reporting party.[23]
- If the collective investment vehicle is a *non-U.S. person*, swaps with a foreign branch of a U.S. bank that is an SD or MSP will be subject to CFTC "Category A" transaction level requirements (everything but the external business conduct standards),

but that branch may be able to comply by "substituted compliance" (that is, complying with the laws of the foreign jurisdiction), if the CFTC determines that foreign laws are "comparable and comprehensive" when reviewed against US law.[24] Again, as the "buy side," the collective investment vehicle would generally only have recordkeeping and, if applicable, large trader reporting requirements. Even if the foreign branch were located outside of those jurisdictions that have applied for a determination of comparability to Dodd-Frank (Australia, Canada, the European Union, Hong Kong, Japan, or Switzerland), substituted compliance would still be available if (1) the aggregate notional value of the swaps of all of that U.S. bank SD's foreign branches in those other foreign jurisdictions does not exceed five percent of the aggregate notional value of all of the swaps of that U.S. SD, and (2) the U.S. SD maintains records with supporting information to verify that the first condition is satisfied, as well as to identify, define, and address any significant risk that may arise from not applying Dodd-Frank.[25]

- If the collective investment vehicle is a *non-U.S. person*, and the counterparty to the transaction is a U.S. person, but is not a registered SD or MSP, then only certain requirements may apply, including: clearing, trade execution, real-time public reporting, large trader reporting, swap data transaction reporting to the SDR, and swap data recordkeeping.[26]
- If the collective investment vehicle is a *non-U.S. person* and is *not guaranteed* by a U.S. person, and the counterparty to the transaction is also a non-U.S. person, Dodd-Frank does not apply.[27]

The determination that a collective investment vehicle is a U.S. person does not necessarily mean that its operator cannot qualify for exemption from CPO registration under CFTC Regulation 4.13(a)(3);[28] conversely, a collective investment vehicle that is not a U.S. person may still be required to have its operator register as a CPO if U.S. investors have invested in the vehicle and the vehicle trades commodity interests in excess of the *de minimis* limits in CFTC Regulation 4.13(a)(3). This is a deviation from the proposed guidance, which would have deemed every collective investment vehicle whose operator had to register as a CPO to be a U.S. person.[29] Notably, the meaning of U.S. person for Dodd-Frank purposes differs from the definition of U.S. person in CFTC Regulation 4.7, which provides an exemption from certain reporting and recordkeeping requirements for registered CPOs and registered commodity trading advisors with respect to funds owned solely by, and advice to, qualified eligible persons.[30] The Guidance also makes clear that the U.S. person definition in the Guidance only applies to swap regulation under Title VII of Dodd-Frank, and not to other CEA provisions or regulations thereunder.[31]

III. Conclusion

Dodd-Frank amended the CEA to establish comprehensive regulation of swaps by the CFTC. The Guidance provides an interpretation of the term "U.S. person" as it is used in the context of Dodd-Frank, which may have a significant impact on both foreign and domestic collective investment vehicles that engage in cross-border swaps transactions. Entities that wish to avoid being subject to Dodd-Frank must, therefore, structure their operations and the persons whom they permit to invest in their collective investment vehicles to avoid being classified as U.S. persons. In addition, they must be mindful whether the counterparties on their swaps transactions are U.S. persons. In any event, due to the CFTC's leading role in setting the agenda for swap regulation on a worldwide basis, it is likely that, whatever regulatory framework applies to a particular transaction and whoever the parties may be, the regulations that apply will at least be comparable to those adopted by the CFTC under Dodd-Frank.

Notes

1. *See* Title VII of Dodd-Frank, 124 Stat. 1376 (2010).

2. *Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations*, 78 Fed. Reg. 45,291 (July 26, 2013).

3. *See Exemptive Order Regarding Compliance with Certain Swap Regulations*, 78 Fed. Reg. 43,785, at 43,787

(July 22, 2013); 7 U.S.C. § 2(i) (the provisions of the CEA relating to swaps do not apply to activities outside the United States unless those activities have a "direct and significant connection with activities in, or effect on, commerce of the United States").

