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# CFTC Final Cross-Border Swaps Rule

28 - Sep - 2020

**CFTC Final Cross-Border Swaps Rule: changes to "U.S. Person" definition**

## The Short Read

The United States ("U.S.") Commodity Futures Trading Commission ("CFTC") final rule on the cross-border application of certain swap provisions under the U.S. Commodity Exchange Act[1] (the "CEA") (the "Final Rule") was published in the Federal Register on 14 September 2020.

Amongst other changes[2], the Final Rule replaces the previous definition of "U.S. Person" set out in the much-criticised Interpretative Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations[3] (the "Guidance"). Significantly, from a cross-border application perspective, the beneficial ownership prong is removed in respect of the CFTC requirements covered by the Final Rule. Previously, under the Guidance, a collective investment vehicle ("CIV") not organised, incorporated or established under the laws of the U.S. and not having its principal place of business in the U.S. was deemed to be a "U.S. Person" if it was majority-owned by other U.S. Persons. The amended "U.S. Person" definition under the Final Rule does away with this. Consequently, CIVs which were previously captured by the extra-territorial reach of the U.S. regulatory framework for swaps established by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Title VII" and the "Dodd Frank Act", respectively) solely due to the status of their beneficial owners, will now fall outside the ambit of such rules for such purposes. This change brings the Final Rule's U.S. Person definition into line with the U.S. Securities Exchange Commission's ("SEC") U.S. person definition.

A CIV which is majority-owned by U.S. Persons but would not otherwise qualify *itself* as a "U.S. Person" under the amended U.S. Person definition will therefore be spared compliance burdens and costs. For example, the time-consuming process of adherence to the International Swaps and Derivative Association, Inc.'s ("ISDA") August 2012 and March 2013 DF Protocols (the "ISDA DF Protocols") may no longer be necessary.

## The Full Read

*The Guidance – a Reminder*

The Dodd Frank Act enhanced the CFTC's regulatory authority to oversee the swaps[4] market and set out its extraterritorial jurisdiction. Section 2(i) of the CEA states that the swap provisions of the CEA enacted by Title VII will not apply to swaps activities outside of the U.S. unless such activities have a "direct and significant connection with activities in, or effect on, commerce of the United States".

On 26 July 2013, the CFTC finalised the Guidance, setting out a non-exhaustive definition of "U.S. Person" which would form much of the basis for determining the applicability of the CFTC rules to non-U.S. entities. One of the prongs of the "U.S. Person" definition in the Guidance (the "Majority Ownership Prong") was as follows:

> "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. person".

In which case, a CIV organised outside of the U.S., with no trading, investment management or decision-making function located in the U.S. would still be categorised as a "U.S. Person" under the Guidance if it was majority owned by "U.S. Persons".

The Majority Ownership Prong required non-U.S. CIVs to 'look through' to their underlying beneficial owners to determine what percentage of these were "U.S. Persons", to then be able to determine if the CIV itself was a "U.S. Person" pursuant to the Guidance. Two primary concerns relating to the Majority Ownership Prong have been as follows:

1. By virtue of being an open-ended CIV, underlying ownership of the CIV will typically change following each subscription and redemption cycle, which may result in a CIV being a "U.S. Person" at one month-end but not the next; thus making it difficult for CIV managers to make accurate status representations to counterparties and creating a practical burden and associated cost of identifying and tracking the beneficial owners; and

2. A CIV (located anywhere in the world) that is managed by an alternative investment fund manager authorised under the European Union Alternative Investment Fund Directive will be a 'financial counterparty' for the purposes of EMIR[5] and therefore subject to the European Union derivatives rules relating (*inter alia*) to clearing, margining and risk mitigation. If such a CIV is also deemed to be a "U.S. Person" as a result of its investor base, it will be subject to two derivatives regimes that may be (at best) duplicative or (at worst) irreconcilable.

That the Guidance was 'guidance' rather than a rule (and therefore did not follow the same involved processes and procedures that a rule making would be subject to) but was in fact effectively treated as a rule was the subject of much consternation and criticism at the time. Indeed, the Securities Industry and Financial Markets Association, ISDA and the Institute of International Bankers sued the CFTC in a failed attempt to have the Guidance vacated, on the basis that it constituted an improper rulemaking under the Administrative Procedures Act and the CEA[6].

*The Final Rule*

*Approach*

The CFTC was a 'first mover' in the attempt to implement the global swaps reforms agreed by the G20 leaders at the Pittsburgh G20 Summit in 2009. The Guidance allowed the CFTC to apply the U.S. rules on a wide-reaching extra-territorial basis. Perhaps unsurprisingly, the CFTC was accused by commentators of overreach in its attempts to regulate the swaps market outside of the U.S. and of a failure to co-operate with regulators in other jurisdictions, potentially leading to fragmented markets. CFTC Chairman Tarbert, in his Statement in Support of Final Cross-Border Swap Rule[7] (the "Statement"), stated that: "the CFTC's own cross-border guidance on swaps has caused concerns about a regulatory arms race and the balkanization of global financial markets".

