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## Commodities Futures Trading Commission

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17 CFR Part 1

Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act; Proposed Rule

## COMMODITY FUTURES TRADING COMMISSION

### 17 CFR Chapter I

RIN 3038-AD57

#### Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act

**AGENCY:** Commodity Futures Trading Commission.

**ACTION:** Proposed interpretive guidance and policy statement.

**SUMMARY:** The Commodity Futures Trading Commission (“Commission” or “CFTC”) is publishing for public comment this proposed interpretive guidance and policy statement regarding the cross-border application of the swaps provisions of the Commodity Exchange Act (“CEA”) that were enacted by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, and the Commission’s regulations promulgated thereunder. Specifically, this proposed interpretive guidance and policy statement describes the following: The general manner in which the Commission will consider whether a person’s swap dealing activities or swap positions may require registration as a swap dealer or major swap participant, respectively, and the application of the related requirements under the CEA to swaps involving such persons; and the application of the clearing, trade execution, and certain reporting and recordkeeping provisions under the CEA, to cross-border swaps involving one or more counterparties that are not swap dealers or major swap participants. This proposed interpretive guidance and policy statement also generally describes the policy and procedural framework under which the Commission may permit compliance with a comparable regulatory requirement of a foreign jurisdiction to substitute for compliance with the requirements of the CEA.

**DATES:** Comments must be received on or before August 27, 2012.

**ADDRESSES:** You may submit comments, identified by RIN number 3038-AD57, by any of the following methods:

- *The agency’s Web site:* at <http://comments.cftc.gov>. Follow the instructions for submitting comments through the Web site.

- *Mail:* David A. Stawick, Secretary of the Commission, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street NW., Washington, DC 20581.

- *Hand Delivery/Courier:* Same as mail above.

- *Federal eRulemaking Portal:* <http://www.regulations.gov>. Follow the instructions for submitting comments. Please submit your comments using only one method.

All comments must be submitted in English, or if not, accompanied by an English translation. Comments will be posted as received to [www.cftc.gov](http://www.cftc.gov). You should submit only information that you wish to make available publicly. If you wish the Commodity Futures Trading Commission to consider information that you believe is exempt from disclosure under the Freedom of Information Act, a petition for confidential treatment of the exempt information may be submitted according to the procedures established in § 145.9 of the Commission’s regulations.<sup>1</sup>

Throughout this proposed interpretive guidance, the Commission requests comment in response to specific questions set out herein. For convenience, the Commission has numbered each of these requests for comment. The Commission asks that, in submitting responses to these requests for comment, commenters kindly identify the specific number of each request to which their comments are responsive.

The Commission reserves the right, but shall have no obligation, to review, pre-screen, filter, redact, refuse or remove any or all of your submission from [www.cftc.gov](http://www.cftc.gov) that it may deem to be inappropriate for publication, such as obscene language. All submissions that have been redacted or removed that contain comments on the merits of the proposal will be retained in the public comment file and will be considered as required under the Administrative Procedure Act<sup>2</sup> and other applicable laws, and may be accessible under the Freedom of Information Act.<sup>3</sup>

#### FOR FURTHER INFORMATION CONTACT:

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#### SUPPLEMENTARY INFORMATION:

##### Table of Contents

##### I. Background

<sup>1</sup> 17 CFR 145.9.

<sup>2</sup> 5 U.S.C. 551, et seq.

<sup>3</sup> 5 U.S.C. 552.

- A. The Dodd-Frank Wall Street Reform and Consumer Protection Act
- B. Scope of the Proposed Interpretive Guidance and Policy Statement
- II. Consideration of Whether a Non-U.S. Person Is a Swap Dealer or Major Swap Participant
  - A. Analysis of Section 2(i)
  - B. Interpretation of the Term “U.S. Person”
  - C. Definitions and Registration Thresholds
    - 1. Background
    - 2. Swap Dealer
      - i. Aggregation of Swaps
      - ii. Regular Business
    - 3. Major Swap Participant
      - i. Aggregation of Positions
    - 4. Relevance of Guarantees
    - 5. Summary
  - D. Branches, Agencies, Affiliates and Subsidiaries of U.S. Swap Dealers and U.S. Branches, Agencies, Affiliates, and Subsidiaries of Non-U.S. Swap Dealers
- III. Cross-Border Application of the CEA’s Swap Provisions
  - A. Principles of International Comity
  - B. Application of Swap Provisions to Non-U.S. Swap Dealers and Foreign Branches, Agencies, Subsidiaries and Affiliates of U.S. Swap Dealers
    - 1. Regulatory Categories
    - 2. Entity-Level Requirements
      - i. Capital Requirements
      - ii. Chief Compliance Officer
      - iii. Risk Management
      - iv. Swap Data Recordkeeping
      - v. Swap Data Reporting
      - vi. Physical Commodity Swaps Reporting
    - 3. Transaction-Level Requirements
      - i. Clearing and Swap Processing
      - ii. Margin and Segregation Requirements 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
      - ix. External Business Conduct Standards
    - 4. Application of the Entity-Level Requirements
    - 5. Application of the Transaction-Level Requirements
      - i. Clearing and Swap Processing, Margin (and Segregation), Trade Execution, Swap Trading Relationship Documentation, Portfolio Reconciliation and Compression, Real-Time Public Reporting, Trade Confirmation, and Daily Trading Records
      - ii. External Business Conduct Standards
  - C. Substituted Compliance
    - 1. Entity-Level Requirements
    - 2. Transaction-Level Requirements
  - D. Application of Entity-Level and Transaction-Level Requirements to Branches, Agencies, Affiliates, and Subsidiaries of U.S. Swap Dealers
    - 1. Foreign Branches and Agencies of U.S. Swap Dealers
    - 2. Foreign Affiliates and Subsidiaries of U.S. Swap Dealers
- IV. Process for Comparability Determinations
  - A. Overview
    - 1. Scope of Review

2. Process
3. Clearing
- V. Cross-Border Application of the CEA's Swap Provisions to Transactions Involving Other (Non-Swap Dealer and Non-MSP) Market Participants
  - A. Cross-Border Transactions With U.S. Persons
  - B. Clearing, Trade Execution, Real-Time Public Reporting, Large-Trader Reporting, SDR Reporting, and Swap Data Recordkeeping

## I. Background

### A. The Dodd-Frank Wall Street Reform and Consumer Protection Act

In the fall of 2008 a series of large financial institution failures triggered a financial and economic crisis that threatened to freeze U.S. and global credit markets. As a result, unprecedented governmental intervention was required to ensure the stability of the U.S. financial system.<sup>4</sup> These failures revealed the vulnerability of the U.S. financial system and economy to wide-spread systemic risk resulting from, among other things, poor risk management practices of financial firms, the lack of supervisory oversight for certain financial institutions as a whole, and the interconnectedness of the global swap business.<sup>5</sup>

American International Group ("AIG") is a prime example of how the stability of a large financial institution could be undermined by its activities abroad and how the entire U.S. financial system could be threatened as a result.<sup>6</sup> AIG was a regulated U.S. insurance company nearly undone by its collateral posting obligations under swaps entered into by its subsidiary, AIG Financial Products ("AIGFP"). AIGFP was headquartered in Connecticut and had major operations in London, with trades routed through Banque AIG, a French bank. AIGFP suffered enormous losses from credit default swaps that it issued

on certain underlying securities, which, because AIGFP's performance on such credit default swaps had been guaranteed by its parent, caused credit agencies to downgrade the credit rating of the entire AIG corporation. The downgrade triggered collateral calls and resulted in a liquidity crisis at AIG, which ultimately necessitated over \$85 billion of indirect assistance from the Federal Reserve Bank of New York to prevent AIG's default.

The Lehman Brothers Holding Inc. ("LBHI") bankruptcy offers another stark lesson on how risks can spread quickly across the affiliated entities of a multinational financial institution, ultimately causing the collapse of the entire financial institution. LBHI was a U.S.-based multinational corporation, with various affiliates and subsidiaries operating globally, including Lehman Brothers International (Europe) ("LBIE").

The Lehman global business and operations relied on "highly integrated, trading and non-trading relationships across the group."<sup>7</sup> The affiliates and subsidiaries within the group provided each other with more than equity investments and capital. They provided each other with treasury functions, custodial arrangements, depository functions, trading facilitation, swaps, funding, management, information technology and other operational services. Most notably, many of LBIE's obligations under its swaps with certain counterparties were guaranteed by the ultimate holding company, LBHI. In fact, at the time of default, LBIE had an estimated 130,000 OTC derivatives trades outstanding, most of which were guaranteed by LBHI.<sup>8</sup>

There are other parallels. In the many events leading up to the 2008 crisis, Citigroup, like many other financial institutions, utilized numerous structured investment vehicles ("SIVs") to shift certain activities off balance sheets and manage both capital requirements and reported accounting.<sup>9</sup> Citigroup stood behind these vehicles

through liquidity puts, a form of a guarantee. When the SIVs' funding was exhausted, Citigroup ultimately assumed approximately \$49 billion of debt directly onto its balance sheet.<sup>10</sup> Similarly, in 2007, Bear Stearns found itself exposed to the failings of two overseas hedge funds, Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd. and Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Master Fund, Ltd.<sup>11</sup> The funds were incorporated in the Cayman Islands as exempted liability companies, with registered offices in the Cayman Islands. However, when the funds collapsed under the weight of their significant investments in subprime mortgages, Bear Stearns bailed out the funds.

A decade before the AIG and Lehman collapses, a hedge fund advised by Long-Term Capital Management L.P. ("LTCM") nearly failed, leading a number of creditors to provide LTCM substantial financial assistance under the supervision of the Federal Reserve Bank of New York. LTCM was based in Greenwich, Connecticut but managed trades in Long-Term Capital Portfolio LP, a partnership registered in the Cayman Islands. This hedge fund, with approximately \$4 billion in capital and a balance sheet of just over \$100 billion, had a swap book in excess of \$1 trillion notional. More recently, J.P. Morgan Chase & Co. ("J.P. Morgan"), the largest U.S. bank, has disclosed a multi-billion dollar trading loss stemming from its Chief Investment Office located in London.<sup>12</sup> The significant reported losses at J.P. Morgan are a reminder of a key lesson from the failures of AIG and Lehman: A regulatory gap or lapse within any part of a financial institution can lead to the failure of the entire institution.

As these examples illustrate, corporate structures and inter-affiliate obligations may cause the activity, regardless of where that activity takes place, to have a direct and significant connection with activities in, or effect

<sup>4</sup> On October 3, 2008, President Bush signed the Emergency Economic Stabilization Act of 2008, which was principally designed to allow the U.S. Treasury and other government agencies to take action to restore liquidity and stability to the U.S. financial system (e.g., the Troubled Asset Relief Program—also known as TARP—under which the U.S. Treasury was authorized to purchase up to \$700 billion of troubled assets that weighed down the balance sheets of U.S. financial institutions). See Public Law 110–343, 122 Stat. 3765 (2008).

<sup>5</sup> See Financial Crisis Inquiry Commission, "The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States," Jan. 2011, at xxvii, available at <http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf>.

<sup>6</sup> See, e.g., Gretchen Morgenson, "Behind Insurer's Crisis, Blind Eye to a Web of Risk," N.Y. Times, Sept. 27, 2008. Corrected version published Sept. 30, 2008, available at <http://www.nytimes.com/2008/09/28/business/28melt.html?pagewanted=all>.

<sup>7</sup> "The global nature of the Lehman business with highly integrated, trading and non-trading relationships across the group led to a complex series of inter-company positions being outstanding at the date of Administration. There are over 300 debtor and creditor balances between LBIE and its affiliates representing \$10.5B of receivables and \$11.0B of payables as at September 15 2008." See Lehman Brothers International (Europe) in Administration, Joint Administrators' Progress Report for the Period 15 September 2008 to 14 March 2009, available at: <http://www.pwc.co.uk/assets/pdf/lbie-progress-report-14049.pdf>.

<sup>8</sup> *Id.*

<sup>9</sup> See, e.g., Andrew Bary, "Of Citi and SIVs: Can Banks Plug the Leak?," Barron's, Oct. 22, 2007, available at <http://online.barrons.com/article/SB119284238641065650.html>.

<sup>10</sup> See, e.g., Financial Times, Citi launches \$49bn SIV rescue (Dec. 14, 2007), available at <http://www.ft.com/intl/cms/s/0/6626b45e-a9dd-11dc-aa8b-0000779fd2ac.html#axzz1yMOOB81b> MarketWatch. Citigroup says it will absorb SIV assets (Dec. 14, 2007), available at [http://articles.marketwatch.com/2007-12-14/news/30679845\\_1\\_sivs-citigroup-ceo-vikram-pandit](http://articles.marketwatch.com/2007-12-14/news/30679845_1_sivs-citigroup-ceo-vikram-pandit).

<sup>11</sup> See In Re: Bear Stearns High-Grade Structured Credit Strategies Master Funds, LTC, 374 B.R. 122 (Bankr. S.D.N.Y. 2007), available at [http://www.nysb.uscourts.gov/opinions/brl/158971\\_25\\_opinion.pdf](http://www.nysb.uscourts.gov/opinions/brl/158971_25_opinion.pdf).

<sup>12</sup> See "Lehman Brothers International (Europe) in Administration, Joint Administrators' Progress Report for the Period 15 September 2008 to 14 March 2009," available at <http://www.pwc.co.uk/assets/pdf/lbie-progress-report-14049.pdf>.

on, commerce in the U.S. In many of the largest financial institutions, the overall business operates as a tightly integrated network of business lines and services conducted through various branches or affiliated legal entities which are under the unified management of the parent entity.<sup>13</sup> These large financial institutions effectively operate their businesses as a single business, by virtue of the relationship with the parent company and to each other, with the constituent parts inextricably linked to each other. The interconnected nature of the relationships among the affiliated entities within a corporate group means that a risk in any part of this group, whether in the United States or abroad, can quickly spread throughout the organization and jeopardize the financial integrity of the entire group.

Congress sought to address the deficiencies in the regulatory system that contributed to the financial crisis through the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), which was signed by President Obama on July 21, 2010.<sup>14</sup> Title VII of the Dodd-Frank Act amended the CEA<sup>15</sup> to overhaul the structure and oversight of the over-the-counter derivatives market that previously had been subject to little or no oversight. One of the cornerstones of this legislation is the establishment of a new statutory framework for comprehensive regulation of financial institutions that participate in the swaps market as swap dealers or major swap participants (“MSPs”), which must register and are subject to greater oversight and regulation.<sup>16</sup> A key goal of this new framework for swap dealers and MSPs is to minimize the potential for the recurrence of the type of

<sup>13</sup> Typically, the various business lines and services—while conducted out of separate legal entities—are highly integrated and inter-dependent. Key strategic and operational decisions are centralized and informed by the firm’s global, group-wide perspective. The individual legal entities affiliates and subsidiaries share common corporate support functions, such as treasury, custodial, brokerage and depository services and related infrastructures. The affiliated entities within the corporate group may also provide funding or credit support for each other and enter into trades with each other. In large part, this consolidated structure is necessary to allow the firm to address and manage customer needs, funding opportunities, capital and other regulatory requirements, financial accounting and tax planning, among other things.

<sup>14</sup> Public Law 111–203, 124 Stat. 1376 (2010). The text of the Dodd-Frank Act may be accessed at [http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/hr4173\\_enrolledbill.pdf](http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/hr4173_enrolledbill.pdf).

<sup>15</sup> 7 U.S.C. 1, *et seq.*

<sup>16</sup> In this proposed interpretative guidance and policy statement, the provisions of the CEA relating to swaps that were enacted by Title VII of the Dodd-Frank Act are also referred to herein as “the Dodd-Frank requirements.”

financial and operational stresses that contributed to the 2008 financial crisis.

Efforts to regulate the swaps market are underway not only in the United States, but also abroad in the wake of the 2008 financial crisis. In 2009, leaders of the Group of 20 (“G20”) whose membership includes the European Union (“EU”), the United States, and 18 other countries—agreed that: (i) OTC derivatives contracts should be reported to trade repositories; (ii) all standardized OTC derivatives contracts should be cleared through central counterparties and traded on exchanges or electronic trading platforms, where appropriate, by the end of 2012; and (iii) non-centrally cleared contracts should be subject to higher capital requirements. In line with the G20 commitment, much progress has been made to coordinate and harmonize international reform efforts, but the pace of reform varies among jurisdictions and disparities in regulations remain due to differences in cultures, legal and political traditions, and financial systems.<sup>17</sup>

<sup>17</sup> Legislatures and regulators in a number of foreign jurisdictions are undertaking significant regulatory reforms over the swaps market and its participants. See CFTC and SEC, Joint Report on International Swap Regulation Required by Section 719(c) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Jan. 31, 2012, at 23, available at [http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/dfstudy\\_isr\\_013112.pdf](http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/dfstudy_isr_013112.pdf).

