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CFTC Issues Final Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations and Exemptive Order; Non-U.S. Publicly Offered Funds Excluded from Definition of U.S. Person

[27385]

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 62-13
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 56-13
ICI GLOBAL MEMBERS
INVESTMENT ADVISER MEMBERS No. 49-13
INTERNATIONAL MEMBERS No. 32-13
SEC RULES MEMBERS No. 68-13 RE: CFTC ISSUES FINAL INTERPRETIVE GUIDANCE AND POLICY STATEMENT REGARDING COMPLIANCE WITH CERTAIN SWAP REGULATIONS AND EXEMPTIVE ORDER; NON-U.S. PUBLICLY OFFERED FUNDS EXCLUDED FROM DEFINITION OF U.S. PERSON

On July 12, 2013, the Commodity Futures Trading Commission ("CFTC" or "Commission") approved final interpretive guidance and a policy statement regarding the cross-border application of the swaps provisions of the Commodity Exchange Act ("CEA"). [1] The CFTC also issued a final order that provides temporary conditional relief to facilitate an orderly transition to the requirements under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). [2] The Final Cross-Border Guidance addresses, among other things, the scope of the term "U.S. person," the general framework for swap dealer ("SD") and major swap participant ("MSP") registration determinations, the categorization of the Dodd-Frank swap provisions as "Entity-Level Requirements" or "Transaction-Level Requirements," application of the CEA's swaps provisions and CFTC regulations to market participants that are not registered as an SD or MSP, and the framework for "substituted compliance."

This memorandum briefly describes the provisions of the Final Cross-Border Guidance that

are most relevant to funds, particularly non-U.S. regulated funds. [3] First, we discuss how the definition of "U.S. person" would apply to non-U.S. regulated funds and then discuss the obligations imposed on non-U.S. regulated funds even if they are not deemed "U.S. persons." [4]

U.S. Person Definition

The term "U.S. person" identifies those persons who, under the CFTC's interpretation, could be expected to satisfy the jurisdictional nexus under section 2(i) of the CEA based on their swap activities. As a result, entities and persons that fall within the definition of "U.S. person" would trigger obligations under the swap provisions of the Dodd-Frank Act. U.S. persons will be subject to certain transaction-level requirements under the Dodd-Frank Act, [5] SDs and MSPs generally will be required to count transactions with U.S. persons towards the thresholds for registration, and SDs and MSPs will be required to comply with CEA requirements for transactions with U.S. persons. The CFTC will interpret the term "U.S. person" to include persons or entities that fall within any of the eight prongs discussed in the Final Cross-Border Guidance. [6] We describe the prongs that could apply to funds below.

Exclusion of Certain Non-U.S. Publicly Offered Funds from Definition of U.S. Person

We are pleased to report that the CFTC has modified the definition of "U.S. person" to exclude funds that are publicly offered only to non-U.S. persons and not offered to U.S. persons from the definition of "U.S. person" in response to comments, including those of ICI. [7] Specifically, the Final Cross-Border Guidance states that "a collective investment vehicle that is publicly offered only to non-U.S. persons and not offered to U.S. persons generally would not fall within any of the prongs of the interpretation of the term 'U.S. person.'" [8] The CFTC expanded the proposed exclusion for collective investment vehicles from those that are publicly traded to those that are publicly offered and extended the exclusion to all of the prongs of the interpretation of the term "U.S. person." According to CFTC, with this revision, a collective investment vehicle that is publicly offered to non-U.S. persons, but not offered to U.S. persons, would generally not be included within the interpretation of the term "U.S. person."

