

# DEFERENCE AND COMITY: CFTC APPROVES CROSS-BORDER SWAPS FINAL RULE

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## Asset Management and Investment Funds Alert

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## INTRODUCTION

The Commodity Futures Trading Commission (CFTC or Commission) recently voted 3–2 to approve a final rule (Final Rule) on the cross-border application of certain swap provisions under the Commodity Exchange Act (CEA).<sup>1</sup> The Final Rule adopts a risk-based approach to the cross-border application of the CEA's swap provisions while also deferring substantially to foreign regulators. The Final Rule was published in the *Federal Register* on 14 September 2020 and will become effective on 13 November 2020.<sup>2</sup> When publishing the Final Rule, the CFTC noted that “[t]he Final Rule supports a cross-border framework that promotes the integrity, resilience, and vibrancy of the swap market while furthering the important policy goals of the Dodd-Frank Act.”<sup>3</sup> The CFTC also expressed its intent that the Final Rule provide a “critical measure of regulatory certainty for the global swaps markets” and represent a “sensible and principled approach to addressing when foreign transactions should fall within the CFTC's swap entity registration and related requirements.”

## PRACTICAL CONSIDERATIONS

- While the Final Rule will become effective on 13 November 2020 (Effective Date), the date of compliance is 14 September 2021 (Compliance Date). Swaps entered into prior to the Compliance Date are not subject to the Final Rule. Market participants may rely on the exceptions in the Final Rule after the Effective Date, as long as they also comply with recordkeeping requirements.
- The CFTC expects the Final Rule to result in limited additional compliance costs for market participants.<sup>4</sup>
- The definition of “U.S. Person” is consistent with the definition adopted by the Securities and Exchange Commission (SEC).<sup>5</sup> As a result, whether a person is a U.S. Person will generally be consistent under both the SEC's and CFTC's rules.
- The new U.S. Person definition does not include a commodity pool, pooled account, investment fund, or other collective investment vehicle (CIV) that is majority-owned by one or more U.S. Persons.
- The Final Rule will require Major Swap Participant (MSP) thresholds to be calculated in largely the same manner as Swap Dealer (SD) thresholds are calculated.

## CFTC INTERPRETATION OF STATUTORY AUTHORITY SUPPORTING EXTRATERRITORIAL APPLICATION

Section 2(i) of the CEA states that the swap provisions of Title VII 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 or regulations as the Commission may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of Title VII of the Wall Street Transparency and Accountability Act of 2010.<sup>6</sup>

In the Final Rule, the CFTC expressed its view that while Section 2(i) provides it express authority over swap activities outside the United States when certain conditions are met, it is not required to extend its reach to the outer bounds of that authorization. However, when exercising its authority with respect to swap activities outside the United States, the CFTC stated that it will be guided by international comity principles and will focus its authority on potential significant risks to the U.S. financial system.<sup>7</sup>

## CROSS-BORDER APPLICATION OF SD REGISTRATION THRESHOLD

The CEA requires registration of an SD,<sup>8</sup> but it exempts entities engaged in a *de minimis* quantity of swap dealing transactions, currently set at US\$8 billion (over the course of the immediately preceding 12 months) except for endowments and other “special entities.”<sup>9</sup> The Final Rule describes how the *de minimis* threshold applies to the cross-border swap dealing transactions of U.S. Persons and Non-U.S. Persons and, specifically, identifies an entity’s cross-border dealing activities that should be included in its *de minimis* threshold.<sup>10</sup>

3. A *U.S. Person* is required to include all of its swap dealing transactions, including those of its foreign branches in its *de minimis* threshold calculation without exception;
4. A *Non-U.S. Person* that is guaranteed by a U.S. Person (a *Guaranteed Entity*) or a *Significant Risk Subsidiary* (SRS) (the definition of SRS is discussed below) is required to include all of its swap dealing transactions in its *de minimis* threshold calculation; and
5. A *Non-U.S. Person* that is neither a *Guaranteed Entity* nor an SRS (collectively referred with its U.S. branches as an *Other Non-U.S. Person*) is subject to special provisions.
  - a. An *Other Non-U.S. Person* includes swap dealing transactions with a U.S. Person or a *Guaranteed Entity* in its *de minimis* threshold calculation, except for swaps conducted through a foreign branch of a registered SD.
  - b. However, an *Other Non-U.S. Person* may exclude swap dealing transactions with a *Guaranteed Entity* where (i) the *Guaranteed Entity* is guaranteed by a nonfinancial entity, or (ii) the *Guaranteed Entity* is itself below the *de minimis* threshold and is affiliated with a registered SD.