For example, the European Parliament adopted the substance of the European Market Infrastructure Regulation (“EMIR”) on March 29, 2012. See Proposal for a Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories—Outcome of the European Parliament’s first reading (Brussels, 28 to 29 March 2012), available at <http://register.consilium.europa.eu/pdf/en/12/st06/st06399.en12.pdf>.

In December 2010, the European Commission released a public consultation on revising the Markets in Financial Instruments Directive (“MiFID”). See “European Commission Public Consultation: Review of the Markets in Financial Instruments Directive,” Dec. 8, 2010, available at [http://ec.europa.eu/internal\\_market/consultations/docs/2010/mifid/consultation\\_paper\\_en.pdf](http://ec.europa.eu/internal_market/consultations/docs/2010/mifid/consultation_paper_en.pdf).

In October 2011, the European Commission released two public consultations, one to revise MiFID and the other for creating a new regulation entitled the Markets in Financial Instruments Regulation (“MiFIR”). See “European Commission Proposal for a Directive of the European Parliament and of the Council on markets in financial instruments repealing Directive 2004/39/EC of the European Parliament and of the Council,” COM (2011) 656 final (Oct. 20, 2011), available at [http://ec.europa.eu/internal\\_market/securities/docs/isd/mifid/COM\\_2011\\_656\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/isd/mifid/COM_2011_656_en.pdf); “European Commission Proposal for a Regulation of the European Parliament and of the Council on markets in financial instruments and amending regulation [EMIR] on OTC derivatives, central counterparties and trade repositories,” COM (2011) 652 final (Oct. 20, 2011), available at [http://ec.europa.eu/internal\\_market/securities/docs/isd/mifid/COM\\_2011\\_652\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/isd/mifid/COM_2011_652_en.pdf).

The Japanese legislature passed the Amendment to the Financial Instruments and Exchange Act

### B. The Scope of the Proposed Interpretative Guidance and Policy Statement

In light of the global nature of the swap market, the extent to which the Dodd-Frank Act’s requirements will apply to cross-border activities is critically important. U.S. market participants regularly enter into swaps with other market participants that are domiciled outside of the U.S. or incorporated in non-U.S. jurisdictions.<sup>18</sup> Many U.S. and non-U.S. domiciled or incorporated financial institutions conduct their swaps business across multiple jurisdictions, with swaps that are negotiated and executed by a branch or affiliate in one jurisdiction while the actual counterparty to the swap is an entity in another jurisdiction.

The Commission received numerous comments during the Dodd-Frank Act rulemaking process from interested parties concerning the application of Title VII of the Dodd-Frank Act and the Commission’s implementing regulations thereunder to the cross-border activities of non-U.S. and U.S. market participants.<sup>19</sup> The key issues raised by

(“FIEA”) in May 2010. See Outline of the bill for amendment of the Financial Instruments and Exchange Act, May 2010, available at <http://www.fsa.go.jp/en/refer/diet/174/01.pdf>.

<sup>18</sup> See Bank of International Settlements (BIS), Committee on the Global Financial System, No. 46, The macro financial implications of alternative configurations for access to central counterparties in OTC derivatives markets, Nov. 2011, at 1, available at <http://www.bis.org/publ/cgfs46.pdf> (“The configuration of access must take account of the globalized nature of the market, in which a significant proportion of OTC derivatives trading is undertaken across borders.”).

<sup>19</sup> See, e.g., Institute of International Bankers (“IIB”) (Jan. 10, 2011); International Swaps and Derivatives Association (“ISDA”) (Feb. 22, 2011), Securities Industry and Financial Markets Association (“SIFMA”) (Feb. 3, 2011), Cleary Gottlieb Steen & Hamilton LLP (“Cleary”) (Sept. 20, 2011), and Barclays Bank PLC, BNP Paribas S.A., Credit Suisse AG, Deutsche Bank AG, HSBC, Nomura Securities International, Inc., Rabobank Nederland, Royal Bank of Canada, The Royal Bank of Scotland Group PLC, Société Générale, The Toronto-Dominion Bank, and UBS AG (“Twelve Foreign Banks”) (Feb. 17, 2011). In total, the Commission received approximately 120 comment letters (submitted in response to various proposed rules implementing the Dodd-Frank Act) that addressed or raised issues related to cross-border swap activities. These letters, received by the Commission in response to various Commission rulemakings, may be found on the Commission’s Web site at <http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/index.htm>.

In addition, the Commission and the Securities and Exchange Commission (“SEC”) held a joint public roundtable on August 1, 2011 on international issues relating to the implementation of Title VII of the Dodd-Frank Act (“Roundtable”). During the Roundtable, commenters discussed the impact of the various requirements on their cross-border activities. A copy of the transcript from the Roundtable can be found on the Commission’s Web site at [http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission21\\_080111-trans.pdf](http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission21_080111-trans.pdf).

the commenters include (i) the nature of the connections to the United States that would require a non-U.S. person to register as a swap dealer or MSP under the CEA and the Commission's regulations;<sup>20</sup> (ii) which Dodd-Frank Act requirements apply to the swap activities of non-U.S. persons, U.S. persons, and their branches, agencies, subsidiaries and affiliates outside of the United States;<sup>21</sup> and (iii) to the extent that Title VII of the Dodd-Frank requirements would apply, the circumstances under which the Commission would consider permitting a non-U.S. person to comply with the regulatory regime of its foreign jurisdiction instead of complying with the Dodd-Frank Act and the Commission's regulations promulgated thereunder.<sup>22</sup>

<sup>20</sup> Commenters agreed generally that non-U.S. persons engaged in swap dealing activity directly with U.S. counterparties should be registered with the Commission as swap dealers. See, e.g., Cleary (Sept. 20, 2011). On the other hand, according to commenters, swap dealing conducted outside of the U.S. between non-U.S. persons is not sufficiently connected to the U.S. to warrant swap dealer registration. See, e.g., Twelve Foreign Banks (Feb. 17, 2011); SIFMA (Feb. 3, 2011). Commenters also said that a non-U.S. person that limits its U.S. swap activity to U.S. persons that are registered as swap dealers should not have to register, because regulation of the U.S. registered swap dealer is sufficient. See Bank of Tokyo-Mitsubishi UFJ Ltd., Mizuho Corporate Bank Ltd., Sumitomo Mitsui Banking Corporation ("Japanese Banks") (May 5, 2011) and Twelve Foreign Banks (Feb. 17, 2011).

<sup>21</sup> See, e.g., Cleary (Sept. 20, 2011) IIB (Jan. 10, 2011) and SIFMA (Feb. 3, 2011). Generally speaking, these commenters urged that the Commission adopt a framework that preserves the strengths of existing market practices and home country supervision, while avoiding regulatory duplication, unrealistic extraterritorial supervisory responsibilities, and fragmentation of the swap markets. See, e.g., IIB (Jan. 10, 2011) and SIFMA (Feb. 3, 2011). According to these commenters, entities outside the United States should comply with rules adopted under the Dodd-Frank Act with respect to requirements applicable to specific swaps, but should be subject to home country supervision by their home country regulators with respect to requirements applicable at the entity level. On the other hand, other commenters said that a U.S. entity must not be able to conduct swap business with non-U.S. persons free from regulation under the Dodd-Frank Act by establishing a non-U.S. affiliate and conducting the swap business through the affiliate. See Better Markets, Inc. (Jan. 24, 2011).

<sup>22</sup> See, e.g., Seven Foreign Banks (Jan. 11, 2011) and Hess (Jan. 24, 2011). Commenters stated that deference to comparable home country regulation accords with principles of international comity and is consistent with the approach taken by U.S. banking regulators with respect to non-U.S. banks. See, e.g., FSR (Feb. 22, 2011), IIB (April 11, 2011), Cleary (Sept. 20, 2011). Numerous commenters also recommended that comparability should be determined based on whether the home country entity-level requirements are reasonably designed to achieve the same policy objectives as the corresponding requirements under the Dodd-Frank Act. See Cleary (Sept. 20, 2011). Commenters said that the Commission should defer to the home country, entity-level requirements only when they are comparable. Commenters also discussed Dodd-

In this proposed interpretive guidance and policy statement ("proposed interpretive guidance"), the Commission addresses the key issues raised by the commenters with respect to the application of Title VII of the Dodd-Frank Act and the Commission's rules promulgated thereunder to cross-border swaps and activities. Following the background discussion in Section I, the Commission sets out its proposed interpretive guidance in the subsequent three sections. Section II sets forth the Commission's proposed interpretation of its authority to apply the Dodd-Frank Act and its regulations extraterritorially under section 2(i) of the CEA.<sup>23</sup> Section II also describes the general manner in which the Commission proposes to consider the following: (i) Whether a non-U.S. person's swap dealing activities are sufficient to require registration as a "swap dealer," as further defined in a joint release adopted by the Commission and the SEC (collectively, the "Commissions"); (ii) whether a non-U.S. person's swap positions are sufficient to require registration as a "major swap participant," as further defined in a joint release adopted by the Commissions; and (iii) the treatment for registration purposes of foreign branches, agencies, affiliates, and subsidiaries of U.S. swap dealers and of U.S. branches of non-U.S. swap dealers.<sup>24</sup>

Section III sets forth the manner in which the Commission proposes to interpret section 2(i) of the CEA as it applies to the requirements under Title VII of the Dodd-Frank Act and the Commission's regulations promulgated thereunder to swaps and activities of non-U.S. swap dealers, non-U.S. MSPs and foreign branches, agencies, affiliates, and subsidiaries of U.S. swap dealers. In section III, the Commission also proposes to permit a non-U.S. swap dealer or non-U.S. MSP to comply with comparable foreign regulatory requirements in order to satisfy

Frank Act requirements that potentially apply to all swap market participants, not just registered swap dealers and MSPs. For instance, commenters said that when a non-U.S. person executes or clears a swap on a U.S.-registered facility, the non-U.S. person should be subject to the Commission's swap position limit requirements. See US Banks (Feb. 22, 2011). Commenters said that clearing requirements should not apply to swaps between two non-U.S. persons, and that the regulators in various countries should work together to recognize comparably-regulated clearinghouses. See SIFMA (Feb. 3, 2011) and Seven Foreign Banks (Jan. 11, 2011).

<sup>23</sup> 7 U.S.C. 2(i).

<sup>24</sup> See Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant"; Final Rule, 77 FR 30596, May 23, 2012.

applicable statutory and regulatory requirements under Title VII of the Dodd-Frank Act.<sup>25</sup> In section IV, the Commission generally describes a process by which a non-U.S. applicant for swap dealer or MSP registration may seek the Commission's recognition of substituted compliance with a comparable foreign regulatory requirement and the general scope of Commission review in making the requisite comparability finding. Section V sets forth the manner in which the Commission proposes to interpret section 2(i) of the CEA as it applies to the clearing, trading, and certain reporting requirements under the Dodd-Frank Act with respect to swaps between counterparties that are not swap dealers or MSPs.

The Commission clarifies that this proposed interpretive guidance does not establish or modify any person's rights and obligations under the CEA or the Commission's regulations promulgated thereunder. The Commission notes that the proposed interpretive guidance does not limit the applicability of any CEA provision or Commission regulation to any person, entity or transaction except as provided herein.

## II. Consideration of Whether a Non-U.S. Person Is a Swap Dealer or Major Swap Participant

### A. Section 2(i) of the CEA

Section 722(d) of the Dodd-Frank Act amends section 2 of the CEA<sup>26</sup> to add a new paragraph (i) entitled "Applicability," which consists of two subsections. Specifically, section 2(i) states that the provisions added to the CEA by Title VII of the Dodd-Frank Act 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 this Act that was enacted by the Wall Street Transparency and Accountability Act of 2010.<sup>27</sup> Section 2(i) provides the Commission with express authority over activities outside the United States when such swaps and activities have a "direct and significant" connection with activities

<sup>25</sup> This proposed interpretative release does not address the scope of the Commission's authority under CEA section 2(i) over non-swap agreements, contracts, transactions or markets within the Commission's jurisdiction or persons who participate in or operate those markets.

<sup>26</sup> 7 U.S.C. 2.

<sup>27</sup> 7 U.S.C. 2(i).

in, or effect on, commerce of the United States or when they contravene such rules as the Commission may promulgate to prevent evasion of the provisions of Title VII of the Dodd-Frank Act.<sup>28</sup> Section 2(i) does not, however, require the Commission to extend its reach to the outer bounds of that authorization. Rather, in exercising its authority with respect to swap activities outside the United States, the Commission will be guided by consideration of international comity principles. The subsections that follow address the general manner in which the Commission will determine the cross-border application of the CEA's swap provisions, consistent with section 2(i) of the CEA.

### *B. Proposed Interpretation of the Term "U.S. Person"*

For purposes of this interpretive guidance, the Commission proposes to interpret the term "U.S. person" by reference to the extent to which swap activities or transactions involving one or more such person have the relevant effect on U.S. commerce. For example, this interpretation would help determine whether non-U.S. persons engaging in swap dealing transactions with "U.S. persons" in excess of the de minimis level would be required to register and regulated as a swap dealer. In addition, for the same reasons, the term "U.S. person" can be helpful in determining the level of U.S. interest for purposes of analyzing and applying principles of international comity when considering the extent to which U.S.

<sup>28</sup> A primary purpose of Title VII of the Dodd-Frank Act is to address risk to the U.S. financial system created by interconnections in the swaps market. Senator Blanche Lincoln, then Chairman of the Senate Agriculture Committee, noted: "In 2008, our Nation's economy was on the brink of collapse. America was being held captive by a financial system that was so interconnected, so large, and so irresponsible that our economy and our way of life were about to be destroyed." Congressional Record S5818, July 14, 2010, available at <http://www.gpo.gov/fdsys/pkg/CREC-2010-07-14/pdf/CREC-2010-07-14.pdf>. Senator Jeanne Shaheen stated: "We need to put in place reforms to stop Wall Street firms from growing so big and so interconnected that they can threaten our entire economy." Congressional Record S5888, July 15, 2010, available at <http://www.gpo.gov/fdsys/pkg/CREC-2010-07-15/pdf/CREC-2010-07-15-senate.pdf>. Senator Debbie Stabenow opined: "For too long the over-the-counter derivatives market has been unregulated, transferring risk between firms and creating a web of fragility in a system where entities became too interconnected to fail." Congressional Record S5905, July 15, 2010, available at <http://www.gpo.gov/fdsys/pkg/CREC-2010-07-15/pdf/CREC-2010-07-15-senate.pdf>. As these legislative records indicate, Congress sought to ensure that the Commission would be able to effectively regulate activities in the swaps marketplace, wherever those activities may occur, that are significantly connected with or affect the U.S. financial system.

transaction-level requirements should apply to swap transactions.

Specifically, as proposed, the term "U.S. person" would include, but not be limited to: (i) Any natural person who is a resident of the United States; (ii) 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, in each case that is either (A) organized or incorporated under the laws of the United States or having its principal place of business in the United States<sup>29</sup> ("legal entity") or (B) in which the direct or indirect owners thereof are responsible for the liabilities of such entity and one or more of such owners is a U.S. person; (iii) any individual account (discretionary or not) where the beneficial owner is a U.S. person; (iv) any commodity pool, pooled account, or collective investment vehicle (whether or not it is organized or incorporated in the United States) of which a majority ownership is held, directly or indirectly, by a U.S. person(s); (v) 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; (vi) a pension plan for the employees, officers, or principals of a legal entity with its principal place of business inside the United States; and (vii) an estate or trust, the income of which is subject to United States income tax regardless of source.

Under this interpretation, the term "U.S. person" generally means that a foreign branch or agency of a U.S. person would be covered by virtue of the fact that it is a part, or an extension, of a U.S. person. By contrast, a foreign affiliate or subsidiary of a U.S. person would be considered a non-U.S. person, even where such an affiliate or subsidiary has certain or all of its swap-related obligations guaranteed by the U.S. person.

### *Request for Comment*

Q1. Please provide specific comments regarding the Commission's proposed interpretation of the term "U.S. person."

Q1a. In the Commission's view, the concerns regarding risks associated with the affiliate group structure are heightened where a U.S. person guarantees (or provides similar support) to a foreign affiliate or subsidiary. In such situations, the risk of the swaps executed abroad are effectively

<sup>29</sup> The term "United States" means the United States, its states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, and any other territories or possessions of the United States government, its agencies or instrumentalities.

transferred to or incurred by the U.S. person. Or stated differently, the risk of the affiliate's swap transactions have a direct and significant connection to, or effect on, the U.S. person that is the guarantor. Under these circumstances, notwithstanding that the U.S. person may be subject to a robust regulatory regime, its financial stability may be put at risk by activities outside the firm. Accordingly, the Commission is considering, and seeks comments on, whether the term "U.S. person" should be interpreted to include a foreign affiliate or subsidiary guaranteed by a U.S. person.