Non-U.S. Regulated Funds that Are Offered to U.S. Persons or Not Publicly Offered to Non-U.S. Persons

The CFTC did not, however, exclude two other types of non-U.S. regulated funds as requested by ICI. These funds include: (1) non-U.S. funds that are publicly offered to only non-U.S. persons but are offered privately to U.S. persons and (2) non-U.S. funds that are authorized for public sale in a foreign jurisdiction but elect to limit their offering to non-U.S. institutional investors. Therefore, these non-U.S. funds are not excluded from the definition of "U.S. person" but must analyze their businesses and activities under the various tests. Specifically, a non-U.S. regulated fund that is not excluded from the term "U.S. person" must determine whether it has its principal place of business in the United States or is majority-owned by one or more U.S. persons as interpreted by the CFTC.

Principal Place of Business Test

The CFTC generally will interpret the term "U.S. person" to include a legal entity that is not incorporated in the United States if it has its "principal place of business" in the United States. For funds, the CFTC intends to look to the location of senior personnel who are responsible for implementing the investment and trading strategy of the fund and its risk management. According to the CFTC, these senior personnel could be those responsible for

investment selection, risk management decisions, portfolio management, or trade execution. In addition, the CFTC may consider the location of the senior personnel who direct, control, and coordinate the formation of the fund (i.e., the promoters). Therefore, the principal place of business of a fund will be considered by the CFTC to be in the United States if the senior personnel responsible for either (1) the formation and promotion of the fund or (2) the implementation of the fund's investment strategy are located in the United States, depending on the facts and circumstances that are relevant to determining the center of direction, control, and coordination of the fund.

In the Final Cross-Border Guidance, the CFTC provides several illustrative examples of non-U.S. domiciled funds with asset management firms located in the United States and outside the United States that would be considered to have their "principal place of business" within the United States.

Majority-Owned by U.S. Persons Test

Under this test, the CFTC will consider a fund to be a "U.S. person" if it is majority-owned by one or more U.S. persons. For purposes of this test, "majority-owned" means the beneficial ownership of more than 50 percent of the equity or voting interests in the fund.

In response to comments, the CFTC has eliminated the reference to "indirect" majority ownership and will require "look-through" to the beneficial ownership of any other legal entity invested in the fund that is controlled by or under common control with the fund. If an unrelated fund invests in a fund, the fund need not "look-through" the unrelated investing fund but may reasonably rely upon written, bona fide representations from the unrelated investing fund regarding whether it is a U.S. person. The CFTC provides several examples illustrating this test. [9]

Elimination of the Commodity Pool Operator Test and Clarification of Test Involving Unlimited Liability of U.S. Persons

In response to comments, including those of ICI, the CFTC did not include in its interpretation the proposed test related to registered commodity pool operators. [10] The CFTC agreed that this test could be overly broad and have the effect of capturing commodity pools with minimal participation of U.S. persons and a minimal U.S. nexus. Moreover, the CFTC confirmed that the unlimited liability test (covering entities that are majority-owned by one or more U.S. persons in which one or more of these U.S. persons bear unlimited responsibilities for the obligations and liabilities of the legal entity) would not include an entity that is a corporation, limited liability company, limited liability partnership or similar entity where shareholders, members, or partners have limited liability.

Effect of Swaps Provisions on Non-U.S. Funds Not Deemed U.S. Persons

Even if a non-U.S. regulated fund is not deemed a "U.S. person," such a fund still may be subject to requirements under the swaps provisions of the Dodd-Frank Act if it engages in transactions with an SD or MSP registered with the CFTC or with a U.S. person. [11]

Transactions Between Non-U.S. Person Fund and SD or MSP

Non-U.S. regulated funds that are not U.S. persons must comply with certain Dodd-Frank requirements as described below. Substituted compliance with foreign regulations may be available under certain circumstances. [12]

Entity-Level and Transaction-Level Requirements

The CFTC categorizes the various Dodd-Frank Act swaps provisions applicable to SDs and MSPs into "Entity-Level Requirements," which apply to an SD or MSP firm as a whole and "Transaction-Level Requirements," which apply on a transaction-by-transaction basis.

