

**MEMO# 32682**

August 17, 2020

# CFTC Adopts Final Rule on Cross-Border Application of Swap Dealer and Major Swap Participant Requirements

[32682]

August 17, 2020 TO: ICI Members

Derivatives Markets Advisory Committee SUBJECTS: Derivatives RE: CFTC Adopts Final Rule on Cross-Border Application of Swap Dealer and Major Swap Participant Requirements

On July 23, the Commodity Futures Trading Commission (CFTC) adopted a final rule on the cross-border application of requirements applicable to swap dealers (SDs) and major swap participants (MSPs).[\[1\]](#) The final rule, which the CFTC proposed in January, supersedes its 2013 cross-border guidance with respect to the provisions adopted in the final rule.

The CFTC's final rule adopts:

- an interpretation of section 2(i) of the Commodity Exchange Act (CEA), the jurisdictional provision that limits applicability of the CEA's swap provisions only to activities outside of the US that have a "direct and significant connection" to the US;
- relevant definitions, including "US person";
- a revised jurisdictional approach to swap transactions "arranged, negotiated, or executed" by US-located personnel ("ANE transactions");
- exceptions and a substituted compliance process for certain entity-level and transaction-level regulations;
- a framework for comparability determinations with foreign jurisdictions that facilitates substituted compliance; and
- related SD and MSP recordkeeping requirements.

We have summarized below aspects of the final rule that are relevant or may be of interest to regulated funds.

## Definition of "US Person"

The CFTC adopted a definition of "US person" largely as proposed and consistent with (i) the SEC's definition of "US person" that it adopted in its 2014 cross-border rule; and (ii) the

CFTC’s own definition that it adopted in 2016 with respect to cross-border margin requirements for uncleared swaps.<sup>[2]</sup> Under the CFTC’s definition in this final rule, a “US person” would include, among others, “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” (emphasis added).

### ***Principal Place of Business***

Consistent with the SEC’s 2014 cross-border rule and its own 2016 cross-border margin rule, the CFTC defines “principal place of business” as “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 a collective investment vehicle (CIV),<sup>[3]</sup> the CFTC noted that determining the center of direction, control, and coordination of the CIV would depend on relevant facts and circumstances.

As applied to an externally managed investment vehicle, e.g., a non-US regulated fund with a US sub-adviser, this definition would capture the office location “from which the manager of the vehicle [including personnel employed by the CIV’s investment advisor or promoter] primarily directs, controls, and coordinates the investment activities of the vehicle.”<sup>[4]</sup>

The CFTC clarified an inconsistency between this adopted definition of “principal place of business” and the definition of “principal place of business” in its 2016 cross-border margin rule. In the 2016 rule, the CFTC stated that it also considers a CIV’s “principal place of business” to be in the US if the senior personnel responsible for the formation and promotion of the CIV are located in the US. In this final rule, however, the CFTC clarified that activities such as mere formation should not be determinative, absent an “ongoing role” by the person responsible for such activities in directing, controlling, and coordinating the CIV’s investment activities. Accordingly, the CFTC stated that it may in the future consider amending the “US person” definition in its 2016 rule.<sup>[5]</sup>

### ***Exclusion of Majority US Ownership Test for Collective Investment Vehicles***

Consistent with the SEC’s 2014 cross-border rule and the CFTC’s 2016 cross-border margin final rule, the “US person” definition in this final rule does not automatically include a commodity pool, pooled account, investment fund, or other CIV that is majority-owned by one or more US persons.<sup>[6]</sup> By omitting this explicit test to determine US person status—which was previously included in the 2013 guidance<sup>[7]</sup>—the CFTC adopted a view similar to the SEC that a CIV’s ownership composition unlikely has “significant bearing” on the level of risk that its swap activity poses to the US financial system. The CFTC also pointed out that other mitigating factors exist to alleviate those systemic risk concerns.<sup>[8]</sup> Further, the CFTC reiterated its belief that obtaining information about a CIV’s beneficial ownership would be difficult, particularly for fund-of-funds or master-feeder structures.<sup>[9]</sup> Nevertheless, the CFTC pointed out that a CIV with majority US ownership may still qualify as a “US person” if it is organized or has a “principal place of business” in the US, even if the CIV is publicly offered only to non-US persons.<sup>[10]</sup>