CFTC Chairman Tarbert also noted in his Statement that the Guidance had caused international discord at the time it was introduced, and that in terms of international co-operation and deference, the CFTC has in recent years shifted away from their early approach of being "… the world's policeman for all swaps". He further notes in his Statement that the Final Rule is intended to represent a "levelheaded approach to the extraterritorial application" of the Title VII rules and that "it acknowledges the important role played by the CFTC's domestic and international counterparts in regulating parts of the global swaps markets".

In recent times, the CFTC has certainly adopted a more constructive and collaborative approach with other international regulators as well as seeking to achieve regulatory harmonisation where appropriate.

*Key Changes to "U.S. Person" Definition*

The Final Rule provides a narrower and exhaustive definition of what constitutes a "U.S. Person" as follows:

1. A natural person resident in the United States;

2. 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;

3. An account (whether discretionary or non-discretionary) of a U.S. person; or

4. An estate of a decedent who was a resident of the United States at the time of death.

Therefore, *inter alia*, the Final Rule has removed the Majority Ownership Prong from the definition of "U.S. Person" entirely. In doing so, the Final Rule notes that:

> "the [CFTC] is of the view that including majority-owned CIVs within the definition of "U.S. person" for the purposes of the Final Rule would likely cause more CIVs to incur additional programmatic costs associated with the relevant Title VII requirements and ongoing assessments, while not significantly increasing programmatic benefits given that the composition of a CIV's beneficial owners is not likely to have significant bearing on the degree of risk that the CIV's swap activity poses to the U.S. financial system. Although many of these CIVs have U.S. participants that could be adversely affected in the event of a counterparty default, systemic risk concerns are mitigated to the extent these CIVs are subject to margin requirements in foreign jurisdictions. In addition, the exposure of participants to losses in CIVs is typically limited to their investment amount, and it is unlikely that a participant in a CIV would make counterparties whole in the event of a default. Further, the [CFTC] 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 structures"[8].

In addition, the Final Rule has also provided some helpful clarification on determining the 'principal place of business' of an entity as set out in prong two of the definition of "U.S. Person". The 'principal place of business' is clarified to mean 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 CIV, this location would be the office from which the manager of the vehicle primarily directs, controls, and coordinates the investment activities of the CIV. Therefore, the Final Rule has also removed the provision in the Guidance which would otherwise classify a CIV as a "U.S. Person" if the senior personnel responsible for the formation and promotion of the CIV were located in the U.S.

For the purposes of the update to the definition of "U.S. Person", the Final Rule will be effective on 13 November 2020 (the "Effective Date"), with compliance with the requirements of the Final Rule required one year after the publication date, which means 14 September 2021.

*Important Limitation*

As noted in the accompanying Press Release[9], the Final Rule supersedes the Guidance but only with respect to the CFTC requirements covered by the Final Rule, which include documentation standards, risk mitigation and external business conduct requirements. In which

case, the Guidance will still be applied to the CFTC requirements under Title VII relating to mandatory clearing, mandatory trade execution, real-time public reporting, swap data repository reporting and large trader reporting requirements.

The Guidance relating to these requirements may be expected to be replaced in full by the Final Rule in due course.

*Harmonisation with Other Rules*

During 2016 the CFTC adopted the "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants – Cross-Border Application of the Margin Requirements"[10] (the "CFTC Cross-Border Margin Rules") which set out the rules relating to the exchange of initial and variation margin in respect of uncleared swaps for swap dealers and major swap participants that do not have a Prudential Regulator[11]. In a departure from the Guidance, in determining the extra-territorial reach of the CFTC Cross-Border Margin Rules, the CFTC defined a "U.S. Person" without reference to a Majority Ownership Prong. However, the 'principal place of business' prong of the "U.S. Person" definition in the CFTC Cross-Border Margin Rules is wider than that set out in the Final Rule (the CFTC Cross-Border Margin Rules generally consider the principal place of business of a CIV to be in the U.S. if the senior personnel responsible for the formation and promotion of the CIV are located in the U.S.) which may cause a CIV to be a "U.S Person" for margining purposes but not for other purposes. It is noted in the Final Rule that the CFTC may consider amending the "U.S. Person" definition in the CFTC Cross-Border Margin Rules in the future.

The SEC, in their equivalent cross-border rules for security-based swaps (the "SEC Cross-Border Swaps Rules")[12], did not include an equivalent to the Beneficial Ownership Prong for the purposes of the definition of "U.S. person" in the SEC Cross-Border Swaps Rules. That the "U.S. Person" definitions in the Final Rule and in the SEC Cross-Border Swaps Rules are now consistent, is a welcome development.