Please see Table A in the Appendix for a summary of the application of the *de minimis* threshold to various cross-border swap dealing transactions.

## DEFINITIONS: U.S. PERSON, SRS, AND OTHER KEY TERMS

The Final Rule includes a total of 24 definitions, including for “Guarantee,” “Foreign-based swap,” and “Swap conducted through a foreign branch.”

Of particular importance, the definition of “U.S. Person” provides more certainty than prior guidance and is consistent with the definition adopted by the SEC. Under the Final Rule, “U.S. Person” means:

6. A natural person resident in the United States;
7. 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;
8. An account (whether discretionary or nondiscretionary) of a U.S. Person; or
9. An estate of a decedent who was a resident of the United States at the time of death.

Importantly, the new U.S. Person definition does not include a commodity pool, pooled account, investment fund, or other CIV that is majority-owned by one or more U.S. Persons. Here, the Commission stated that it “continues to believe that identifying and tracking a CIV’s beneficial ownership may pose a significant challenge, particularly in certain circumstances such as fund-of-funds or master-feeder structure.”<sup>11</sup> The Commission further noted that “although the U.S. participants in such CIVs may be adversely affected in the event of a counterparty default, the Commission has determined that the majority ownership test should not be included in the definition of ‘U.S. person.’”<sup>12</sup> However, the Commission recognized that a CIV fitting within the majority U.S. ownership prong may still be a U.S. Person for purposes of the margin for uncleared swaps rule.<sup>13</sup>

The Final Rule replaces the concept of a “conduit affiliate” from prior CFTC guidance with that of an SRS, which is generally defined as “any non-U.S. significant subsidiary of a 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. GAAP at the end of the most recently completed fiscal year....” An SRS must be treated like a U.S. Person for regulatory purposes because of its potential to affect a U.S. parent entity and, generally, U.S. commerce.

## CROSS-BORDER APPLICATION OF MSP REGISTRATION THRESHOLD

The Final Rule will require the *de minimis* threshold for an MSP to be calculated in largely the same manner as the *de minimis* threshold for an SD, except with regard to swap positions with guarantees. MSP calculations for swap positions with guarantees will require that all swap positions subject to recourse must be attributed to the guarantor unless the guarantor, the Guaranteed Entity, and its counterparty are Other Non-U.S. Persons. The Commission’s methodology for formulating the *de minimis* threshold calculations for MSPs and SDs has been influenced by the scope of the Commission’s regulatory interest in certain swaps and the existence or nonexistence of certain mitigating factors.

Please see Table B in the Appendix for a summary of the application of the *de minimis* threshold to various cross-border MSP transactions.

## ANE TRANSACTIONS

Transactions involving a non-U.S. SD that uses personnel or agents located in the United States to “arrange, negotiate, or execute” the swaps (ANE Transactions) will not be considered for purposes of applying the Final Rule.<sup>14</sup> In making this determination, the CFTC agreed with commenters that:

10. ANE Transactions do not present a direct financial risk to the United States;
11. The CFTC's anti-fraud and anti-manipulation rules that would remain applicable would mitigate potential concerns associated with any potential misconduct occurring in connection with ANE Transactions and any other conduct subject to the jurisdiction of the CEA;
12. Most ANE Transactions are expected to be subject to foreign regulatory requirements similar to the CFTC's own, unlike at the time of the adoption of earlier guidance; and
13. Applying the CFTC's rules to ANE Transactions would likely result in disruptive and unnecessary market fragmentation, as transactions ordinarily arranged, negotiated, or executed by U.S. personnel would shift to non-U.S. locations, resulting in decreased CFTC oversight.<sup>15</sup>

However, the CFTC declined to take any additional action with respect to previous guidance on transaction-level requirements. Instead, the CFTC stated that until it issues new rules, the CFTC will not consider “a non-U.S. swap entity's use of their personnel or agents located in the United States to 'arrange, negotiate, or execute' swap transactions with non-U.S. counterparties for purposes of determining whether [the unaddressed transaction-level requirements] apply to such transactions.”<sup>16</sup>

## EXCEPTIONS FROM GROUP B AND GROUP C REQUIREMENTS, SUBSTITUTED COMPLIANCE FOR GROUP A AND GROUP B REQUIREMENTS, AND COMPARABILITY DETERMINATIONS

In the interests of international comity, the CFTC has provided exceptions from, and a substituted compliance for, certain regulations applicable to registered SDs and MSPs. Please see Table C and Table D in the Appendix for a summary of these exceptions.