### ***Withdrawal of CFTC ANE Advisory No. 13-69 and CFTC No-Action Letter No. 17-36***

As part of the final rule, the CFTC withdrew Advisory No. 13-69 and related no-action relief letters, the former of which applied a broad range of transaction-level requirements<sup>[11]</sup> to ANE transactions, i.e., transactions between non-US SDs and counterparties that are not US

persons, where the non-US SD utilizes personnel or agents located in the US to arrange, negotiate, or execute the transaction.<sup>[12]</sup> Under the final rule's revised approach, an ANE transaction would be treated as a foreign transaction between two non-US persons, and therefore, subject to home regulator jurisdiction, not CFTC jurisdiction.<sup>[13]</sup> The CFTC cited several factors in revising its approach, including its oversight experience since 2013, international comity, and view that ANE transactions pose greater financial risk to other jurisdictions than to the United States.<sup>[14]</sup>

### ***Applicability of Transaction-Level Requirements to ANE Transactions***

Under the final rule's revised approach, certain SD and MSP transaction-level requirements that the CFTC re-designated under "Group B" and "Group C" would not apply to ANE transactions:<sup>[15]</sup>

- "Group B": requirements related to (i) swap trading relationship documentation; (ii) portfolio reconciliation and compression; (iii) trade confirmation; and (iv) daily trading records.
- "Group C": requirements regarding (i) external business conduct standards; and (ii) the elective initial margin segregation requirement.

Despite withdrawing Advisory 13-69, the CFTC did not formally extend this revised approach to a fourth group of transaction-level requirements that include mandatory clearing, mandatory trade execution, and real-time public reporting.<sup>[16]</sup> Instead, the CFTC stated that it would not apply these requirements to ANE transactions "as a matter of policy" and would address this issue in future cross-border rulemakings.<sup>[17]</sup> In support of this position and consistent with past no-action relief, Commission staff issued No-Action Letter No. 20-21 to provide relief for ANE transactions from these requirements until they are addressed in future rules.<sup>[18]</sup>

### **Substituted Compliance**

The final rule specifies where exceptions exist or where "substituted compliance" is otherwise available for the CFTC's entity-level and transaction-level requirements, *i.e.*, Groups A through C requirements. Of note is the CFTC's approach to Group C requirements—substituted compliance is not available, but certain exceptions may apply depending upon the classification of the counterparties under the CFTC's cross-border framework.

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#### **endnotes**

<sup>[1]</sup> Cross-Border Application of Registration Thresholds and Certain Requirements Applicable to Swap Dealers and Major Swap Participants (July 23, 2020) ("2020 CFTC Cross-Border Rule"), available at <https://www.cftc.gov/media/4346/votingdraft072320/download>.

<sup>[2]</sup> Application of "Security-Based Swap Dealer" and "Major Security-Based Swap Participant" Definitions to Cross-Border Security-Based Swap Activities, 79 FR 47278 (Aug.

12, 2014) (“2014 SEC Cross-Border Rule”), *available at* <https://www.govinfo.gov/content/pkg/FR-2014-08-12/pdf/R1-2014-15337.pdf>; Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants—Cross-Border Application of the Margin Requirements, 81 FR 34818 (May 31, 2016) (“2016 CFTC Cross-Border Margin Rule”), *available at* <https://www.cftc.gov/sites/default/files/idc/groups/public/@lrfederalregister/documents/file/2016-12612a.pdf>. In its 2013 guidance, the CFTC indicated that a collective investment vehicle (CIV) that is publicly offered only to non-US persons and not offered to US persons generally would not be viewed as a “US person.” Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations, 78 FR 45291, 45314 (July 26, 2013) (“2013 CFTC Cross-Border Guidance”), *available at* <https://www.govinfo.gov/content/pkg/FR-2013-07-26/pdf/2013-17958.pdf>. The SEC adopted a different approach from the CFTC’s 2013 guidance when adopting a definition of “US person” in its 2014 cross-border final rule. 2014 SEC Cross-Border Rule at 47311-12 (declining to exclude investment vehicles that are offered publicly only to non-US persons and are not offered to US persons because it was not adopting an ownership test for funds). The CFTC largely conformed to the SEC’s definition when it adopted a “US person” definition for cross-border margin requirements in 2016. 2016 CFTC Cross-Border Margin Rule at 34824 n.62. In this final rule, the CFTC notes that the definition of “US person” is consistent with that 2016 definition, which it previously noted is “substantially similar” to the SEC’s 2014 definition. 2016 CFTC Cross-Border Margin Rule at 34824 n.63.

[3] 2020 CFTC Cross-Border Final Rule at 35. In its 2013 guidance, the CFTC defines a CIV 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.” 2013 CFTC Cross-Border Guidance at 45309. Examples of a CIV include an investment fund, commodity pool, or pooled account. 2020 CFTC Cross-Border Rule at 53.