The CFTC will consider as Entity-Level Requirements the CFTC's regulations related to (1) capital adequacy; (2) chief compliance officer; (3) risk management; (4) swap data recordkeeping; (5) swap data repository reporting ("SDR Reporting"); and (5) physical commodity swaps trader reporting ("Large Trader Reporting"). [13] The CFTC then splits the Entity-Level Requirements into two categories. The first category includes capital adequacy, chief compliance officer, risk management, and swap data recordkeeping ("First Category"). The second category includes SDR Reporting, certain aspects of swap data recordkeeping relating to complaints and marketing and sales materials, and Large Trader Reporting ("Second Category").

The Transaction-Level Requirements include: (1) required clearing and swap processing; (2) margining (and segregation) for uncleared swaps; (3) mandatory trade execution; (4) swap trading relationship documentation; (5) portfolio reconciliation and compression; (6) real-time public reporting; (7) trade confirmation; (8) daily trading records; and (9) external business conduct standards. The CFTC then separates the Transaction-Level Requirements into two categories: Category A includes all of the Transaction-Level Requirements except external business conduct standards and Category B includes the external business conduct standards.

Transactions with U.S. SDs and MSPs

The CFTC would require U.S. SDs and U.S. MSPs to comply with all of the Entity-Level Requirements and Transaction-Level Requirements (regardless of whether the counterparty is a U.S. person or non-U.S. person) without substituted compliance. [14] Therefore, a non-U.S. regulated fund that is not a "U.S. person" transacting with a U.S. SD or U.S. MSP would be subject to Transaction-Level Requirements, and the U.S. SD or U.S. MSP would be required to comply with the Entity-Level Requirements with respect to all of its counterparties (including non-U.S. person counterparties).

Transactions with Non-U.S. SDs and MSPs

The CFTC expects non-U.S. SDs and non-U.S. MSPs to comply with all of the Entity-Level Requirements. Non-U.S. SDs or MSPs will, however, be eligible for substituted compliance with regard to Entity-Level Requirements (except for Large Trader Reporting) with respect to their non-U.S. person counterparties. [15]

The CFTC will not impose Category A or Category B Transaction-Level Requirements if a non-U.S. person engages in a transaction with a non-U.S. SD or MSP. [16] For swaps between a non-U.S. SD or non-U.S. MSP and a non-U.S. regulated fund that is not a U.S. person, the parties will not be required to comply with the Transaction-Level Requirements.

Transactions with Non-U.S. Market Participants That Are Not SDs or MSPs

Several of the CEA's swaps provisions and CFTC regulations also apply to persons or counterparties other than an SD or MSP: clearing; trade execution; real-time public reporting; Large Trader Reporting; SDR Reporting; and swap data recordkeeping ("Non-Registrant Requirements"). [17] If a non-U.S. regulated fund that is not a U.S. person transacts with a U.S. person, the Non-Registrant Requirements will apply and substituted

compliance is not available. [18] Where a swap is between two non-U.S. persons [19] and neither counterparty is required to register as an SD or MSP, the Non-Registrant Requirements would not apply except for the Large Trader Reporting.

Substituted Compliance

The CFTC will permit eligible entities to comply with a substituted compliance regime under certain circumstances provided that the CFTC finds that a foreign jurisdiction's requirements are comparable with, and as comprehensive as, the regulatory obligations under the Entity- and Transaction-Level Requirements. In the Final Cross-Border Guidance, the CFTC describes the process for the comparability determination. The CFTC comparability analysis will be based on a comparison of specific foreign requirements against specific related CEA provisions and CFTC regulations in 13 categories of regulatory obligations. Once a comparability determination is made for a jurisdiction, it will apply to all entities and transactions in that jurisdiction to the extent provided in the determination as approved by the CFTC.