Q1b. Several commenters have suggested that the Commission adopt the definition of "U.S. person" in the SEC's Regulation S.<sup>30</sup> Should the Commission interpret the term "U.S. person" in a similar manner notwithstanding that Regulation S has a different focus?

Q1c. As an alternative to the proposed interpretation of the term "U.S. person," should the Commission interpret the term to include a concept of control under which a non-U.S. person who is controlled by or under common control with a U.S. person would also be considered a U.S. person? If so, how should the Commission define the term "controlled by or under common control?"

Q1d. Are there other examples of persons or interests that should be specifically identified as a "U.S. person" in the final interpretive guidance?

### *C. The Definitions and Registration Thresholds*

#### *1. Background*

The Commission adopted its final rulemaking further defining the terms "swap dealer" and "major swap participant" jointly with the SEC on April 18, 2012 ("Final Entities Rulemaking").<sup>31</sup> In the Final Entities Rulemaking, the Commissions, among other things, adopted final rules and interpretive guidance implementing the statutory definitions of the terms "swap dealer" and "major swap participant" in CEA sections 1a(49) and 1a(33).<sup>32</sup> The final rules and interpretive guidance delineate the activities that cause a person to be a swap dealer and the level of swap positions that cause a person to be an MSP. In addition, the

<sup>30</sup> See 17 CFR 230.902(k); SEC Release No. 33-6863, 55 FR 18306, May 2, 1990.

<sup>31</sup> Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant;" Final Rule, 77 FR 30596, May 23, 2012.

<sup>32</sup> 7 U.S.C. 1a(49) and 1a(33).

Commissions adopted rules concerning the statutory exceptions from the definition of swap dealer, including a de minimis exception.<sup>33</sup>

Section 1.3(ggg)(4) of the Commission's regulations sets forth a de minimis threshold of swap dealing, which takes into account the notional amount of a person's swap dealing activity over the prior 12 months.<sup>34</sup> When a person engages in swap dealing transactions above that threshold, such person meets the definition of a swap dealer under section 1a(49) of the CEA,<sup>35</sup> and is required to register as a swap dealer with the Commission under CEA section 4s(b).<sup>36</sup> Sections 1.3(jjj)(1) and 1.3(III)(1) of the Commission's regulations set forth swap position thresholds for the MSP definition.<sup>37</sup> When a person holds swap positions above those thresholds, such person meets the definition of an MSP under section 1a(33) of the CEA,<sup>38</sup> and is required to register as an MSP with the Commission under CEA section 4s(b).<sup>39</sup>

Once required to register as a swap dealer or MSP, the person becomes subject to all of the requirements imposed on swap dealers or MSPs under Title VII, respectively, including but not limited to sections 2(a)(13), 4r, and 4s of the CEA,<sup>40</sup> which require swap dealers and MSPs to comply with various prudential, business conduct, reporting, clearing, and trading requirements. Unless a swap dealer or MSP applies for and is granted a limited designation, all of the swap dealer's or MSP's swap activities are subject to such requirements, not only the swap activities that trigger the registration requirement.

<sup>33</sup> Section 1a(49)(D) of the CEA (7 U.S.C. 1a(49)(D)) provides that "[t]he Commission shall exempt from designation as a swap dealer an entity that engages in a de minimis quantity of swap dealing in connection with transactions with or on behalf of its customers. The Commission shall promulgate regulations to establish factors with respect to the making of this determination to exempt." This provision is implemented in section 1.3(ggg)(4) of the Commission's regulations.

<sup>34</sup> The limitations associated with the de minimis exception apply only in connection with a person's dealing activities. See Final Entities Rulemaking at Part II.D. As used in this release, the meaning of the term "swap dealing" is consistent with that used in the Final Entities Rulemaking.

<sup>35</sup> 7 U.S.C. 1a(49).

<sup>36</sup> 7 U.S.C. 6s(b). See also Registration of Swap Dealers and Major Swap Participants, Final Rule 77 FR 2613, 2616, Jan. 19, 2012 ("Final Registration Rule").

<sup>37</sup> See Final Entities Rulemaking at Parts IV.B. and IV.E.

<sup>38</sup> 7 U.S.C. 1a(33).

<sup>39</sup> 7 U.S.C. 6s(b). See also Final Registration Rule at 2616, Jan. 19, 2012, available at <http://www.cftc.gov/ucm/groups/public/lrfederalregister/documents/file/2012-792a.pdf>.

<sup>40</sup> 7 U.S.C. 2(a)(13), 6r, and 6s.

The statutory definitions of swap dealer and MSP do not contain any geographic limitations and do not distinguish between U.S. and non-U.S. swap dealers or non-U.S. MSPs.<sup>41</sup> Similarly, the Final Entities Rulemaking does not contain any such limitations or distinctions. In this proposed interpretive guidance, the Commission interprets section 2(i) of the CEA as it applies to the provisions in the CEA related to swap dealers and MSPs and, accordingly, proposes the general manner in which the swap dealer and MSP registration and related requirements apply to the activities of non-U.S. persons, and to the foreign branches, agencies, subsidiaries and affiliates of U.S. persons and U.S. branches of non-U.S. persons.

## 2. Swap Dealer

In enacting the swap dealer definition and the associated requirements for swap dealers Congress sought to ensure that those entities that engage in more than a de minimis level of swap dealing be considered swap dealers, register, and be regulated as swap dealers.<sup>42</sup> In the Final Entities Rulemaking, the Commission established a notional threshold for determining whether a person engages in more than a de minimis level of swap dealing and therefore must register as a swap dealer. The Commission proposes that the level of swap dealing that is substantial enough to require a person to register as a swap dealer when conducted by a U.S. person also constitutes a "direct and significant connection" within the meaning of section 2(i)(1) of the CEA when such dealing activities are conducted by a non-U.S. person with U.S. persons as counterparties. Accordingly, consistent with this

<sup>41</sup> The statutory definition of MSP in CEA section 1a(33)(B) (7 U.S.C. 1a(33)(B)) does state, however, that the Commission should consider the impact on "the financial system of the United States" in defining what constitutes a "substantial position" for purposes of the definition. The Commission believes that this proposed interpretive guidance, which focuses on a non-U.S. person's swap positions with U.S. persons, is consistent with this statutory directive.

<sup>42</sup> The Commission does not believe it is necessary for purposes of this proposed interpretive guidance to determine whether such swaps or activities between a non-U.S. person and a U.S. person are located within or outside of the United States. Regardless of whether the location of any particular swap or activity is within or outside the United States, the Commission proposes that it is the aggregate notional amount of such swap dealing activities that is relevant for registration. Accordingly, the consideration of such swaps within the meaning of CEA section 2(i) for the purposes of this proposed guidance does not necessarily mean that the Commission considers such activities to be outside of the United States. See Final Entities Rulemaking at Part II.B.4. for what constitutes "swap dealing activities."

interpretation and the Commission's Final Entities Rulemaking, the Commission proposes that non-U.S. persons who engage in more than a de minimis level of swap dealing with U.S. persons would be required to register as swap dealers.<sup>43</sup>

The Commission does not propose, however, that a non-U.S. person should include, in determining whether the de minimis threshold is met, the notional value of dealing transactions with foreign branches of registered U.S. swap dealers. This is intended to address the concerns of non-U.S. persons who may be required to register as a swap dealer, notwithstanding the fact that their dealing activities with U.S. persons as counterparties are limited to foreign branches of registered U.S. swap dealers. In such cases, the Dodd-Frank Act transactional requirements (or comparable requirement) would nevertheless apply to swaps with those foreign branches and, thus, there is little concern that this exclusion could be used to engage in swap activities outside of the Dodd-Frank Act (comparable) requirements. Accordingly, the Commission believes that it would be appropriate and consistent with section 2(i) to allow non-U.S. persons to conduct swap dealing activities with registered U.S. swap dealers outside the United States (through their foreign branches), without triggering registration as a swap dealer as a result.

### i. Aggregation of Swaps

The Commission notes that section 1.3(ggg)(4) of the Commission's regulations requires that a person include, in determining whether its swap dealing activities exceed the de minimis threshold, the aggregate notional value of swap dealing transactions entered into by its affiliates under common control. It is the Commission's view that this provision would require that a non-U.S. person, in determining whether its swap dealing transactions exceed the de minimis threshold, include the aggregate notional value of any swap dealing transactions between U.S. persons and any of its non-U.S. affiliates under common control, and any swap dealing transactions of any of its non-U.S. affiliates under common control where

<sup>43</sup> In the Final Entities Rulemaking, the Commissions codified exclusions from the dealer definition for swaps and security-based swaps between majority-owned affiliates. The Commission construes section 2(i) to apply such inter-affiliates exclusion to swaps between a non-U.S. person and its U.S. affiliate or between two affiliated non-U.S. persons. See section 1.3(ggg)(6)(f) of the Commission's regulations.

the obligations of such non-U.S. affiliates are guaranteed by U.S. persons.<sup>44</sup>

The Commission is not proposing, however, that a non-U.S. person should include, in this determination, the notional value of dealing transactions in which its U.S. affiliates engage. Again, the Commission's proposed interpretation is that a direct and significant connection with activities in, or effect on, U.S. commerce, in these circumstances, exists when non-U.S. persons conduct more than a de minimis level of swap dealing activities with U.S. persons. In the case of an affiliated group of non-U.S. persons under common control, the Commission believes that all of the affiliated non-U.S. persons should aggregate the notional value of their swap dealing transactions with U.S. persons (and their swap dealing transactions with non-U.S. persons in which such person's obligations are guaranteed by U.S. persons), in order to determine, in effect, the level of swap dealing activities conducted by the affiliated group of non-U.S. persons in the aggregate. However, since the focus is on the level of activity conducted by non-U.S. persons, swap dealing transactions of affiliated U.S. persons should not be included.<sup>45</sup>

#### ii. Regular Business

As stated in the Final Entities Rulemaking, a person is required to apply the de minimis test only if it determines it is engaged in swap dealing activity under the rule further defining the term "swap dealer," which excludes swap activities that are not part of "a regular business." A person that is not engaged in swap dealing as part of "a regular business" is not required to apply the de minimis test and is not a swap dealer under the CEA.

The Commission proposes that a non-U.S. person without a guarantee from a U.S. person applying the swap dealer definition should determine first whether its swap activities with respect to U.S. persons as counterparties qualify as swap dealing activity under the rule further defining the term "swap dealer" and the exclusion of swap activities that are not part of "a regular business." Thus, for example, a non-U.S. person without a guarantee that determines it is not engaged in swap dealing as part of "a regular business" with respect to U.S. persons as counterparties is not required to apply the de minimis test or to register as a swap dealer. This would be true even if the non-U.S. person were

engaged in swap dealing as part of "a regular business" with respect to non-U.S. persons as counterparties.

The determination of whether a person is engaged in swap dealing activity involves application of the interpretive guidance in Part II.A.4. of the Final Entities Rulemaking, which provides for consideration of the relevant facts and circumstances. Similarly, the Commission proposes that the determination by a non-U.S. person without a guarantee of whether it is engaged in swap dealing as part of "a regular business" with respect to U.S. persons as counterparties (as opposed to its swap dealing activity with respect to non-U.S. persons as counterparties) will depend on consideration of the relevant facts and circumstances in light of the interpretive guidance in the Final Entities Rulemaking.

#### Request for Comment

Q2. Do commenters agree that in determining whether it is a swap dealer, a non-U.S. person without a guarantee from a U.S. person should consider whether it is engaged in swap dealing as part of "a regular business" only with respect to U.S. persons (as opposed to non-U.S. persons)? Why or why not? In such an analysis, would it generally be feasible for the non-U.S. person to distinguish swap dealing activities with U.S. persons from swap dealing activities with non-U.S. persons and are there any practical difficulties in this approach?

#### 3. Major Swap Participant

The MSP definition and associated requirements for MSPs reflect Congress' direction that any entity that holds swap positions above a level that could, among other things, "significantly impact the financial system of the United States," be considered an MSP and register and be regulated as an MSP.<sup>46</sup> In the Final Entities Rulemaking, the Commission further defined MSP to clarify when a person must register. The Commission believes that the level of swap positions that is substantial enough to require a person to register as an MSP when held by a U.S. person, also constitutes a "direct and significant connection" within the meaning of section 2(i) of the CEA when such positions reflect swaps between a non-U.S. person and U.S. persons. Consistent with this interpretation and

<sup>46</sup> CEA section 1a(33)(B), 7 U.S.C. 1a(33)(B). As is the case with respect to swap dealers, the Commission does not believe it is necessary, for purposes of this proposed interpretive guidance, to determine whether such swaps or activities between a non-U.S. person and a U.S. person are located within or outside of the United States.

the Commission's Final Entities Rulemaking, a non-U.S. person who holds swap positions where a U.S. person is a counterparty above the specified MSP thresholds would qualify and register as an MSP.

#### i. Aggregation of Positions

In determining whether it is an MSP, a non-U.S. person would "count" all of its swap positions where its counterparty is a U.S. person, but would not "count" any swap position where its counterparty is a non-U.S. person. As with swap dealing transactions, a swap between a non-U.S. person and a U.S. person, or a swap between a non-U.S. person and another non-U.S. person under which the first non-U.S. person's obligations are guaranteed by a U.S. person, in and of itself may have a direct and significant connection with activities in, or effect on, commerce of the United States within the meaning of section 2(i) of the CEA. Similarly, for purposes of applying section 2(i) of the CEA to the MSP definition and associated requirements, the Commission believes the appropriate focus is on whether in the aggregate such swaps have a direct and significant connection with activities in, or effect on, U.S. commerce, rather than whether each particular swap has such a connection or effect.

#### 4. Relevance of Guarantees

In the event of a default or insolvency of a non-U.S. swap dealer with more than a de minimis level of swap dealing with U.S. persons or a non-U.S. MSP with more than the threshold level of swap positions with U.S. persons, the swap dealer's or MSP's U.S. counterparties could be adversely affected. Such an event may adversely affect numerous persons engaged in commerce within the United States, disrupt such commerce, and increase risks of a widespread disruption to the financial system in the United States. For that reason, the Commission has a significant regulatory interest in ensuring that the swap dealer or MSP is managing the risks of such swaps appropriately and ensuring that its U.S. counterparties receive the appropriate protections under the CEA.

Similar effects on U.S. persons and on the U.S. financial system may occur in the event of a default or insolvency of a non-U.S. person with respect to a non-de minimis level of swap dealing transactions, or swap positions above the MSP threshold, of the non-U.S. person that are guaranteed by a U.S. person. In these circumstances, and regardless of whether the non-U.S. person's counterparty is a U.S. person or

<sup>44</sup> See Final Entities Rulemaking at Part II.D.4.

<sup>45</sup> See also 77 FR at 2616.



a non-U.S. person, the risk of default by the non-U.S. person with respect to its guaranteed swaps ultimately rests with a U.S. person. If there is a default by the non-U.S. person, the U.S. person would be held responsible to settle those obligations. However, the Commission's interpretive guidance with respect to guarantees differs slightly for swap dealers and MSPs.<sup>47</sup> We therefore discuss the two cases separately here.

Accordingly, the Commission proposes to interpret CEA section 2(i) as requiring a non-U.S. person to register with the Commission as a swap dealer when the aggregate notional value of its swap dealing activities with U.S. persons, or of its swap dealing activities with non-U.S. persons where the dealing non-U.S. person's obligations are guaranteed, or its ability to pay or perform its obligations thereunder are otherwise formally supported, by a U.S. person, exceed the de minimis level of swap dealing as set forth in section 1.3(ggg)(4) of the Commission's regulations. The Commission believes that when the aggregate level of swap dealing by a non-U.S. person, considering both swaps directly with U.S. persons and swaps with non-U.S. persons under which the dealing non-U.S. person's obligations are guaranteed by a U.S. person, exceeds the de minimis level of swap dealing, the dealing non-U.S. person's activities have the requisite "direct and significant connection with activities in, or effect on, commerce of the United States."

With respect to whether a person is an MSP, the Commission's interpretive guidance in the Final Entities Rulemaking provides that a person's swap positions are attributed to a parent, other affiliate or guarantor to the extent that the counterparties to those positions would have recourse to the other entity in connection with the position unless the first person is itself subject to capital regulation by the CFTC or SEC (e.g., including where the first person is a swap dealer or MSP) or is a U.S. entity regulated as a bank in the United States.<sup>48</sup> In accordance with this guidance, the Commission proposes that swap positions between a non-U.S. person, where the obligations of such non-U.S. person thereunder are guaranteed by a U.S. person, should be

<sup>47</sup> For purposes of this interpretive guidance, references to a guarantee are intended to refer not only to traditional guarantee of payment or performance of the related swaps, but would also include other formal arrangements to support the non-U.S. person's ability to pay or perform its obligations, including without limitation, liquidity puts and keepwell agreements.