[4] 2020 CFTC Cross-Border Rule at 53-54. ICI and ICI Global previously advocated that the “principal place of business” provision should not apply to non-US regulated funds. See, e.g., Letter from Karrie McMillan, General Counsel, ICI, and Dan Waters, Managing Director, ICI Global, to Elizabeth M. Murphy, Commission (Aug. 21, 2013) (comment letter to SEC’s 2013 proposed cross-border rule), *available at* <https://www.sec.gov/comments/s7-02-13/s70213-43.pdf>; Letter from Karrie McMillan, General Counsel, ICI, and Dan Waters, Managing Director, ICI Global, to David A. Stawick, Secretary, Commission (Aug. 23, 2012) (comment letter to CFTC’s 2012 proposed cross-border guidance) (“2012 ICI CFTC Cross-Border Comment Letter”), *available at* <https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58425>.

[5] 2020 CFTC Cross-Border Rule at 54.

[6] *Id.* at 48. This element was originally included in the CFTC’s interpretation of “US person” in its 2013 cross-border guidance. 2013 CFTC Cross-Border Guidance at 45313. ICI previously advocated to the CFTC that this element of the definition was not workable for operational reasons. See, e.g., 2012 ICI CFTC Cross-Border Comment Letter at 3.

[7] While the CFTC included a majority ownership test in its 2013 guidance, the SEC did not follow suit in its 2014 cross-border rule because its adopted definition of “US person” does not focus on ownership by US persons. 2014 SEC Cross-Border Rule at 47311. The CFTC subsequently excluded the majority ownership test from its “US person” definition with respect to cross-border margin requirements. 2016 CFTC Cross-Border Margin Rule at

34824.

[8] For example, a CIV's US owners could be adversely affected by counterparty default, but a CIV would be subject to margin requirements in foreign jurisdictions. Further, the loss exposure would be generally limited to the investment amount. 2020 CFTC Cross-Border Rule at 49.

[9] *Id.*

[10] *Id.*

[11] As defined under the advisory, these CFTC transaction-level requirements include (i) required clearing and swap processing; (ii) margining (and segregation) for uncleared swaps; (iii) mandatory 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.

[12] CFTC No-Action Letter No. 13-71, which Commission staff issued shortly after Advisory No. 13-69, provided no-action relief to non-US SDs from the transaction-level requirements in connection with ANE transactions. Commission staff had extended this relief on several occasions prior to this final rule.

[13] The Commission, however, noted that persons engaging in any aspect of the swap transaction in the US remain subject to the CEA and Commission regulations prohibiting the employment, or attempted employment, of manipulation, fraudulent, or deceptive devices. 2020 CFTC Cross-Border Rule at 226 n.497.

[14] *Id.* at 158-59.

[15] In the final rule, the CFTC re-designated its "entity-level" and "transaction-level" requirements into four categories: "Group A" (formerly SD and MSP entity-level requirements), "Group B," "Group C," and a group of requirements not within Groups A through C. These designations inform the availability of certain exceptions from, and/or substituted compliance for those requirements, as mentioned herein.

[16] 2020 CFTC Cross-Border Rule at 159. These requirements include certain CFTC regulations applicable to SDs and MSPs (Regulation 23.205, 23.505, 23.506, 23.610) and applicable CFTC regulations in parts 37, 38, 43, and 50, and CEA section 2(h)(8). The CFTC has previously requested comment on whether these requirements should apply to ANE transactions but has not followed up with formal action. See Request for Comment on Application of Commission Regulations to Swaps Between Non-U.S. Swap Dealers and Non-U.S. Counterparties Involving Personnel or Agents of the Non-U.S. Swap Dealers Located in the United States, 79 FR 1347 (Jan. 8, 2014), *available at* <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2014-00080a.pdf>.

[17] 2020 CFTC Cross-Border Rule at 159-60. In contrast to the CFTC, the SEC applies external business conduct and reporting requirements to ANE transactions. See Proposed Rule Amendments and Guidance Addressing Cross-Border Application of Certain Security-Based Swap Requirements, 84 FR 24206, 24208 n.14-15 (May 24, 2019), *available at* <https://www.govinfo.gov/content/pkg/FR-2019-05-24/pdf/2019-10016.pdf>. However, the SEC's most recent 2019 supplemental guidance and rule amendments to its cross-border rules did not provide further guidance on the application of these requirements to ANE transactions, despite requesting comment in the corresponding proposal. *Id.* at 24217.

[18] CFTC Letter No. 20-21, available at <https://www.cftc.gov/csl/20-21/download>. The no-action letter refers to ANE transactions as “Covered Transactions” and these fourth category of requirements as “Unaddressed [Transaction Level Requirements].”

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