Finding of "Essentially Identical" Requirements

According to the CFTC, even if substituted compliance is not available, a market participant would be deemed in compliance with relevant Dodd-Frank requirements where it complies with requirements in its home jurisdiction that are essentially identical to the Dodd-Frank requirements. The CFTC will make a determination whether a foreign jurisdiction's requirements are essentially identical to the corollary Dodd-Frank requirements on a provision-by-provision basis. The finding will be made through Commission action or through staff no-action, if appropriate. The CFTC staff has issued a no-action letter related to risk mitigation for the rules under the European Market Infrastructure Regulation ("EMIR"). [20]

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endnotes

[1] Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations (July 12, 2013), available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister071213b.pdf ("Final Cross-Border Guidance"). See Further Proposed Guidance regarding Compliance with Certain Swap Regulations, 78 FR 909 (Jan. 7, 2013), available at http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-31734a.pdf ("Further Proposed Guidance"); Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, 77 FR 41214, available at http://www.gpo.gov/fdsys/pkg/FR-2012-07-12/pdf/2012-16496.pdf (July 12, 2012) (together, "Proposed Guidance").

[2] Exemptive Order Regarding Compliance with Certain Swap Regulations (July 12, 2013), available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister071213.pdf.

[3] A non-U.S. regulated fund refers to any fund that is organized or formed outside the United States, is authorized for public sale in the country in which it is organized or formed,

and is regulated as a public investment company under the laws of that country.

[4] This memorandum does not describe which transactions should be included for purposes of whether an entity exceeds the registration thresholds for SDs and MSPs. See Section IV.B. of the Final Cross-Border Guidance, supra note 1. This memorandum also does not discuss the application of the swaps provisions to foreign branches of U.S. persons. See Section IV.C. of the Final Cross-Border Guidance, supra note 1.

[5] For example, if a non-U.S. fund is deemed a "U.S. person," its transactions even with a non-U.S. dealer (e.g., London dealer) would be subject to certain Dodd-Frank requirements such as clearing, trade execution, recordkeeping, and reporting.

[6] The CFTC summarizes the eight prong test of the term "U.S. person" generally as follows:

(i) any natural person who is a resident of the United States; (ii) any estate of a decedent who was a resident of the United States at the time of death; (iii) any corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund or any form of enterprise similar to any of the foregoing (other than an entity described in prongs (iv) or (v), below) (a "legal entity"), in each case that is organized or incorporated under the laws of a state or other jurisdiction in the United States or having its principal place of business in the United States; (iv) any pension plan for the employees, officers or principals of a legal entity described in prong (iii), unless the pension plan is primarily for foreign employees of such entity; (v) 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 supervision over the administration of the trust; (vi) 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. persons; (vii) any legal entity (other than a limited liability company, limited liability partnership or similar entity where all of the owners of the entity have limited liability) that is directly or indirectly majority-owned by one or more persons described in prong (i), (ii), (iii), (iv), or (v) and in which such person(s) bears unlimited responsibility for the obligations and liabilities of the legal entity; and (viii) any individual account or joint account (discretionary or not) where the beneficial owner (or one of the beneficial owners in the case of a joint account) is a person described in prong (i), (ii), (iii), (iv), (v), (vi), or (vii).

[7] See Letter from Karrie McMillan, General Counsel, ICI, and Dan Waters, Managing Director, ICI Global, to Melissa Jurgens, Secretary, CFTC, dated July 5, 2013; Letter from Karrie McMillan, General Counsel, ICI, and Dan Waters, Managing Director, ICI Global, to Melissa Jurgens, Secretary, CFTC, dated Feb. 6, 2013; Letter from Karrie McMillan, General Counsel, ICI, and Dan Waters, Managing Director, ICI Global, to David Stawick, Secretary, CFTC, dated Aug. 23, 2012.

[8] See Final Cross-Border Guidance, supra note 1, at page 85 (emphasis added). The "summary" of the interpretation of the term "U.S. person" is not written as clearly to exclude funds that are publicly offered only to non-U.S. persons and not offered to U.S. person from all of the prongs of the definition. See supra note 6.