**AB Trading Advisors' View and Comment**

- It is common practice for CIVs and/or their managers to be required to make representations to swap dealer counterparts as to the CIV's "U.S. Person" status, either directly in trading documentation or via a cross-border representation side letter. Whilst the Final Rule permits counterparties to continue to rely on "U.S. Person" representations made under the Guidance or the CFTC Cross-Border Margin Rules prior to the Effective Date until 31 December 2027, the Final Rule also states that "best practice is to obtain updated representations as soon as possible" – so it is likely that swap dealers will require new representations in due course. However, swap dealers must obtain representations from client counterparts based on the Final Rule for counterparty relationships entered into after the Effective Date.
- The new suite of cross-border "U.S. Person" representations required by dealers is likely to be complicated. Dealers will require:

1. a "U.S. Person" representation in relation to the those matters covered by the Final Rule;
2. a "U.S. Person" representation in relation to the those matters still covered by the Guidance;
3. a "U.S. Person" representation in relation to the those matters covered by the CFTC Cross-Border Margin Rules; and
4. a "U.S. person" representation in relation to security-based swaps further to the SEC Cross-Border Swaps Rules.

Of course, further representations as to "U.S. Person" status (according to definitions of that term different to those under the Final Rule, the CFTC Cross-Border Margin Rules and the SEC Cross-Border Swaps Rules) will also be required in relation to other areas of U.S. legislation, including Regulation S, Regulation X and Section 1.1441-4(a)(3)(ii) of the U.S. Treasury Regulations.

- In order to enable a swap dealer to comply with (*inter alia*) its obligations pursuant to the CFTC's external business conduct rules, a "U.S. Person" CIV swap counterparty (per the Guidance definition) would frequently have been required to adhere to one or more of the ISDA DF Protocols or to incorporate equivalent provisions into the ISDA Master Agreement between the parties (although given the complexity and length of the ISDA DF Protocols, incorporating equivalent provisions was not common). Where the swap dealer is a U.S. swap dealer, adherence to the ISDA DF Protocols will still be required (by virtue of the status of the swap dealer). However, if adherence to the ISDA DF Protocols was necessary solely due to the "U.S Person" status of the CIV swap counterparty (and that status will now change as a result of the Final Rule), the CIV swap counterparty client may consider an approach to the swap dealer to explore the best way to address those now-unnecessary requirements. As it is not possible to revoke (in full or in part) adherence to the ISDA DF Protocols, a simple side letter disapplying the terms of the ISDA DF Protocols to the relationship, notwithstanding adherence, should be sufficient. Some swap dealers transposed the ISDA DF Protocols into a series of bilateral agreements (rather than requiring their counterparties to navigate the complexities of adherence to the ISDA DF Protocols via ISDA Amend) and the necessity for the continued application of any such bilateral arrangements should also be considered.

**The above material is provided in brief, summary form. It is provided for information purposes only and should not be taken to constitute legal advice. Professional legal advice should be obtained before taking or refraining from any action in relation to the contents of this email.**

[1] Available at: https://www.govinfo.gov/content/pkg/FR-2020-09-14/pdf/2020-16489.pdf

[2] Whilst, most notably, the Final Rule and the No-Action Letters issued at the same time also: (i) exclude transactions between two non-U.S. Persons 'arranged, negotiated or executed' by U.S. personnel from the U.S. regulatory requirements; (ii) establish new processes for comparability determinations and the associated standard of review; and (iii) extend the ability to rely on substituted compliance in certain circumstances, this *Briefs for the Buy side* only addresses the change to the "U.S. Person" definition.

[3] Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations 78 FR 45292 (Jul. 26, 2013). Available at: https://www.cftc.gov/sites/default/files/idc/groups/public/@lrfederalregister/documents/file/2013-17958a.pdf

[4] In this *Briefs for the Buy side*, a 'swap' transaction refers to a transaction which is subject to the CFTC's jurisdiction and should be distinguished from those "security based swaps" over which the SEC have jurisdiction.

[5] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (available at: https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ%3AL%3A2012%3A201%3A0001%3A0059%3AEN%3APDF), as amended from time to time including by EMIR REFIT (available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R0834&from=EN

[6] Sec. Indus. & Fin. Mkts. Ass'n., et al., v. CFTC, 13-CV-1916 slip op. (D.D.C. Sept. 14, 2014).

[7] Available at: https://www.cftc.gov/PressRoom/SpeechesTestimony/tarbertstatement072320b

[8] Section II.B.2(v) of the Final Rule

[9] Available at: https://www.cftc.gov/PressRoom/PressReleases/8211-20

[10] Cross-Border Margin Rules, 81 FR 34817 (May 31, 2016). Available at: https://www.federalregister.gov/documents/2016/05/31/2016-12612/margin-requirements-for-uncleared-swaps-for-swap-dealers-and-major-swap-participants-cross-border

[11] The Prudential Regulators are: The Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve, Comptroller of the Currency, Farm Credit Administration and Federal Housing Finance Agency.

[12] Application of "Security-Based Swap Dealer" and "Major Security-Based Swap Participant" Definitions to Cross-Border Security-Based Swap Activities; Republication, 79 FR 47278 (Aug. 12, 2014). Available at: https://www.govinfo.gov/content/pkg/FR-2014-08-12/pdf/R1-2014-15337.pdf