<sup>48</sup> See Final Entities Rulemaking at part IV.H.

attributed to the U.S. person (and not the non-U.S. person) in determining whether either person is an MSP. In other words, the Commission proposes to interpret CEA section 2(i) as requiring non-U.S. persons to register with the Commission as MSPs when their swaps with U.S. persons, disregarding any such positions where their obligations thereunder are guaranteed by U.S. persons, exceed a relevant MSP threshold as set forth in the Final Entities Rulemaking.

## 5. Summary

This proposed interpretation may be summarized as follows. In determining whether a non-U.S. person is engaged in more than a de minimis level of swap dealing, the person should consider the aggregate notional value of:

- Swap dealing transactions between it (or any of its non-U.S. affiliates under common control) and a U.S. person (other than foreign branches of U.S. persons that are registered swap dealers); and
- Swap dealing transactions (or any swap dealing transactions of its non-U.S. affiliates under common control) where its obligations or its non-U.S. affiliates' obligations thereunder are guaranteed by U.S. persons.

In determining whether a non-U.S. person holds swap positions above the MSP thresholds, the person should consider the aggregate notional value of:

- Any swap position between it and a U.S. person (but its swap positions where its obligations thereunder are guaranteed by a U.S. person generally should be attributed to that U.S. person and not included in the non-U.S. person's determination); and
- Any swap between another non-U.S. person and a U.S. person, where it guarantees the obligations of the non-U.S. person thereunder.

## D. Foreign Branches, Agencies, Affiliates, and Subsidiaries of U.S. Swap Dealers and U.S. Branches, Agencies, Affiliates, and Subsidiaries of Non-U.S. Swap Dealers

### 1. Foreign<sup>49</sup> Branches and Agencies of U.S. Swap Dealers

The Commission understands that branches and agencies are not separate legal entities; rather, a branch or agency is a corporate extension of its principal entity.<sup>50</sup> Given that a foreign branch or

<sup>49</sup> In this release, the term "foreign" is used interchangeably with the term "non-U.S."

<sup>50</sup> See, e.g., Federal Reserve Bank of New York, Foreign Banks and the Federal Reserve, at <http://www.ny.frb.org/aboutthefed/fedpoint/fed26.html> (last visited Feb. 26, 2012). See also Federal Reserve Board, "Policy Statement on the Supervision and Regulation of Foreign Banking Organizations," Feb.

agency has no legal existence separate from a U.S. principal entity that is the legal counterparty to swaps, the Commission would apply the Dodd-Frank Act registration requirements to a U.S. person and its foreign branches and agencies on an entity-wide basis.<sup>51</sup> Under this approach, the Commission would require the U.S. person (principal entity) to register as the swap dealer. Although certain duties and obligations may be performed by the foreign branches and agencies, the U.S. person (principal entity) would remain responsible for compliance with all of the applicable responsibilities.<sup>52</sup>

### 2. Foreign Affiliates or Subsidiaries of U.S. Persons

A number of large financial institutions operate a "central booking" model under which swaps are solicited or negotiated through their branches, agencies, affiliates or subsidiaries but are booked, directly or indirectly, in a single legal entity (typically the parent company) for balance sheet and financial reporting purposes.<sup>53</sup> In some cases, the affiliate which has negotiated the swap may be acting as a principal and may transfer the exposure to the central booking entity by back-to-back transactions or other arrangements. In other cases, the affiliate that has arranged or negotiated the trade may be acting as an agent for the central booking entity, in which case the central booking entity may enter into the swap transaction so that the central booking entity is, as a contractual matter, directly facing the third-party counterparty in the swap transaction. Given these various ways of implementing a central booking arrangement, the question arises as to how the Dodd-Frank Act registration

23, 1979, Federal Reserve Regulatory Service 4-835; Federal Reserve Board Supervisory Letter SR 08-09 re: Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations, Oct. 16, 2008. See also Institute of International Bankers, Comment Letter at 15-16, Jan. 10, 2011 (acknowledging the principal-agency relationship and advocating for the Commission to adopt a registration regime predicated on the intermediating activities of U.S. branches and agencies).

<sup>51</sup> The Commission notes that the supervisory authority of the Office of the Comptroller of the Currency extends to foreign branch offices of national banks under its jurisdiction.

<sup>52</sup> Under this model, the foreign branch or agency of the U.S. person would not register separately as a swap dealer.

<sup>53</sup> See Seven Foreign Banks ("Many foreign banks operate and manage their global swaps businesses out of a single entity \* \* \*. [T]his entity is the central booking vehicle, acting as principal to counterparties in the U.S. and other jurisdictions.") (Jan. 11, 2011); IIB (Jan. 10, 2011). These comment letters are available on the Commission's Web site at <http://comments.cftc.gov/PublicComments/CommentList.aspx?id=903>.

requirement would apply to the affiliate facing the third party counterparty and the central booking entity or guarantor. The following subsection addresses which entity must register as a swap dealer in such central “booking” model.

The Commission proposes to interpret section 2(i) of CEA so that the U.S. person who books the swaps would be required to register as a swap dealer, regardless of whether the swaps were directly booked by the U.S. person (by such person becoming a party to the swap) or indirectly transferred to the U.S. person (by way of a back-to-back swap or other arrangement). In either case, the affiliate may also be required to register as a swap dealer if by its activities it independently meets the definition of swap dealer.

### 3. U.S. Branches, Agents, Affiliates, or Subsidiaries of Non-U.S. Persons

A similar analysis applies when a non-U.S. person is the booking entity (*i.e.*, the legal counterparty) to swaps.<sup>54</sup> Under these circumstances, even if the U.S. branch, agency, affiliate, or subsidiary of a non-U.S. person engages in solicitation or negotiation in connection with the swap entered into by the non-U.S. person, the Commission proposes to interpret section 2(i) of CEA such that the Dodd-Frank Act requirements, including the registration requirement, applicable to swap dealers also apply to the non-U.S. person.

#### Request for Comment

Q3. Please provide comments regarding all aspects of the Commission’s proposed interpretation, including particular alternative interpretations the Commission should

<sup>54</sup> As further described below (in subsection E), a number of commenters urge the Commission to treat a branch of a non-U.S. bank as a separate legal entity. Extending this logic to the registration context, these commenters support the registration and regulation of the branch. The Commission notes CEA section 1a(39) (7 U.S.C. 1a(39)) states that the term “prudential regulator” shall mean the Board of Governors of the Federal Reserve System in the case of a swap dealer, MSP, security-based swap dealer, or major security-based swap participant that is—

(v) any bank holding company [citation omitted], any foreign bank (as defined in section 1(b)(7) of the International Banking Act of 1978 (12 U.S.C. 3101(b)(7))) that is treated as a bank holding company under section 8(a) of the International Banking Act of 1978 (12 U.S.C. 3106(a)), and any subsidiary of such a company or foreign bank (other than a subsidiary that is described in subparagraph (A) or (B) or that is required to be registered with the Commission as a swap dealer or major swap participant under this Act or with the [SEC] as a security-based swap dealer or major security-based swap participant).

Clearly, Congress contemplated that foreign banks that become bank holding companies by virtue of the presence of a branch or a subsidiary in the United States may be regulated as swap dealers.

consider in assessing whether a non-U.S. person should be required to register as a swap dealer or MSP.

Q3a. Do commenters agree that the Commission should determine whether a non-U.S. person, without a guarantee from a U.S. affiliate, is a swap dealer based solely upon the aggregate notional amount of swap dealing activities with U.S. persons as counterparties? Why or why not?

Q3b. Do commenters agree that the Commission should determine whether a non-U.S. person is a swap dealer based on the aggregate notional amount of swap dealing obligations of such non-U.S. person are guaranteed by a U.S. person? Why or why not?

Q3c. Do commenters agree that in determining whether a non-U.S. person is a swap dealer, the notional amount of swap dealing activities conducted by it and all of its non-U.S. affiliates under common control should be aggregated together? Why or why not? Should the Commission further interpret the phrase “under common control” and, if so, how should the Commission define “common control” for aggregation purposes? Should the notional amount of swap dealing activities conducted by its U.S. affiliates also be included?

Q3d. Are any other aspects of a swap—such as, for example, the place of execution or clearing—relevant to the determination of whether a non-U.S. person is a swap dealer?

Q3e. Do commenters agree that the Commission should determine whether a non-U.S. person is an MSP based solely on its swap positions with U.S. persons as counterparties? If not, why?

Q3f. Do commenters agree that, in determining whether a non-U.S. person is an MSP, its swap positions guaranteed by a U.S. person should be attributed to such U.S. person and not the non-U.S. person? If not, why? How should the Commission’s determination change when some but not all of the non-U.S. person’s swap obligations are guaranteed by a U.S. person?

Q3g. Are any other aspects of a swap—such as the place of execution or clearing—relevant to the determination of whether a non-U.S. person is an MSP?

Q4. As noted above, the Commission does not propose that a non-U.S. person should include, in determining whether the swap dealer *de minimis* threshold is met, the notional value of swap dealing transactions with foreign branches of U.S. swap dealers. Noting the risk-based, as opposed to activities-based, nature of the MSP registration category and related calculations, the Commission seeks comment on whether

a non-U.S. person should include, in determining whether it is required to register as an MSP, its swap positions with foreign branches of U.S. swap dealers.

Q5. Under the aggregation description above, a non-U.S. person, in determining whether the *de minimis* threshold is met, must include the notional value of dealing swaps by its non-U.S. affiliates under common control. The Commission requests comments on whether, to the extent that any such non-U.S. affiliate is registered with the Commission as a swap dealer, the notional value of dealing swaps entered into by such registered swap dealer should not be aggregated with the notional value of dealing swaps entered into by the other non-U.S. affiliates under common control.<sup>55</sup>

Q7. Should the Commission consider any other types of swap dealing transactions by non-U.S. persons to determine whether a non-U.S. person is a swap dealer? If so, which ones?

Q8. Do commenters agree that the Commission should exclude the swap dealing transactions of a non-U.S. person from the determination of whether such non-U.S. person qualifies as a swap dealer, where the counterparty to such dealing swaps are non-U.S. persons (guaranteed or not)? Should the Commission exclude swap obligations in excess of a capped guaranty provided by a U.S. person (*i.e.*, a guaranty that limits the U.S. person’s liability to a capped or maximum amount)? How should the Commission account for the reduced risks assumed by a U.S. person guaranteeing certain or all swaps of a particular non-U.S. person under that non-U.S. person’s master agreements with non-U.S. counterparties, where the U.S. person’s liability under the guaranty is limited?

Q9. Can a limited designation registration as provided for in the statutory definitions of the terms “swap dealer” and “major swap participant” be used to address the Commission’s regulatory interests under the Dodd-Frank Act with respect to cross-border swap activities? If so, how?

<sup>55</sup> Thus, within an affiliated group of firms, the dealing activities of any affiliates that are registered with the Commission as swap dealers would not be included in considering whether any of the other affiliates are required to register as a swap dealer. However, all non-U.S. affiliates under common control that are not so registered would have to aggregate the notional value of any swap dealing transactions with U.S. persons (or where the obligations of such non-U.S. affiliates are guaranteed by U.S. persons) to determine if such swap dealing transactions exceed the *de minimis* threshold of swap dealing activity.

### III. Cross-Border Application of the CEA's Swap Provisions and Implementing Regulations

A non-U.S. person who meets or exceeds the de minimis threshold for swap dealers or the position thresholds for MSPs would be required to register with the Commission as a swap dealer or MSP, respectively, pursuant to the procedures prescribed in Part 3 of the Commission's regulations.<sup>56</sup> Once registered, the non-U.S. swap dealer or non-U.S. MSP would become subject to all of the substantive requirements under Title VII of the Dodd-Frank Act that apply to registered swap dealers or MSPs, including but not limited to sections 2(a)(13), 4r, and 4s of the CEA, with respect to all of their swap activities. In other words, the requirements under Title VII of the Dodd-Frank Act related to swap dealers and MSPs apply to all registered swap dealers and MSPs, irrespective of where such dealer or MSP is based. In exercising its authority over non-U.S. swap dealers, non-U.S. MSPs, or cross-border activities, however, the Commission will be informed by canons of statutory construction regarding the application of its authority in a manner consistent with principles of international comity. A brief discussion of these principles follows.

#### A. Principles of International Comity

The Supreme Court has held that "an act of Congress ought never to be construed to violate the law of nations if any other possible construction remains."<sup>57</sup> Jurisdiction is generally construed, "to avoid unreasonable interference with the sovereign authority of other nations."<sup>58</sup> The most relevant Supreme Court precedents addressing the application of international comity concepts in determining the extraterritorial applicability of federal statutes come from antitrust.<sup>59</sup> In these cases, the Supreme Court has noted that the principles in the Third Restatement of Foreign Relations Law are relevant to the interpretation of U.S. law:

This rule of construction reflects principles of customary international law—law that (we must assume) Congress ordinarily seeks to follow. See Restatement (Third) of Foreign Relations Law of the United States §§ 403(1), 403(2) (1986). \* \* \*

This rule of statutory construction cautions courts to assume that legislators take account

of the legitimate sovereign interests of other nations when they write American laws. It thereby helps the potentially conflicting laws of different nations work together in harmony—a harmony particularly needed in today's highly interdependent commercial world.<sup>60</sup>

In accordance with judicial and executive branch precedent and guidance in interpreting statutes with cross-border application, the Commission proposes that it should exercise its regulatory authority over cross-border activities in a manner consistent with these principles of statutory construction and international comity.<sup>61</sup> The Commission is therefore guided by these principles as discussed in these precedents.<sup>62</sup>

<sup>60</sup> *F. Hoffmann-La Roche, Ltd.*, 542 U.S. at 164–65. Specifically, section 403 of the Restatement (Third) of Foreign Relations Law states, in relevant part:

Whether exercise of jurisdiction over a person or activity is unreasonable is determined by evaluating all relevant factors, including, where appropriate:

(a) The link of the activity to the territory of the regulating state, *i.e.*, the extent to which the activity takes place within the territory, or has substantial, direct, and foreseeable effect upon or in the territory;

(b) The connections, such as nationality, residence, or economic activity, between the regulating state and the person principally responsible for the activity to be regulated, or between that state and those whom the regulation is designed to protect;

(c) The character of the activity to be regulated, the importance of regulation to the regulating state, the extent to which other states regulate such activities, and the degree to which the desirability of such regulation is generally accepted;

(d) The existence of justified expectations that might be protected or hurt by the regulation;

(e) The importance of the regulation to the international political, legal, or economic system;

(f) The extent to which the regulation is consistent with the traditions of the international system;

(g) The extent to which another state may have an interest in regulating the activity; and

(h) The likelihood of conflict with regulation by another state.

<sup>61</sup> For a similar consideration of the application of principles of international comity by federal agencies in the enforcement of the antitrust laws, see U.S. Department of Justice and the Federal Trade Commission, Antitrust Enforcement Guidelines for International Operations, Apr. 1995, which is available at <http://www.justice.gov/atr/public/guidelines/internat.htm>.

<sup>62</sup> The Commission has a longstanding policy of considering principles of international comity in its rulemakings and interpretations. For example, the Commission adopted regulatory amendments that codify its longstanding policy towards foreign brokers. See Exemption from Registration for Certain Foreign Persons, 72 FR 63976, 63978–79, Nov. 14, 2007. The amendments codified a registration exemption for any foreign person functioning as an introducing broker, commodity pool operator or commodity trading advisor solely on behalf of customers located outside the United States, if all commodity interest transactions are submitted for clearing to a registered FCM. See *id.* at 63978–79. In addition, the Commission amended § 3.12 of the Commission's regulations to codify a registration exemption for any individual located in the branch office of a Commission registrant that

*B. Proposed Application of the CEA's Swap Provisions to Non-U.S. Swap Dealers and Foreign Branches, Agencies, Affiliates, and Subsidiaries of U.S. Swap Dealers*

#### 1. Categories of Regulatory Requirements

Title VII of the Dodd-Frank Act establishes a comprehensive new regulatory framework for swap dealers and MSPs. This framework is an important element of the "improve[d] financial architecture" that Congress intended in enacting the Dodd-Frank Act and its goal of reducing systemic risk and enhancing market transparency.<sup>63</sup> Among other things, a registered swap dealer or MSP must comport with certain standards (and regulations as the Commission may promulgate) governing risk management, internal and external business conducts, and reporting. Further, U.S. swap dealers and MSPs, once registered, are required to comply with all of the requirements applicable to swap dealers and MSPs for all their swaps, not just the swaps that make them a swap dealer or MSP.