[9] As a example of a U.S. person, the CFTC describes a limited company formed under the

laws of the Cayman Island that has a single investor, which is an investment company registered with the Securities and Exchange Commission ("SEC") under the Investment Company Act of 1940, and both the SEC-registered fund and the Cayman Island limited company are sponsored by the same investment adviser. The Cayman Island limited company will be viewed by the CFTC as a "controlled foreign corporation" of the SEC-registered fund, and the Cayman Island limited company will be required to "look through" the SEC-registered fund and be considered majority owned by U.S. persons.

[10] In the Proposed Guidance, the CFTC proposed to deem any commodity pool, pooled account, or collective investment vehicle the operator of which would be required to register as a commodity pool operator under the CEA to be a "U.S. person." Proposed Guidance, supra note 1.

[11] We do not discuss the requirements imposed on a non-U.S. fund that is deemed a U.S. person because the Dodd-Frank requirements generally would apply equally to such a fund as to a SEC-registered fund. See infra note 16.

[12] Substituted compliance means that a non-U.S. SD or non-U.S. MSP is permitted to conduct business by complying with its home regulations without being subject to additional requirements under the CEA if the CFTC finds that such requirements are comparable to requirements under the CEA and CFTC regulations. A non-U.S. person may request the CFTC's permission to comply with comparable requirements of its home jurisdiction or a group of non-U.S. persons from the same jurisdiction or a foreign regulator may submit an application for substituted compliance on behalf of non-U.S. persons subject to a foreign supervisory regime.

[13] Although not included in the Proposed Guidance, the CFTC states that the monitoring of position limits under CFTC regulation 23.601 is included in the Entity-Level Requirements.

[14] For a foreign branch of a U.S. bank that is an SD or MSP, Category B Transaction-Level Requirements would not apply to transactions with a non-U.S. person.

[15] For the First Category Entity-Level Requirements, substituted compliance will be available for a non-U.S. SD or non-U.S. MSP regardless of whether the counterparty is a U.S. person or a non-U.S. person. For Entity-Level Requirements in the Second Category, substituted compliance will be available for a non-U.S. SD or MSP only where the counterparty is a non-U.S. person.

[16] Where a swap is between a non-U.S. SD or non-U.S. MSP and a U.S. person, the CFTC will not permit substituted compliance for Transaction-Level Requirements. Therefore, a non-U.S. regulated fund that is deemed a U.S. person must comply with the Transaction-Level Requirements as well as any requirements imposed by its home jurisdictions.

[17] A party to a swap will generally be permitted to reasonably rely on its counterparty's written representation in determining whether the counterparty is within the CFTC's interpretation of the term "U.S. person."

[18] Conversely, a non-U.S. fund that is deemed a U.S. person transacting with a non-U.S. person will be subject to the Non-Registrant Requirements and substituted compliance will not be available. See supra note 5.

[19] At least one of the non-U.S. counterparties must not be guaranteed by, or an "affiliate

conduit" of, a U.S. person, The CFTC will consider the following factors in determining whether a non-U.S. person is an "affiliate conduit:" the non-U.S. person is a majority-owned affiliate of a U.S. person; the non-U.S. person is controlling, controlled by or under common control with the U.S. person; the financial results of the non-U.S. person are included in the consolidated financial statements of the U.S. person; and the non-U.S. person, in the regular course of business, engages in swaps with non-U.S. third parties for the purpose of hedging or mitigating risks faced by, or to take positions on behalf of, its U.S. affiliate(s), and enters into offsetting swaps or other arrangements with its U.S. affiliate(s) in order to transfer the risks and benefits of such swaps with third parties to its U.S. affiliates.

[20] See CFTC Letter No. 13-45, No-Action Relief for Registered Swap Dealers and Major Swap Participants from Certain Requirements under Subpart I of Part 23 of Commission Regulations in Connection with Uncleared Swaps Subject to Risk Mitigation Techniques under EMIR (July 11, 2013) (CFTC staff determined that where a swap/OTC derivative is subject to concurrent jurisdiction under U.S. and EU risk mitigation rules, compliance under EMIR will achieve compliance with the relevant CFTC rules because they are essentially identical).