## LOOKING AHEAD

The CFTC continues to implement Chairman Heath Tarbert's rulemaking agenda despite the impact of COVID-19 and related government actions. The Final Rule is the latest example of how the CFTC is continuing to reconsider how to best regulate derivatives inside the United States and in the global marketplaces to promote liquidity and transparency and to protect U.S. investors. During Chairman Tarbert's leadership, the CFTC has taken action on a number of key derivatives issues, including position limits,<sup>17</sup> enforcement penalty guidance, swap data reporting, and bankruptcy rules.<sup>18</sup> In addition, the CFTC is expected to finalize proposed rules on these topics in the coming months, and consequently, these rules could greatly impact market participants. K&L Gates' global futures and derivatives team will continue to monitor these developments over this critical period and welcomes the opportunity to assist market participants in the navigation of these developments.

## APPENDIX

Click [here](#) for more information on the following:

- Table A: Cross-Border Application of the SD *De Minimis* Threshold
- Table B: Cross-Border Application of the MSP Threshold
- Table C: Cross-Border Application of the Group B Requirements in Consideration of Related Exceptions and Substituted Compliance
- Table D: Cross-Border Application of the Group C Requirements in Consideration of Related Exceptions

## FOOTNOTES

<sup>1</sup> See Press Release, CFTC, Release No. 8211-20, [CFTC Approves Final Cross-Border Swaps Rule and an Exempt SEF Amendment Order at July 23 Open Meeting](#), (July 23, 2020).

<sup>2</sup> See [Cross-Border Application of the Registration Thresholds and Certain Requirements Applicable to Swap Dealers and Major Swap Participants](#), 85 Fed. Reg. 56,924 (Sept. 14, 2020).

<sup>3</sup> *Supra* note 2, at 56,926.

<sup>4</sup> *Id.*

<sup>5</sup> See [SEC, Application of “Security-Based Swap Dealer” and “Major Security-Based Swap Participant” Definitions to Cross-Border Security-Based Swap Activities](#); Republication, 79 Fed. Reg. 47,277 (Aug. 12, 2014).

<sup>6</sup> See 7 U.S.C. § 2 – Jurisdiction of Commission; liability of principal for act of agent; Commodity Futures Trading Commission; transaction in interstate commerce.

<sup>7</sup> See *supra* note 4, at 56,928.

<sup>8</sup> See 7 U.S.C. § 6s(a). The CEA defines the term “SD” as any person who (i) holds itself out as a dealer in swaps, (ii) makes a market in swaps, (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account, or (iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps; provided, however, in no event shall an insured depository institution be considered to be a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer. The term “swap dealer” 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 a regular business.

<sup>9</sup> The *de minimis* threshold with regard to swaps with special entities is set at \$25 million. 17 C.F.R. § 1.3, Swap dealer, paragraph (4)(i)(A). A special entity is: “1) a Federal agency; 2) a State, State agency, city, county, municipality, or other political subdivision of a State, or any instrumentality, department, or a corporation of or established by a State or political subdivision of a State; 3) any employee benefit plan subject to Title I of the Employee Retirement Income Security Act of 1974 (ERISA) (29 U.S.C. 1002); 4) any governmental plan, as defined in Section 3 of ERISA; 5) any endowment, including an endowment that is an organization described in Section 501(c)(3) of the Internal Revenue Code of 1986; or 6) any employee benefit plan defined in Section 3 of ERISA, not otherwise defined as a Special Entity, that elects to be a Special Entity by notifying an SD of its election prior to entering into a swap with the particular SD.” See [CFTC, Q & A – Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties Final Rulemaking](#).

<sup>10</sup> 17 C.F.R. § 23.23(b).

<sup>11</sup> *Supra* note 2, at 56,935–36.

<sup>12</sup> *Id.*

<sup>13</sup> *Supra* note 2, at 56,936.

<sup>14</sup> *Id.*

<sup>15</sup> *Supra* note 2, at 56,963.

<sup>16</sup> *Id.*

<sup>17</sup> See Stephen M. Humenik et al., [The CFTC Once Again Proposes Position Limits for Energy Derivatives Related to Oil, Gas and Refined Products](#), K&L GATES (Mar. 20, 2020).

See also Press Release, [CFTC, Release No. 8287-20, CFTC Finalizes Position Limits Rule](#) at October 15 Open Meeting, (Oct. 15, 2020).

<sup>18</sup> See Stephen M. Humenik et al., [Undeterred CFTC Unanimously Approves Three Proposed Rules, Two Final Rules at First Virtual Open Meeting](#), K&L GATES (June 23, 2020).

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