A number of commenters recommended that the Commission, in interpreting the cross-border applicability of the Dodd-Frank Act swap provisions to a registered swap dealer or MSP, should distinguish between requirements that: (i) Apply at an entity level (*i.e.*, to the firm as a whole); or (ii) apply at a transactional level (*i.e.*, to the individual transaction or trading relationship).<sup>64</sup> These commenters believed that requirements that relate to the core operations of a firm should be applied on an entity-level basis and would include the capital and related prudential requirements and recordkeeping, as well as certain risk mitigation requirements (*e.g.*, information barriers and the designation of a chief compliance officer). The commenters stated that other requirements, such as margin, should apply on transaction-by-transaction basis and only to swaps with U.S. counterparties.<sup>65</sup>

The Commission agrees with the commenters that the various Dodd-Frank Act swap provisions can be conceptually divided into the following

does not solicit or accept orders from customers located in the United States.

<sup>63</sup> S. Rep. No. 111–176, at 228 (2010), available at <http://www.gpo.gov/fdsys/pkg/CRPT-111srpt176/pdf/CRPT-111srpt176.pdf>.

<sup>64</sup> See, *e.g.*, SIFMA (Feb. 3, 2011), ISDA (Jan. 24, 2011), Cleary (Sept. 20, 2011), Seven Foreign Banks (Jan. 11, 2011), and Twelve Foreign Banks (Feb. 17, 2011).

<sup>65</sup> See SIFMA (Feb. 3, 2011).

<sup>56</sup> See 7 U.S.C. 6s(b)(1). See also 77 FR 2613, 2616, Jan. 19, 2012.

<sup>57</sup> *Hartford Fire Ins. Co. et al.*, 509 U.S. 764, 817 (1993); *F. Hoffmann-La Roche, Ltd.*, 542 U.S. 155, 164 (2004).

<sup>58</sup> *F. Hoffmann-La Roche, Ltd.*, 542 U.S. at 164.

<sup>59</sup> See notes 82–84, *supra*.

two categories: (i) Entity-Level Requirements, which apply to a swap dealer or MSP to the firm as a whole; and (ii) Transactional-Level Requirements, which apply to the individual swap. A discussion of the Entity-Level Requirements is set out in the section immediately below, followed by discussions of the Transaction-Level Requirements.

## 2. Entity-Level Requirements

The Entity-Level Requirements under Title VII of the Dodd-Frank Act and the Commission's regulations promulgated thereunder relate to: (i) Capital adequacy; (ii) chief compliance officer; (iii) risk management; (iv) swap data recordkeeping; (v) swap data reporting ("SDR Reporting"); and (vi) physical commodity swaps reporting ("Large Trader Reporting"). The Entity-Level Requirements apply to registered swap dealers and MSPs across all their swaps without distinctions as to the counterparty or the location of the swap.

The first subcategory of Entity-Level Requirements relating to capital adequacy, chief compliance officer, risk management, and swap data recordkeeping relate to risks to a firm as a whole. These requirements address and manage risks that arise from a firm's operation as a swap dealer or MSP. Individually, they represent a key component of a firm's internal risk controls. Collectively, they constitute a firm's first line of defense against financial, operational, and compliance risks that could lead to a firm's default or failure.

At the core of a robust internal risk controls system is the firm's capital—and particularly, how the firm identifies and manages its risk exposure arising from its portfolio of activities.<sup>66</sup> Equally foundational to the financial integrity of a firm is an effective internal risk management process, which must be comprehensive in scope and reliant on timely and accurate data regarding its swap activities. To be effective, such system must have a strong and independent compliance function. These internal controls-related requirements—namely, the requirements related to chief compliance officer, risk management, swap data recordkeeping—are designed to serve that end. Given their functions, this subcategory of Entity-Level Requirements must be applied on a

<sup>66</sup> By way of illustration, consistent with the purpose of the capital requirement, which is intended to reduce the likelihood and cost of a swap dealer's default by requiring a financial cushion, a swap dealer's or MSP's capital requirements would be set on the basis of its overall portfolio of assets and liabilities.

firm-wide basis to effectively address risks to the swap dealer or MSP as a whole.

The second subcategory of Entity-Level Requirements, namely, SDR Reporting and Large Trader Reporting, relates more closely to the Commission's market surveillance program. Among other things, data reported to swap data repositories ("SDRs") will enhance the Commission's understanding of concentrations of risks within the market, as well as promote a more effective monitoring of risk profiles of market participants in the swaps market. Large Trader Reporting, along with an analogous reporting system for futures contracts, is essential to the Commission's ability to conduct effective surveillance of the futures market and their economically equivalent swaps. Given the functions of these reporting requirements, each must be applied across swaps, irrespective of the counterparty or the location of the swap, in order to ensure that the Commission has a comprehensive and accurate picture of market activities. Otherwise, the intended benefits of these Entity-Level Requirements would be significantly compromised, if not undermined. Each of the Entity-Level Requirements is discussed in the subsections that follow.

### i. Capital Requirements

Section 4s(e)(3)(A) of the CEA specifically directs the Commission to set capital requirements for swap dealers and MSPs that are not subject to the capital requirements of prudential regulators (hereinafter referred to as "non-bank swap dealers or MSPs").<sup>67</sup>

<sup>67</sup> See 7 U.S.C. 6s(e)(3)(A). Section 4s(e) of the CEA explicitly requires the adoption of rules establishing capital and margin requirements for swap dealers and MSPs, and applies a bifurcated approach that requires each swap dealer and MSP for which there is a prudential regulator to meet the capital and margin requirements established by the applicable prudential regulator, and each swap dealer and MSP for which there is no prudential regulator to comply with the Commission's capital and margin regulations. See 7 U.S.C. 6s(e). Further, systemically important financial institutions ("SIFIs") that are not futures commission merchants would be exempt from the Commission's capital requirements, and would comply instead with Federal Reserve Board requirements applicable to SIFIs, while nonbank (and non-futures commission merchant) subsidiaries of U.S. bank holding companies would calculate their Commission capital requirement using the same methodology specified in Federal Reserve Board regulations applicable to the bank holding company, as if the subsidiary itself were a bank holding company. The term "prudential regulator" is defined in CEA section 1a(39) as the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency. See 7 U.S.C. 1a(39).

These requirements must: "(1) [h]elp ensure the safety and soundness of the swap dealer or major swap participant; and (2) [be] appropriate for the risk associated with the non-cleared swaps held as a swap dealer or major swap participant."<sup>68</sup> Pursuant to section 4s(e)(3), the Commission proposed regulations, which would require non-bank swap dealers and MSPs to hold a minimum level of adjusted net capital (*i.e.*, "regulatory capital") based on whether the non-bank swap dealer or MSP is: (i) Also a futures commission merchant ("FCM"); (ii) not an FCM, but is a non-bank subsidiary of a bank holding company; or (iii) neither an FCM nor a non-bank subsidiary of a bank holding company.<sup>69</sup> The purpose of the capital requirement is to reduce the likelihood and cost of a swap dealer's or MSP's default by requiring a financial cushion that can absorb losses in the event of the firm's default.

### ii. Chief Compliance Officer

Section 4s(k) requires that each swap dealer and MSP designate an individual to serve as its chief compliance officer ("CCO") and specifies certain duties of the CCO.<sup>70</sup> Pursuant to section 4s(k), the Commission recently adopted § 3.3, which requires swap dealers and MSPs to designate a CCO who would be responsible for administering the firm's compliance policies and procedures, reporting directly to the board of directors or a senior officer of the swap dealer or MSP, as well as preparing and filing with the Commission a certified report of compliance with the CEA.<sup>71</sup> The chief compliance function is an integral element of a firm's risk management and oversight and the Commission's effort to foster a strong culture of compliance within swap dealers and MSPs.

<sup>68</sup> See 7 U.S.C. 6s(e)(3)(A).

<sup>69</sup> See 7 U.S.C. 6s(e). See also Capital Requirements of Swap Dealers and Major Swap Participants, 76 FR 27802, May 12, 2011. "The Commission's capital proposal for [swap dealers] and MSPs includes a minimum dollar level of \$20 million. A non-bank [swap dealer] or MSP that is part of a U.S. bank holding company would be required to maintain a minimum of \$20 million of Tier 1 capital as measured under the capital rules of the Federal Reserve Board. [A swap dealer] or MSP that also is registered as an FCM would be required to maintain a minimum of \$20 million of adjusted net capital as defined under [proposed] section 1.17. In addition, a [swap dealer] or MSP that is not part of a U.S. bank holding company or registered as an FCM would be required to maintain a minimum of \$20 million of tangible net equity, plus the amount of the [swap dealer's] or MSP's market risk exposure and OTC counterparty credit risk exposure." See *id.* at 27817.

<sup>70</sup> See 7 U.S.C. 6s(k).

<sup>71</sup> See 17 CFR 3.3.

### iii. Risk Management

Section 4s(j) of the CEA requires each swap dealer and MSP to establish internal policies and procedures designed to, among other things, address risk management, monitor compliance with position limits, prevent conflicts of interest, and promote diligent supervision, as well as maintain business continuity and disaster recovery programs.<sup>72</sup> The Commission recently adopted implementing sections 23.600, 23.601, 23.602, 23.603, 23.605, 23.606, and 23.607 of its regulations.<sup>73</sup> The Commission also recently adopted section 23.609 of its regulations, which requires certain risk management procedures for swap dealers or MSPs that are clearing members of a derivatives clearing organization (“DCO”).<sup>74</sup> Collectively, these requirements help to establish a robust and comprehensive internal risk management program for swap dealers and MSPs, which is critical to effective systemic risk management for the overall swaps market.

### iv. Swap Data Recordkeeping

CEA section 4s(f)(1)(B) requires swap dealers and MSPs to keep books and records for all activities related to their business.<sup>75</sup> Section 4s(g)(1) requires swap dealers and MSPs to maintain trading records for each swap and all related records, as well as a complete audit trail for comprehensive trade reconstructions.<sup>76</sup> Pursuant to these provisions, the Commission adopted §§ 23.201 and 23.203, which require swap dealers and MSPs to keep records

including complete transaction and position information for all swap activities, including documentation on which trade information is originally recorded.<sup>77</sup> Swap dealers and MSPs also must comply with Part 46 of the Commission’s regulations, which addresses the recordkeeping requirements for swaps entered into before the date of enactment of the Dodd-Frank Act (“pre-enactment swaps”) and data relating to swaps entered into on or after the date of enactment but prior to the compliance date of the swap data reporting rules (“transition swaps”).<sup>78</sup>

### v. Swap Data Reporting

CEA section 2(a)(13)(G) requires all swaps, whether cleared or uncleared, to be reported to a registered SDR.<sup>79</sup> CEA section 21 requires SDRs to collect and maintain data related to swaps as prescribed by the Commission, and to make such data electronically available to regulators.<sup>80</sup> Swap dealers and MSPs would be required to comply with Part 45 of the Commission’s regulations, which sets forth the specific transaction data that reporting counterparties and registered entities must report to a registered SDR; and Part 46, which addresses the recordkeeping requirements for pre-enactment swaps and data relating to transition swaps. Among other things, data reported to SDRs will enhance the Commission’s understanding of concentrations of risks within the market, as well as promote a more effective monitoring of risk profiles of market participants in the swaps market. The Commission also believes that there are benefits that will accrue to swap dealers and MSPs as a result of the timely reporting of comprehensive swap transactional data and consistent data standards for recordkeeping, among other things. Such benefits include more robust risk monitoring and management capabilities for swap dealers and MSPs, which in turn will improve the monitoring of their current swap market positions.

### vi. Physical Commodity Swaps Reporting (Large Trader Reporting)

CEA section 4t<sup>81</sup> authorizes the Commission to establish a large trader reporting system for significant price discovery swaps (of which economically equivalent swaps subject to part 20 reporting are a subset) in order to implement the statutory mandate in CEA section 4a<sup>82</sup> for the Commission to establish and monitor position limits, as appropriate, for physical commodity swaps. Pursuant thereto, the Commission adopted part 20 rules requiring swap dealers, among other entities, to submit routine position reports on certain physical commodity swaps and swaptions.<sup>83</sup> Additionally, part 20 rules require that swap dealers, among other entities, comply with certain recordkeeping obligations.

### 3. Transaction-Level Requirements

The Transaction-Level Requirements under Title VII of the Dodd-Frank Act and the Commission’s regulations (proposed or adopted) include: (i) 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.

The Transaction-Level Requirements—with the exception of external business conduct standards—relate to both risk mitigation and market transparency. Certain of these requirements, such as clearing and margining, serve to lower a firm’s risk of failure. In that respect, these Transaction-Level Requirements could be classified as Entity-Level Requirements. Other Transaction-Level Requirements—such as trade confirmation, swap trading relationship documentation, and portfolio reconciliation and compression—also serve important risk mitigation functions, but are less closely connected to risk mitigation of the firm as a whole and thus are more appropriately applied

<sup>72</sup> 7 U.S.C. 6s(j).

<sup>73</sup> 7 CFR 23.600, 23.601, 23.602, 23.603, 23.605, 23.606, and 23.607; *see also* Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rule, Futures Commission Merchant and Introducing Broker Conflicts of Interest Rule, and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants, 77 FR 20128, Apr. 3, 2012 (relating to risk management program, monitoring of position limits, business continuity and disaster recovery, conflicts of interest policies and procedures, general information availability, and antitrust considerations, respectively).

<sup>74</sup> 17 CFR 23.609, *see also* Customer Clearing Documentation, Timing of Acceptance for Clearing, and Clearing Member Risk Management, 77 FR 21278, Apr. 9, 2012. Also, swap dealers must comply with § 23.608, which prohibits swap dealers providing clearing services to customers from entering into agreements that would: (i) Disclose the identity of a customer’s original executing counterparty; (ii) limit the number of counterparties a customer may trade with; (iii) impose counterparty-based position limits; (iv) impair a customer’s access to execution of a trade on terms that have a reasonable relationship to the best terms available; or (v) prevent compliance with specified time frames for acceptance of trades into clearing.

<sup>75</sup> 7 U.S.C. 6s(f)(1)(B).

<sup>76</sup> 7 U.S.C. 6s(g)(1).

<sup>77</sup> 17 CFR 23.201 and 23.203; *see also* 77 FR 20128, Apr. 3, 2012. These requirements also require a swap dealer to provide the Commission with regular updates concerning its financial status, as well as information concerning internal corporate procedures.

<sup>78</sup> 17 CFR 46.1 *et seq.*; Swap Data Recordkeeping and Reporting Requirements: Pre-Enactment and Transition Swaps, 76 FR 22833, Apr. 25, 2011.

<sup>79</sup> 7 U.S.C. 2(a)(13)(G).

<sup>80</sup> 7 U.S.C. 24a.

<sup>81</sup> 7 U.S.C. 6t.

<sup>82</sup> 7 U.S.C. 6a.

<sup>83</sup> Large Trader Reporting for Physical Commodity Swaps, 76 FR 43851, July 22, 2011. The rules require regular position reporting and recordkeeping by clearing organizations, clearing members, and swap dealers for any principal or counterparty accounts with reportable position in physical commodity swaps. In general, the rules apply to swaps that are linked to either the price of any of the 46 physical commodity futures contracts the Commission enumerates (Covered Futures Contracts) or the price of the physical commodity at the delivery location of any of the Covered Futures Contracts.

on a transaction-by-transaction basis. Likewise, the requirements related to trade execution, trade confirmation, daily trading records, and real-time public reporting have a closer nexus to the transparency goals of the Dodd-Frank Act, as opposed to addressing the risk of a firm's failure.

As a result, whether a particular Dodd-Frank Act requirement should apply on a transaction-by-transaction basis in the context of cross-border activity for purposes of section 2(i) of the CEA requires the Commission to exercise some degree of judgment, including considerations of international comity. Each of the Transaction-Level Requirements is discussed below.

#### i. Clearing and Swap Processing

Section 2(h) of the CEA requires a swap to be submitted for clearing to a DCO if the Commission has determined that the swap is required to be cleared, unless one of the parties to the swap is eligible for an exception from the clearing requirement and elects not to clear the swap.<sup>84</sup> Clearing via a DCO eliminates the risk of settlement for swap dealers or MSPs and their counterparties. Closely interlocked with the clearing requirement are the following swap processing requirements: (i) The recently finalized § 23.506, which requires swap dealers and MSPs to submit swaps promptly for clearing; and (ii) § 23.610, which establishes certain standards for swap processing by swap dealers and MSPs that are clearing members of a DCO.<sup>85</sup> Together, the clearing and swap processing requirements promote safety and soundness of swap dealers and MSPs, and aim to protect their counterparties from the risk of a default.

#### ii. Margin and Segregation Requirements for Uncleared Swaps

Section 4s(e) of the CEA requires the Commission to set margin requirements for swap dealers (and MSPs) that trade in swaps that are not cleared.<sup>86</sup> The

margin requirements aim to reduce the risk of swap dealers, MSPs, and their counterparties taking on excessive risks posed by uncleared swaps without having adequate financial backing to fulfill their obligations under the swap. In addition, with respect to swaps that are not submitted for clearing, section 4s(l) requires that a swap dealer or MSP notify the counterparty of its right to require segregation of funds provided as margin, and upon such request, to segregate the funds with a third-party custodian for the benefit of the counterparty. In this way, the segregation requirement enhances the safety of margin and thereby provides additional financial protection to counterparties.