4. The Guidance defines a collective investment vehicle as "an entity or group of related entities created for the purpose of pooling assets of one or more investors and channeling these assets to trade or invest to achieve the investment objectives of the investor(s), rather than being a separate, active operating business." Guidance, 78 Fed. Reg. at 45,309.

5. *Id.*

6. *Id.*, at 45,310, note 201. Senior personnel, therefore, may be direct employees or independent contractors of the collective investment vehicle, or have some other employment arrangement with the vehicle. *Id.*

7. *Id.*, at 45,310.

8. *Id.*, at 45,313.

9. *Id.*

10. *Id.* These other prongs include: (i) any natural person who is a resident of the United States; (ii) an estate of a decedent who was a resident of the United States at the time of death; (iii) companies organized or incorporated under the laws of a state or other jurisdiction in the United States or having their principal place of business in the United States, and their pension plans, unless the plan is primarily for the benefit of foreign employees of such entity; and (iv) 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 jurisdiction over the administration of the trust.

11. *Id.*

12. *Id.*

13. *Id.* ("where a collective investment vehicle is owned in part by an unrelated investor collective investment vehicle, the collective investment vehicle need not 'look through' the unrelated investor entity, but may reasonably rely upon written, bona fide representations from the unrelated investor entity regarding whether it is a U.S. person, unless the investee collective investment vehicle has reason to believe that such unrelated investor entity was formed or is operated principally for the purpose of avoiding looking through to the ultimate beneficial owners of that entity.").

14. *Id.*, at 45,314. Note 224 states that "a [Undertakings for Collective Investment in Transferable Securities (UCITS)] would not be included in the term 'U.S. person,' provided it is not offered, directly or indirectly, to U.S. persons." *Id.*, note 224. Therefore, if a UCITS makes a private placement to U.S. investors, and the U.S. investors own a majority of the fund, that vehicle would likely be deemed a U.S. person.

15. *Id.*, at 45,314.

16. *Id.*

17. *Id.*

18. On May 23, 2012, the CFTC and Securities and Exchange Commission published joint rules regarding the *de minimis* threshold for SDs, among other things. *See Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant,"* 77 Fed. Reg. 30,596, at 30,626-43 (May 23, 2012).

19. The transaction-level requirements apply on a transaction-by-transaction basis and include the following: (i) required clearing and swap processing; (ii) margining and segregation for uncleared swaps; (iii) trade execution; (iv) swap trading relationship documentation; (v) portfolio reconciliation and compression; (vi) real-time public reporting; (vii) trade confirmation; (viii) daily trading records; and (ix) external business conduct standards. In addition, requirements pertaining to recordkeeping, large trader reporting, and swap transaction data reporting to a swap data repository (SDR), will apply.

20. The letter is dated July 11, 2013.

21. The provisions of EMIR deemed to be essentially identical are requirements related to confirmation, portfolio reconciliation, portfolio compression, and trading relationship documentation. DSIO's letter states that it may consider similar relief with respect to other jurisdictions.

22. Guidance, 78 Fed. Reg. at 45,361-63 and 45,370.

23. *Id.*, at 43,350-51 and 43,369.

24. *Id.*, at 45,353.

25. *Id.*, at 45,351.

26. *Id.*, at 45,361.

27. *Id.*, at 45,359.

28. Regulation 4.13(a)(3) provides an exemption from CPO registration for operators of pools that limit their commodity interest trading to meet one of two tests. Under the first limit, the initial margin and premiums required to establish commodity interest positions cannot exceed 5% of the fund's net asset value (NAV). The alternative limit provides that the aggregate net notional value of the fund's commodity interest positions cannot exceed 100% of the fund's NAV. Either test must be satisfied whenever a new commodity interest position is entered into.

29. Guidance, 78 Fed. Reg. at 45,314.

30. *See* 17 C.F.R. § 4.7.

31. Guidance, 78 Fed. Reg. at 45,316.