#### iii. Trade Execution Requirement

Integrally linked to the clearing requirement is the trade execution requirement, which is intended to bring the trading of mandatorily cleared swaps onto regulated exchanges. Specifically, section 2(h)(8) of the CEA provides that unless a clearing exception applies and is elected, a swap that is subject to a clearing requirement must be executed on a designated contract market ("DCM") or swap execution facility ("SEF"), unless no such DCM or SEF makes the swap available to trade.<sup>87</sup> By requiring the trades of mandatorily cleared swaps to be executed on an exchange—with its attendant pre- and post-trade transparency and safeguards to ensure market integrity—the trade execution requirement furthers the statutory goals of financial stability, market efficiency and enhanced transparency.

#### iv. Swap Trading Relationship Documentation

CEA Section 4s(i) requires each swap dealer and MSP to conform to Commission standards for the timely and accurate confirmation, processing, netting, documentation and valuation of swaps. Pursuant thereto, the Commission has proposed § 23.504(a) of its regulations, which would require swap dealers and MSPs to "establish, maintain and enforce written policies and procedures" to ensure that the swap dealer or MSP executes written swap trading relationship documentation.<sup>88</sup> Under proposed §§ 23.505(b)(1), 23.504

In contrast, the segregation requirements in section 4s(l) do not use a bifurcated approach—that is, all swap dealers and MSPs are subject to the Commission's rule regarding notice and third party custodians for margin collected for uncleared swaps.

<sup>87</sup> See 7 U.S.C. 2(h)(8).

<sup>88</sup> See Swap Trading Relationship documentation Requirements for Swap Dealers and Major Swap Participants, 76 FR 6715, Feb. 8, 2011.

(b)(3), and 23.504(b)(4) of the Commission's regulations, the swap trading relationship documentation must include, among other things: all terms governing the trading relationship between the swap dealer or MSP and its counterparty; credit support arrangements; investment and re-hypothecation terms for assets used as margin for uncleared swaps, and custodial arrangements.<sup>89</sup> Further, the swap trading relationship documentation requirement applies to all swaps with registered swap dealers and MSPs. A robust swap documentation standard may promote standardization of documents and transactions, which are key conditions for central clearing, and lead to other operational efficiencies, including improved valuation and risk management.

#### v. Portfolio Reconciliation and Compression

CEA section 4s(i) directs the Commission to prescribe regulations for the timely and accurate processing and netting of all swaps entered into by swap dealers and MSPs. Pursuant to CEA section 4s(i), the Commission proposed §§ 23.502 and 23.503 of its regulations, which would require swap dealers and MSPs to perform portfolio reconciliation and compression, respectively, for all swaps.<sup>90</sup> Portfolio reconciliation is a post-execution risk management tool to ensure accurate confirmation of a swap's terms and to identify and resolve any discrepancies between counterparties regarding the valuation of the swap. Portfolio compression is a post-trade processing and netting mechanism that is intended to ensure timely, accurate processing and netting of swaps.<sup>91</sup> Proposed § 23.503(c) would require all swap dealers and MSPs to participate in bilateral compression exercises and/or multilateral portfolio compression exercises conducted by their self-regulatory organizations ("SROs") or DCOs of which they are members.<sup>92</sup> Further, participation in multilateral

<sup>89</sup> The requirements under section 4s(i) relating to trade confirmations is a Transaction-Level Requirement. Accordingly, proposed section 23.504(b)(2), which requires a swap dealer's and MSP's swap trading relationship documentation to include all confirmations of swaps, will apply on a transaction-by-transaction basis.

<sup>90</sup> See Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants, 75 FR 81519, Dec. 28, 2010.

<sup>91</sup> For example, the reduced transaction count may decrease operational risk as there are fewer trades to maintain, process and settle.

<sup>92</sup> See 17 CFR 23.503(c), 75 FR 81519, Dec. 28, 2010.

<sup>84</sup> 7 U.S.C. 2(h)(1), (7).

<sup>85</sup> 17 CFR 23.506, 23.610 and Customer Clearing Documentation, Timing of Acceptance for Clearing, and Clearing Member Risk Management, 77 FR 21278, Apr. 9, 2012.

<sup>86</sup> See 7 U.S.C. 6s(e). See also Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 FR 23732, 23733–40, Apr. 28, 2011. Section 4s(e) explicitly requires the adoption of rules establishing margin requirements for swap dealers and MSPs, and applies a bifurcated approach that requires each swap dealer and MSP for which there is a prudential regulator to meet the margin requirements established by the applicable prudential regulator, and each swap dealer and MSP for which there is no prudential regulator to comply with the Commission's margin regulations.

portfolio compression exercises is mandatory for dealer-to-dealer trades.

#### vi. Real-Time Public Reporting

Section 2(a)(13) of the CEA directs the Commission to promulgate rules providing for the public availability of swap transaction data on a real time basis.<sup>93</sup> In accordance with this mandate, the Commission promulgated part 43 of its rules on December 20, 2011, which provide that all “publicly reportable swap transactions” must be reported and publicly disseminated.<sup>94</sup> The real-time dissemination of swap transaction and pricing data supports the fairness and efficiency of markets and increases transparency, which in turn improves price discovery and decreases risk (e.g., liquidity risk).<sup>95</sup>

#### vii. Trade Confirmation

Section 4s(i) of the CEA<sup>96</sup> requires that each swap dealer and MSP must comply with the Commission’s regulations prescribing timely and accurate confirmation of swaps. The Commission has proposed § 23.501, which requires, among other things, a timely and accurate confirmation of all swaps and life cycle events for existing swaps.<sup>97</sup> Timely and accurate confirmation of swaps—together with portfolio reconciliation and compression—are important post-trade processing mechanisms for reducing risks and improving operational efficiency.<sup>98</sup>

#### viii. Daily Trading Records

Pursuant to section CEA 4s(g)(1), the Commission adopted § 23.202 of its regulations, which requires swap dealers and MSPs to maintain daily trading records, including records of trade information related to pre-execution, execution, and post-execution data that is needed to conduct a comprehensive and accurate trade reconstruction for each swap. The final rule also requires that records be kept of

cash or forward transactions used to hedge, mitigate the risk of, or offset any swap held by the swap dealer or MSP.<sup>99</sup> Accurate and timely recordkeeping regarding all phases of a swap can serve to greatly enhance a firm’s internal supervision, as well as the Commission’s ability to detect and address market abuses.

#### ix. External Business Conduct Standards

Pursuant to CEA section 4s(h), the Commission has adopted external business conduct rules, which establish business conduct standards governing the conduct of swap dealers and MSPs in dealing with their counterparties in entering into swaps.<sup>100</sup> Broadly speaking, these rules are designed to enhance counterparty protection by significantly expanding the obligations of swap dealers and MSPs towards their counterparties. Under these rules, swap dealers and MSPs will be required, among other things, to conduct due diligence on their counterparties to verify eligibility to trade, provide disclosure of material information about the swap to their counterparties, provide a daily mid-market mark for uncleared swaps and, when recommending a swap to a counterparty, make a determination as to the suitability of the swap for the counterparty based on reasonable diligence concerning the counterparty.

#### 4. Application of the Entity-Level Requirements<sup>101</sup>

The Dodd-Frank Act takes a comprehensive and integrated approach to the regulation of the swaps market. The first subcategory of Entity-Level Requirements, relating to capital adequacy, chief compliance officer, risk management, and swap data recordkeeping are at the heart of such framework. Specifically, these Entity-Level Requirements ensure that registered swap dealers and MSPs implement and maintain a comprehensive and robust system of internal controls to ensure the financial integrity of the firm, and in turn, the protection of the financial system. In this respect, the Commission has strong

supervisory interests in applying the same rigorous standards, or comparable standards, to non-U.S. swap dealers and non-U.S. MSPs whose swaps activities or positions are substantial enough to require registration under the CEA. Requiring such swap dealers and MSPs to rigorously monitor and address the risks they incur as part of their day-to-day businesses would lower the registrants’ risk of default—and ultimately protect the public and the financial system.

Therefore, the Commission proposes to interpret CEA section 2(i) so as to require that registered non-U.S. swap dealers and non-U.S. MSPs comply with all of the first subcategory of Entity-Level Requirements.<sup>102</sup> In consideration of principles of international comity, the Commission further proposes to interpret CEA section 2(i) so as to permit substituted compliance with foreign regulations for these Entity-Level Requirements in certain circumstances. The circumstances in which the Commission proposes to consider permitting substituted compliance are explained below in the Section III.C. of this proposed interpretative guidance.

With respect to SDR Reporting, the Commission believes that direct access to data concerning all swaps in which a registered swap dealer or MSP enters is essential in order for the Commission to carry out its supervisory mandates concerning, among other things, increased transparency, systemic risk mitigation, market monitoring, and market abuse prevention. For example, data reported to SDRs would be critical to ensure that the Commission has a comprehensive and accurate picture of swap dealers and MSPs that are its registrants, including the gross and net counterparty exposures of swaps of all swap dealers and MSPs, to the greatest extent possible. Similarly, swap data reported by swap dealers to the Commission under Large Trader Reporting is critical to the Commission’s ability to effectively monitor and oversee the swaps market.

For these reasons, the Commission proposes to interpret CEA section 2(i) so as to require non-U.S. swap dealers and non-U.S. MSPs to report all of their swaps to a registered SDR<sup>103</sup> and to require non-U.S. swap dealers to report

<sup>93</sup> See 7 U.S.C. 2(a)(13). See also Real-Time Public Reporting of Swap Transaction Data, 77 FR 1182, 1183, Jan. 9, 2012.

<sup>94</sup> Part 43 defines a “publicly reportable swap transaction” as (i) any swap that is an arm’s-length transaction between two parties that results in a corresponding change in the market risk position between the two parties; or (ii) any termination, assignment, novation, exchange, transfer, amendment, conveyance, or extinguishing of rights or obligations of a swap that changes the pricing of a swap. See 77 FR 1182, Jan. 9, 2012.

<sup>95</sup> See 77 FR 1182, 1183.

<sup>96</sup> 7 U.S.C. 6s(i).

<sup>97</sup> See 17 CFR 23.501; see also 75 FR 81519, Dec. 28, 2010.

<sup>98</sup> In addition, the Commission notes that proposed § 23.504(b)(2) requires a swap dealer’s and MSP’s swap trading relationship to include all confirmations of swaps.

<sup>99</sup> See Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants, 77 FR 20128, Apr. 3, 2012.

<sup>100</sup> See 7 U.S.C. 6s(h). See also *Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties*, 77 FR 9734, 9822–29, Feb. 17, 2012.

<sup>101</sup> Appendix A in this release provides a chart describing the application of the Entity-Level Requirements to U.S. and non-U.S. swap dealers and MSPs.

<sup>102</sup> As discussed above in Section II.D of this proposed interpretive guidance, the Commission considers foreign branches and agencies of U.S. swap dealers to be the agents of their U.S. person. Thus, in all instances, the U.S. swap dealer would be responsible for complying with all Entity-Level Requirements.

<sup>103</sup> See 7 U.S.C. 2(a)(13)(G). See also 77 FR at 2197–2211.

all of their reportable positions under part 20. At the same time, the Commission recognizes the interests of foreign jurisdictions with respect to swaps between a non-U.S. swap dealer or non-U.S. MSP with a non-U.S. counterparty and therefore, further interprets CEA section 2(i) so as to permit substituted compliance with comparable foreign regimes for SDR Reporting and Large Trader Reporting.

#### 5. Application of the Transaction-Level Requirements<sup>104</sup>

As discussed above, Transaction-Level Requirements serve to mitigate risks to swap dealers and MSPs and their counterparties, to promote greater market transparency and efficiency in the U.S. swaps market, and to provide counterparty protections. The Commission has a strong supervisory interest in ensuring that these Dodd-Frank Act requirements apply to swaps between a registered swap dealer or MSP (regardless of whether they are a U.S. person or non-U.S. person) and U.S. persons as counterparties, with a limited exception. Accordingly, the Commission proposes to interpret section 2(i) in a manner so as to require non-U.S. swap dealers and non-U.S. MSPs to comply with Transaction-Level Requirements for all of their swaps with U.S. persons, other than foreign branches of U.S. persons, as counterparties.<sup>105</sup> Consistent with the foregoing rationale, in most cases, the Commission does not intend to permit substituted compliance for the Transaction-Level Requirements for swaps between non-U.S. swap dealers or non-U.S. MSPs and U.S. persons.<sup>106</sup> The following discussion provides proposed guidance on the application of the Transaction-Level Requirements to swaps by non-U.S. swap dealers and non-U.S. MSPs with non-U.S. counterparties.

i. Clearing and Swap Processing, Margin (and Segregation), Trade Execution, Swap Trading Relationship Documentation, Portfolio Reconciliation and Compression, Real-Time Public Reporting, Trade Confirmation, and Daily Trading Records

With respect to swaps between non-U.S. swap dealers or non-U.S. MSPs and non-U.S. counterparties, the Commission proposes to interpret section 2(i) so as to require non-U.S. swap dealers and non-U.S. MSPs to comply with the clearing and swap processing and margin (and segregation) requirements for swaps where the non-U.S. counterparty's performance is guaranteed by (or otherwise supported by) a U.S. person.<sup>107</sup> The Commission interprets section 2(i) in this manner because where a non-U.S.

counterparty's swap obligations are guaranteed by a U.S. person, the risk of non-performance by the counterparty rests with the U.S. person. If the non-U.S. person defaults on its obligations under the swaps, then the U.S. person guarantor will be held responsible (or would bear the cost) to settle those obligations. In circumstances in which a U.S. person ultimately bears the risk of non-performance of a counterparty to a swap with a non-U.S. swap dealer or non-U.S. MSP, the Commission has a strong regulatory interest in the performance of the swap by both parties to the swap, and hence the application of these Transaction-Level Requirements with respect to such swaps is warranted. In consideration of international comity principles, the Commission further interprets CEA section 2(i) so as to permit substituted compliance for these Transaction-Level Requirements.<sup>108</sup>

Similarly, the requirements relating to portfolio reconciliation and compression can serve to significantly mitigate risks to the counterparties, and by extension, the U.S. person guaranteeing the non-U.S. counterparty's obligations under the swap. Specifically, portfolio reconciliation serves to diminish the

risk of disputes for the counterparties. Portfolio compression also has the effect of lowering the risk for the counterparties by diminishing operational risks. Other Transaction-Level Requirements—trade confirmation, swap trading relationship documentation, and daily trading records—by ensuring that swaps are properly documented and recorded, serve to protect the counterparties, as well as the U.S. person that is the guarantor.<sup>109</sup>

The Commission also proposes to interpret section 2(i) so as to require non-U.S. swap dealers and non-U.S. MSPs to comply with the trade execution requirement for swaps where the non-U.S. counterparty's performance is guaranteed by a U.S. person.

The trade execution requirement is linked to the clearing requirement and for that reason, should be treated in same manner as the clearing requirement for regulatory purposes, which better ensures the effectiveness of the clearing and trading mandates. Requiring swaps to be traded on a regulated exchange provides market participants with greater pre- and post-trade transparency. Similarly, real-time public reporting improves price discovery by requiring that swap transaction and pricing data be made publicly available. Together, trade execution and real-time reporting requirements provide important information for risk management purposes and bring greater efficiency to the marketplace—to the benefit of the individual counterparties. As with the other Transaction-Level Requirements, the Commission further interprets CEA section 2(i), consistent with comity principles, so as to permit substituted compliance with respect to these transactions.

Similar concerns regarding the flow of risk to the United States are raised by an entity that effectively operates as a "conduit" for a U.S. person to execute swaps outside the Dodd-Frank Act regime. The Commission recognizes that such conduits may be used legitimately to move economic risks from one person within a corporate group to another in order to manage the group's overall swap portfolio. The Commission also recognizes that, in many cases, the

<sup>104</sup> Appendix B in this release provides charts describing the application of the Transaction-Level Requirements to U.S. and non-U.S. swap dealers and MSPs.

<sup>105</sup> Moreover, the U.S. counterparties, as well as the non-U.S. swap dealers and non-U.S. MSPs, may have an expectation that the Dodd-Frank Act will extend to them and their swaps.

<sup>106</sup> Section III.D. (below) addresses the application of the Entity and Transaction-Level Requirements to branches, agencies, subsidiaries, and affiliates of U.S. swap dealers.

<sup>107</sup> As noted above in Section II.B of this proposed interpretive guidance, risk may be imported into the U.S. In these circumstances, and regardless of whether the non-U.S. swap dealer's counterparty is a U.S. person or a non-U.S. person, the risk of default by the non-U.S. swap dealer with respect to its swap dealing transactions ultimately rests with a U.S. person.

<sup>108</sup> Below (in Section IV), the Commission describes the specific circumstances under which it proposes to permit compliance with a foreign regulatory regime's clearing requirement for swaps entered into by non-U.S. swap dealers, non-U.S. MSPs, and other non-U.S. market participants in lieu of compliance with a Commission-issued clearing requirement.

<sup>109</sup> As noted above, the portfolio compression and swap trading relationship documentation requirements apply to all swaps between registered swap dealers. Thus, where the non-U.S. counterparty is another U.S.-registered swap dealer, these Transaction-Level Requirements apply. The Commission believes that this inclusive approach is necessary given the significant role registered swap dealers play in the swaps market.



conduits could be subject to prudential and risk management requirements and may lay off the risk of its dealing activities on an individual or portfolio basis through transactions that would be subject to and reported under the Dodd-Frank Act.

Nevertheless, the Commission is concerned that given the nature of the relationship between the conduit and the U.S. person, the U.S. person is directly exposed to risks from and incurred by the conduit. The Commission is further concerned that rather than execute a swap opposite a U.S. counterparty, which would be subject to the Dodd-Frank transactional requirements, a U.S. swap dealer or MSP could execute a swap with its foreign affiliate or subsidiary, which could then execute a swap with a non-U.S. third-party in a jurisdiction that is unregulated or lack comparable transactional requirements. Accordingly, the Commission proposes to apply these Transaction-Level Requirements to swaps in which: (i) A non-U.S. counterparty is majority-owned, directly or indirectly, by a U.S. person; (ii) the non-U.S. counterparty regularly enters into swaps with one or more other U.S. affiliates or subsidiaries of the U.S. person; and (iii) the financials of such non-U.S. counterparty are included in the consolidated financial statements of the U.S. person. Further, the Commission interprets CEA section 2(i), consistent with comity principles, so as to permit substituted compliance for these Transaction-Level Requirements with respect to swaps between a non-U.S. swap dealer or non-U.S. MSP and such affiliate conduit.

Conversely, and consistent with the foregoing rationale, the Commission proposes to interpret section 2(i) so as to not require the application of any of these Transaction-Level Requirements to swaps between a non-U.S. swap dealer or non-U.S. MSP with a non-U.S. counterparty that is not guaranteed by a U.S. person. In such instances, the Commission recognizes that foreign regulators have a strong supervisory interest in swaps occurring within their territories involving their domiciles.

#### ii. External Business Conduct Standards

With respect to the external business conduct standards, the Commission proposes to interpret section 2(i) to not require non-U.S. swap dealers and non-U.S. MSPs to comply with these requirements for swaps with a non-U.S. counterparty (whether or not guaranteed by a U.S. person). The Commission believes that sales practice concerns related to swaps between non-U.S. persons taking place outside the United

States implicate fewer U.S. supervisory concerns and, when weighed together with the supervisory interests of foreign regulatory regimes, may not warrant application of these requirements.<sup>110</sup>

#### C. Substituted Compliance With Respect to Particular Requirements

The Commission believes that a cross-border policy that allows for flexibility in the application of the CEA, while ensuring the high level of regulation contemplated by the Dodd-Frank Act and avoiding potentially conflicting regulations is consistent with principles of international comity. It would also advance the congressional directive that the Commission act in order to “promote effective and consistent global regulation of swaps \* \* \* as appropriate, shall consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards with respect to regulation (including fees) of swaps \* \* \*.”<sup>111</sup> Practical considerations—namely, the limitations in the Commission’s supervisory resources and its ability to effectively oversee and enforce application of the CEA to cross-border transactions and activities—also support the Commission applying its regulations in a manner that is focused on the primary objectives of the CEA.

In light of the foregoing considerations, the Commission proposes to permit a non-U.S. swap dealer or non-U.S. MSP, once registered with the Commission, to comply with a substituted compliance regime under certain circumstances. Substituted compliance means that a non-U.S. swap dealer or non-U.S. MSP is permitted to conduct business by complying with its home regulations, without additional requirements under the CEA. Specifically, the Commission proposes to permit non-U.S. swap dealers and non-U.S. MSPs to substitute compliance with the requirements of the relevant home jurisdiction’s law and regulations, in lieu of compliance with the CEA and Commission’s regulations, if the Commission finds that such requirements are comparable to cognate

requirements under the CEA and Commission regulations. As discussed below, this approach would build on the Commission’s longstanding policy of recognizing comparable regulatory regimes based on international coordination and comity principles with respect to cross-border activities involving futures (and options).<sup>112</sup>

The Commission proposes that it would make comparability determinations on an individual requirement basis, rather than the foreign regime as a whole. In the Commission’s view, this would allow for a more flexible registration process as it would permit a non-U.S. person to become registered as a swap dealer or MSP even in the absence of comparability with respect to all of the Dodd-Frank Act requirements. Rather, a non-U.S. swap dealer or non-U.S. MSP may be permitted to comply with regulations in its home jurisdiction to the extent that the comparability standard is met but also may be required to comply with certain of the Dodd-Frank Act requirements where comparable home regulation(s) are lacking.<sup>113</sup>

In this section, the Commission broadly outlines the circumstances under which the Commission would permit a non-U.S. swap dealer or non-U.S. MSP to rely on foreign regulation and supervision as a substitute for compliance by that swap dealer or MSP with some or all of the requirements that would otherwise be applicable to it under Title VII of the Dodd-Frank Act.

#### 1. Entity-Level Requirements

The Commission anticipates that non-U.S. persons that will register as swap dealers or MSPs with the Commission will likely have their principal swap business in their home jurisdiction. The Commission believes that it would be appropriate to permit substituted compliance with respect to the previously-described Entity-Level Requirements where the non-U.S. swap dealers or non-U.S. MSPs are subject to comparable regulation in their home jurisdiction. In these circumstances, the Commission notes that the home

<sup>110</sup> That is to say, just as the Commission would have a strong supervisory interest in regulating and enforcing sales practices associated with activities taking place within the United States, the foreign regulators would have a similar claim to overseeing sales practices occurring within their jurisdiction.

<sup>111</sup> See section 752 of the Dodd-Frank Act. As the Supreme Court observed in *Hoffmann-LaRoche*, principles of international comity “help[ ] the potentially conflicting laws of different nations work together in harmony—a harmony particularly needed in today’s highly interdependent commercial world.” See *Hoffmann-LaRoche*, 542 U.S. at 164–165.

<sup>112</sup> For example, under part 30 of the Commission’s regulations, if the Commission determines that compliance with the foreign regulatory regime would offer comparable protection to U.S. customers and there is an appropriate information-sharing arrangement between the home supervisor and the Commission, the Commission has permitted foreign brokers to comply with their home regulations (in lieu of the applicable Commission regulations), subject to appropriate conditions. See, e.g., 67 FR 30785 (Apr. 29, 2002); 71 FR 6759 (Feb. 9, 2001).

<sup>113</sup> The details concerning the Commission’s comparability determinations will be discussed below in Section IV.

regulator would have a primary relationship to the swap dealer or MSP, which, coupled with the firm-wide focus of the Entity-Level Requirements, supports permitting substituted compliance.

With respect to SDR Reporting, the Commission proposes to permit substituted compliance with respect to swaps by non-U.S. swap dealers and non-U.S. MSPs with non-U.S. counterparties (whether or not such non-U.S. swap dealers or such non-U.S. MSPs are guaranteed by U.S. persons), provided that the Commission has direct access to the swap data for such non-U.S. swap dealers or non-U.S. MSPs that is stored at the foreign trade repository. The Commission believes that this approach would minimize burdens on non-U.S. swap dealers and non-U.S. MSPs that report their swaps data to a foreign trade repository, while ensuring that the Commission has access to information that is critical to its oversight of these entities.

## 2. Transaction-Level Requirements

As discussed above, the Commission proposes to interpret section 2(i) so as to require non-U.S. swap dealers and non-U.S. MSPs to comply with the clearing and swap processing, margining (and segregation), trade execution, swap trading relationship documentation, portfolio reconciliation and compression, real-time public reporting, trade confirmation, and daily trading records requirements for all transactions with a counterparty that is a U.S. person or is a non-U.S. person whose swap obligations are guaranteed by a U.S. person.

The Commission would not permit substituted compliance with respect to these Transaction-Level Requirements for a non-U.S. swap dealer's or non-U.S. MSP's transactions with a counterparty that is a U.S. person, with a limited exception.<sup>114</sup> Generally, where swaps are executed with U.S. persons, the Commission's supervisory interests in such transactions, which have a direct and significant connection with activities in, or effect on, U.S. commerce, and in ensuring the protection of U.S. counterparties weighs in favor of applying the requirements of the CEA, rather than permitting substituted compliance.

On the other hand, it may be more appropriate for the Commission to permit substituted compliance for

transactions between a non-U.S. swap dealer or non-U.S. MSP and a non-U.S. person whose swap obligations are guaranteed by a U.S. person. In such circumstances, the foreign jurisdiction has a strong supervisory interest in regulating the activities of its domiciles occurring within its territory. At the same time, given that such transactions are guaranteed by a U.S. person, the Commission also has a strong supervisory interest in ensuring that the protections of the Dodd-Frank Act are extended to the U.S. guarantor. In consideration of these factors, the Commission would permit substituted compliance with respect to these Transaction-Level Requirements for swaps between a non-U.S. swap dealer or non-U.S. MSP with a non-U.S. person guaranteed by a U.S. person, as well as swaps with non-U.S. affiliate conduits. Substituted compliance, the Commission believes, would address its supervisory concerns while, at the same time, minimizing the potential for conflicts with the requirements under foreign jurisdictions.<sup>115</sup>

### *D. Application of Entity-Level and Transaction-Level Requirements to Branches, Agencies, Affiliates, and Subsidiaries of U.S. Swap Dealers*

#### 1. Foreign Branches and Agencies of U.S. Swap Dealers

As discussed above, the Commission considers foreign branches and agencies of a U.S. person to be a part of the U.S. person. Thus, the Commission proposes that the U.S. person would be legally responsible for complying with all applicable Entity-Level Requirements. Further, the Commission proposes to require compliance with most of the Transaction-Level Requirements (*i.e.*, clearing and swap processing, margin (and segregation) for uncleared swaps, trade execution, real-time reporting, trade confirmation, swap trading relationship documentation, daily trading records, and portfolio reconciliation and compression), irrespective of whether the counterparty is a U.S. person or non-U.S. person.<sup>116</sup> This approach is appropriate in light of the Commission's strong supervisory

interests in entities that are part or an extension of a U.S.-based swap dealer.

The Commission further interprets section 2(i) to permit substituted compliance with respect to the Transaction-Level Requirements for swaps with certain counterparties. Specifically, the Commission proposes to permit substituted compliance for swaps between a foreign branch of a U.S. person and a non-U.S. person counterparty (both whose obligations under the swap are guaranteed by a U.S. person and those that are not). Given that the counterparty is a non-U.S. person, coupled with the supervisory interest of the foreign jurisdiction in the execution and clearing of trades occurring in that jurisdiction, the Commission believes that it would be appropriate to permit the parties to comply with comparable foreign requirements. In doing so, the Commission notes that, as discussed in further detail below, its recognition of substituted compliance would be based on an evaluation of whether the requirements of the home jurisdiction are comparable and comprehensive to the applicable requirement(s) under the CEA and Commission regulations based on a consideration of all relevant factors, including, among other things: (i) The comprehensiveness of the foreign regulator's supervisory compliance program; and (ii) the authority of such foreign regulator to support and enforce its oversight of the registrant's branch or agency with regard to such activities to which substituted compliance applies.

In limited circumstances where foreign regulations are not comparable, the Commission believes that it could be appropriate to permit foreign branches and agencies of U.S. swap dealers to comply with the transaction-level requirements applicable to entities domiciled or doing business in the foreign jurisdiction, rather than the Transaction-Level Requirements that would otherwise be applicable to the U.S. person's activities.<sup>117</sup> Specifically, the Commission understands that U.S. swap dealers' swap dealing activities through branches or agencies in emerging markets in many cases may not be significant but may be nevertheless an integral element of their global business. Under the circumstances, the Commission proposes that section 2(i) should be interpreted to permit foreign branches and agencies of U.S. swap dealers to

<sup>114</sup> The Commission, however, would continue to permit substituted compliance with comparable home country regulations with respect to Entity-Level Requirements in this instance. Transactions with a foreign branch or agency of a U.S. swap dealer are discussed below.

<sup>115</sup> As noted above, swaps with non-U.S. persons satisfying each prong of the conduit test would be similarly subject to the Transaction-Level Requirements, provided, however, that the non-U.S. swap dealer or non-U.S. MSP executing such swaps may substitute compliance with a comparable foreign regulatory regime in appropriate cases.

<sup>116</sup> For reasons stated above, with respect to external business conduct standards, the Commission would apply such requirements only for swaps where the counterparty is a U.S. person.

<sup>117</sup> As noted above, the proposed interpretive guidance does not limit the applicability of any CEA provision or Commission regulation to any person, entity or transaction except as provided herein.

participate in the swap markets in such countries on a limited basis. To be eligible for this exception, the aggregate notional value (expressed in U.S. dollars and measured on a quarterly basis) of the swaps of all foreign branches and agencies in such countries may not exceed five percent of the aggregate notional value (expressed in U.S. dollars and measured on a quarterly basis) of all of the swaps of the U.S. swap dealer. However, the U.S. person relying on this exception would be required to maintain records with supporting information to verify its eligibility for the exception, as well as identify, define, and address any significant risk that may arise from the non-application of the Transaction-Level Requirements.<sup>118</sup>

Further, as discussed above, the Commission proposes that the U.S. person may task its foreign branch or agency to fulfill its regulatory obligations with respect to the Transaction-Level Requirements. The Commission would consider compliance by the foreign branch or agency to constitute compliance with the Transaction-Level Requirements. The Commission proposes, however, that the U.S. person remains responsible for compliance with the Transaction-Level Requirements.

## 2. Foreign Affiliates and Subsidiaries of U.S. Swap Dealers

With respect to foreign affiliates or subsidiaries of U.S. swap dealers, the Commission proposes that the regulatory requirements that may apply to such affiliate or subsidiary would depend on where their swaps are booked and whether the affiliate or subsidiary engages in activities that trigger swap dealer registration. Where the swaps are directly booked in the U.S. swap dealer but the foreign affiliate or subsidiary facing the counterparty engages in swap dealing and independently meets the definition of a swap dealer, the U.S. swap dealer must comply with all of the swap dealer duties and obligations, including capital-related prudential requirements. The foreign affiliate or subsidiary would be required to separately register as a swap dealer and comply with any Entity-Level and Transaction-Level Requirements applicable to its swap dealing activities.

Thus, if the counterparty facing affiliate or subsidiary was acting merely

as a disclosed agent and did not meet the definition of a swap dealer, then the Dodd-Frank Act requirements applicable to swap dealers would not be applicable to the affiliate or subsidiary, provided that the agency relationship was properly documented and the principal remained primarily responsible for the actions of the affiliate. On the other hand, if the counterparty facing affiliate or subsidiary independently met the definition of a swap dealer, then it would be required to register as a swap dealer and satisfy the Dodd-Frank Act requirements applicable to swap dealers, even though all exposure to the swaps it entered into were transferred to a central booking entity, regardless of how those transfers were accomplished.<sup>119</sup> In this scenario, the Commission interprets section 2(i), consistent with the principles of international comity, so as to permit substituted compliance by the foreign affiliate or subsidiary.

Where the counterparty-facing affiliate or subsidiary and the central booking entity are both required to comply with Dodd-Frank Act requirements with respect to swap dealers, the question may arise as to the allocation of responsibilities between the two entities for obligations owed to the third-party counterparty. In such cases, the Commission is of the view that both entities are responsible for satisfying the Dodd-Frank Act requirements applicable to swap dealers and with respect to the performance of an obligation owed to a third party; satisfactory performance by one may satisfy the obligations of both, but an unsatisfactory performance of an obligation owed to a counterparty is a responsibility that will be borne by both entities.

In the case where non-U.S. affiliates or subsidiaries enter into swaps that are not directly booked in a U.S. person, the Commission proposes to interpret section 2(i) so as to require any such foreign affiliates or subsidiaries to register as a swap dealer, assuming that they individually or in the aggregate meet the definition of a swap dealer. Because these affiliates or subsidiaries are domiciled in a foreign jurisdiction and the swaps are not booked in the U.S. swap dealer, these affiliates or subsidiaries would be treated in a

manner consistent with respect to non-U.S. swap dealers.<sup>120</sup>

With respect to SDR Reporting, the Commission proposes to interpret section 2(i) so as to require foreign affiliates or subsidiaries of a U.S. swap dealer to comply with the SDR Reporting requirement but would permit substituted compliance, provided that the Commission has direct access to the swap data for these swaps that is stored at the foreign trade repository. As noted above, the Commission believes that this approach would best minimize burdens on counterparties that report their swaps data to a foreign trade repository, while ensuring that the Commission has direct access to the information critical to its oversight of the swaps market.

## Request for Comment

Q10. Please provide comments regarding all aspects of the Commission's proposed grouping of requirements into Entity-Level and Transaction-Level Requirements and application of the same to U.S. and non-U.S. persons as discussed above.

Q11. Are there any Entity-Level Requirements that should be reclassified as Transaction-Level Requirements, or vice versa? In particular, the Commission is interested in comments on whether portfolio reconciliation and compression requirements, as central risk mitigation and back-office functions, could or should be categorized as entity-level requirements. Similarly, the Commission is interested in comments on whether clearing and margin and segregation for uncleared swaps should be categorized as Entity-Level requirements.

Q11a. Should the Commission group the Entity-Level Requirements and Transaction-Level Requirements differently for swap dealers and MSPs? If so, how and why?

<sup>120</sup> Accordingly, the Commission would apply the clearing and swap processing, margining (and segregation), trade execution, swap trading relationship documentation, portfolio reconciliation and compression, real-time public reporting, trade confirmation, and daily trading records requirements to transactions with a non-U.S. person guaranteed by a U.S. person. The Commission further believes that it is appropriate to permit a foreign affiliate or subsidiary to comply with comparable and comprehensive regulatory requirement(s). Substituted compliance would mitigate any burden associated with potentially duplicative or conflicting foreign regulations and is appropriate in light of the foreign regulator's supervisory interests in entities domiciled and operating in its jurisdiction. Similar concerns regarding the risk of non-performance is not present where the non-U.S. counterparty is not guaranteed or similarly supported by a U.S. person, and therefore, the Commission proposes to not apply the Transaction-Level Requirements with respect to such swaps.

<sup>118</sup> The Commission solicits comments on all aspects of the proposed exception, including the conditions for eligibility. In particular, the Commission is interested in the types of risk-mitigating measure(s) that should be imposed on a firm as a condition to the exception.

<sup>119</sup> As noted earlier, the booking entity itself also would be required to register as a swap dealer and satisfy the Dodd-Frank Act requirements applicable to swap dealers, even though the affiliate facing the third party counterparty also was required to register as a swap dealer.

Q11b. Should the real-time reporting and trade execution requirements be treated in the same manner as the external business conduct standards?

Q12. Please provide specific comments regarding the proposed application of the Transaction-Level Requirements to swaps with counterparties that are U.S. persons. Should the Commission permit substituted compliance for swaps between a non-U.S. swap dealer or non-U.S. MSP with a U.S. person?

Q13. Please provide specific comments regarding the proposed application of the Transaction-Level Requirements to swaps with counterparties that are non-U.S. persons.

Q14. Market participants may not be able to determine, in certain cases, whether their counterparties are U.S. persons, non-U.S. persons with a guarantee from U.S. persons, or non-U.S. persons without guarantees. How should the Commission address this issue?

Q15. Please provide comments regarding the Commission's proposed interpretation with respect to non-U.S. swap counterparties whose swap obligations are guaranteed by U.S. persons. Should the interpretation for swaps between non-U.S. swap dealers or non-U.S. MSPs and non-U.S. counterparties whose swap obligations are guaranteed by U.S. persons be different than with respect to swaps between non-U.S. swap dealers or non-U.S. MSPs and U.S. persons (*e.g.*, should fewer Transaction-Level Requirements apply)? If so, how (*e.g.*, which Transaction-Level Requirements should apply)? Should the Commission not permit substituted compliance with respect to the Entity-Level and Transaction-Level Requirements in connection with transactions with non-U.S. persons?

Q15a. Should the Commission permit substituted compliance for some requirements but not others? If so, which ones? Should the applicable requirements be different for non-U.S. swap dealers as compared to non-U.S. MSPs?

Q16. For Entity-Level Requirements, should the Commission not permit substituted compliance for U.S. persons?

Q17. The Commission is aware that some non-U.S. swap dealers or MSPs may be prohibited from reporting swap transaction data to an SDR as a result of their home country's privacy laws, especially with respect to such swap dealer's or MSP's swaps with non-U.S. persons. How should the Commission address the application of the SDR

Reporting requirement with respect to these swaps? Should the Commission address the application of such requirements differently with respect to non-U.S. swap dealers and non-U.S. MSPs?

Q18. The Commission seeks comments concerning the proposed disapplication of the external business conduct standards to swaps involving non-U.S. persons. Would it be consistent with the expectations of non-U.S. persons to not apply these requirements to swaps with their local swap dealer, irrespective of whether such dealer is a foreign- or U.S.-based person? Should such requirements apply only to swaps involving the foreign branches or affiliates of a U.S.-based swap dealer?

Q19. Should the Commission interpret section 2(i) so as to not apply the Transaction-Level requirements to the foreign branches of U.S.-swap dealers operating in the emerging markets? If so, is it appropriate to condition eligibility for such an exception in the manner discussed above? Should the Commission permit a higher or lower percentage of swaps to be executed through foreign branches of U.S. registrants in emerging market jurisdictions without comparable regulation? If so, why and what percentage would be appropriate?

Q20. With respect to the exception for foreign branches of a U.S. swap dealer operating in the emerging markets with respect to swaps with a non-U.S. person guaranteed by a U.S. person, should the Commission change the baseline from the aggregate notional value of a firm's swap activities to \$8 billion (or certain fixed numerical threshold) so as to not disadvantage small swap dealers?

Q21. The Commission requests comment on its proposed approach of applying the Transaction-Level Requirements to a conduit's swaps as if counterparty were a non-U.S. person that is guaranteed by a U.S. person (*i.e.*, Transaction-Level Requirements will apply, with substituted compliance permitted).

Q22. The Commission requests comment on its proposed definition of "conduit." Are the three prongs of that definition appropriate? If not, how should they be modified? Should the second prong include language that limits application of the conduit test to "regular" inter-affiliate transactions moving economic risk, in whole or in part, to the United States. Should the definition of conduit distinguish between different types of counterparties or registration status of such counterparties?

Q23. The Commission requests comment on: (i) The prevalence of cross-border inter-affiliate swaps and the mechanics of moving swap-related risks between U.S. and non-U.S. affiliated entities for risk management and other purposes; (ii) risk implications of cross border inter-affiliate conduit swaps for the U.S. markets; and (iii) specific means to address the risk issues potentially presented by cross-border conduit arrangements.

Q24. The Commission proposed anti-evasion provisions in proposed rule 1.6 of the product definitions joint rulemaking with the SEC.<sup>121</sup> To what extent would inter affiliate conduit transactions be undertaken for purposes of evasion as described in proposed rule 1.6?

Q25. The Commission requests comments on whether substituted compliance should be permitted for swaps entered between a foreign branch of a U.S. person with another foreign branch of a U.S. person.

#### IV. Substituted Compliance: Process for Comparability Determination

##### A. Overview

As noted above, the Commission will use its experience exempting foreign brokers from registration as FCMs under its rule 30.10 "comparability" findings in developing an approach for swaps. However, the Commission contemplates that it will calibrate its approach to reflect the heightened requirements and expectations under the Dodd-Frank Act. Accordingly, the Commission will examine the regulatory requirements to which non-U.S. swap dealers and non-U.S. MSPs are subject. The Commission will use an outcomes based approach to determine whether these requirements are designed to meet the same regulatory objectives of the Dodd-Frank Act. The Commission contemplates that its approach also will require a more robust and ongoing process of cooperation and coordination between the Commission and the relevant foreign regulatory authority regarding ongoing compliance efforts.

##### 1. Scope of Review

As noted above, the Commission would determine comparability and comprehensiveness by reviewing the foreign jurisdiction's laws and regulations. In making this determination, the Commission may

<sup>121</sup> See Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 76 FR 29818, May 23, 2011.

find that a jurisdiction has comparable law(s) and regulation(s) in some, but not all, of the applicable Dodd-Frank Act provisions (and related Commission regulations).<sup>122</sup> Similar to its policy under rule 30.10, the Commission would retain broad discretion to determine that the objectives of any program elements are met, notwithstanding the fact that the foreign requirement(s) may not be identical to that of the Commission.<sup>123</sup> However, in cases where the foreign regulatory regime does not achieve the objectives of the Dodd-Frank Act, the Commission proposes to recognize substituted compliance in only those areas that are determined to be comparable and comprehensive to the CEA and Commission regulations.

In evaluating whether a particular foreign regulatory requirement(s) is comparable and comprehensive to the applicable requirement(s) under the CEA and Commission regulations, the Commission would take into consideration all relevant factors, including but not limited to, the scope and objectives of the relevant regulatory requirement(s), and the comprehensiveness of those requirement(s), the comprehensiveness of the foreign regulator's supervisory compliance program, as well as the authority to support and enforce its oversight of the non-U.S. swap dealer or non-U.S. MSP applicant. In this context, comparable does not necessarily mean identical. Rather, the Commission would evaluate whether the home jurisdiction's regulatory requirement is comparable to the regulatory requirement(s) supported and enforced by the Commission.

## 2. Process

The Commission may recognize the comparability of a foreign regime and permit substituted compliance subject to such terms and conditions as the Commission finds appropriate.<sup>124</sup>

<sup>122</sup> The Commission anticipates that it would review comparability in the areas described above: (i) Capital requirements; (ii) chief compliance officer (iii) clearing and swap processing; (iv) daily trading records; (v) margin (and segregation) requirements for uncleared swap transactions; (vi) physical commodity swaps reporting; (vii) portfolio reconciliation and compression; (viii) real-time public reporting; (ix) SDR Reporting; (x) risk management; (xi) swap data recordkeeping; (xii) swap trading relationship documentation; (xiii) trade confirmation (xiv) trade execution.

<sup>123</sup> The Commission would retain broad enforcement authority, including anti-fraud and anti-manipulation authority, with respect to the subject cross-border swap activities.

<sup>124</sup> The procedures described in this subsection, which are not all-inclusive, are contemplated for applicants for substituted compliance. The Commission further notes that non-compliance

Further, similar to its policy under rule 30.10, the Commission would retain broad discretion to determine that the objectives of any program elements are met, notwithstanding the fact that the foreign regulations(s) may not be identical to that of the Commission.

A non-U.S. person may request the Commission's permission to comply with comparable requirements of its home jurisdiction, in lieu of the applicable Dodd-Frank Act requirements, as described above. In lieu of a non-U.S. person requesting substituted compliance, 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.

Such request would be made directly to the Commission in connection with its application to register as a swap dealer or MSP.<sup>125</sup> The Commission anticipates that it would work closely with the National Futures Association to develop the necessary procedural framework.

The Commission would expect that the applicant, at minimum, state with specificity the factual basis for requesting that the Commission recognize comparability with respect to a particular Dodd-Frank Act requirement as described above and include with specificity all applicable legislation, rules and policies.<sup>126</sup>

An applicant would be expected to state that it is licensed and in good standing with the applicant's supervisor(s) in its home country. Further, the Commission expects that, in a substituted compliance situation, it would enter into an appropriate memorandum of understanding ("MOU") or similar arrangement between the Commission and the relevant foreign supervisor(s). Existing information-sharing and/or enforcement arrangements would be indicative of a foreign supervisor's ability to cooperate with the Commission. However, going forward, the Commission and relevant foreign supervisor(s) would need to establish supervisory MOUs or other

with the comparable home country regulations would constitute a breach of the terms and conditions of the registration with the Commission and potentially would serve as a basis for de-registration of the non-U.S. swap dealer or non-U.S. MSP and/or the commencement of an enforcement action.

<sup>125</sup> After it completes its evaluation, the Commission intends to post a finding of comparability on its Web site.

<sup>126</sup> The Commission may, as it deems appropriate and necessary, conduct an on-site examination of the applicant, as well as consult with the applicant's home regulator. For certain matters, the Commission may request an opinion of counsel.

arrangements that provide for information sharing and cooperation in the context of supervising swap dealers and MSPs. The Commission contemplates that such a supervisory MOU would establish the type of ongoing coordination activities that would continue on an ongoing basis between the Commission and the foreign supervisor(s), including topics such as, but not limited to, procedures for confirming continuing oversight activities, access to information,<sup>127</sup> on-site visits, and notification and procedures in certain situations.<sup>128</sup>

It is expected that the Commission generally may rely on prior comparability determinations with respect to a particular jurisdiction to facilitate its review of a subsequent applicant's request for recognition of substituted compliance.<sup>129</sup> Subsequent to registration with the Commission, the Commission expects that a non-U.S. swap dealer or non-U.S. MSP would notify the Commission of any material changes to information submitted in support of a comparability finding (including, but not limited to, changes in the relevant supervisory or regulatory regime) as the Commission's comparability determination may no longer be valid. In order to avoid an unduly burdensome notification process, the Commission contemplates that it would enumerate the specific foreign requirements or category of requirements which, if changed, would trigger a notification requirement.

Where the Commission proposes a change to its regulations governing swaps, the Commission will evaluate whether the proposed regulatory change would affect the basis upon which a prior comparability finding was made. The Commission would initiate discussions with the affected swap dealers and MSPs and their regulator(s) to determine how to address any possible discrepancy in requirements.

## 3. Clearing

In response to a number of inquiries, with regard to swaps covered by a

<sup>127</sup> The Commission notes that under Commission's regulation § 23.603(i), a registered swap dealer or MSP must make all records required to be maintained in accordance with Commission regulation 1.31 promptly upon request to representatives of the Commission. The Commission reserves this right to access records held by registered swap dealers and MSPs, including those that are non-U.S. persons who may comply with the Dodd-Frank recordkeeping requirement through substituted compliance.

<sup>128</sup> In this regard, the Commission has started working with foreign regulators to prepare for such arrangements.

<sup>129</sup> Prior determinations of comparability under part 30.10 of the Commission's regulations will not be determinative for those purposes.

Commission-issued clearing requirement, the Commission notes that it expects to find comparability with foreign regulatory regimes when (i) the swap is subject to a mandate issued by appropriate government authorities in the home country of the counterparties to the swap, provided that the foreign mandate is comparable and comprehensive to the Commission's mandate; and (ii) the swap is cleared through a DCO that is exempted from registration under the CEA.

#### Request for Comment

Q26. Please provide comments regarding the Commission's substituted compliance proposal, including the appropriate standard and degree of comparability and comprehensiveness that should be applied to make such determination.

Q27. What are some of the factors or elements of a supervisory program that the Commission should consider in making a comparability finding?

Q27a. Should the Commission take a different approach with respect to swap dealers as compared to MSPs?

Q28. How should the Commission address potential inconsistencies or conflicts between U.S. and non-U.S. requirements with respect to the oversight of non-U.S. swap dealers and non-U.S. MSPs?

Q29. Many foreign jurisdictions are in the process of implementing major changes to their oversight of the swaps market. Assuming that a foreign jurisdiction has adopted swaps legislation but has yet to finalize implementing regulations, should the Commission develop an interim process that takes into account the development of "comparable" legislation and proposed regulations?

Q30. How should the Commission ensure that prior comparability determinations remain appropriate over time?

### V. Cross-Border Application of the CEA's Swap Provisions to Transactions Involving Other (Non-Swap Dealer and MSP) Market Participants

#### A. Cross-Border Transactions With U.S. Persons<sup>130</sup>

Several of the CEA's swap provisions—namely, those relating to clearing,<sup>131</sup> trade execution,<sup>132</sup> real-time public reporting,<sup>133</sup> Large Trader

<sup>130</sup> Appendix C in this release provides a chart describing the application of the specified Dodd-Frank provisions to transactions between counterparties that are neither a swap dealer or MSP.

<sup>131</sup> See Section III.B.3.i., *supra*.

<sup>132</sup> See Section III.B.3.iii. *supra*.

<sup>133</sup> See Section III.B.3.vi. *supra*.

Reporting,<sup>134</sup> and SDR Reporting,<sup>135</sup> and recordkeeping<sup>136</sup>—also apply to persons or counterparties other than a swap dealer or MSP. As a result, questions arise as to whether, and the extent to which, these requirements apply to transactions outside the United States involving U.S. and non-U.S. persons. In this section, the Commission provides interpretive guidance concerning the application of these Dodd-Frank Act provisions to cross-border transactions in which neither counterparty is a swap dealer or MSP (*i.e.*, all other market participants including "financial entities," as defined in CEA section 2(h)(7)(C)).<sup>137</sup>

The Commission believes that U.S. persons' swap activities outside the United States have a direct and significant connection with activities in, or effect on, U.S. commerce. The swaps market today is global in nature. To manage risks in a global economy, U.S. persons may need to—and often do—transact swaps with both U.S. and non-U.S. persons. Many such swap activities of U.S. persons, particularly those with global operations, may be located outside the United States. In light of the significant extent of U.S. persons' swap activities outside the United States in today's global marketplace, and the risks to U.S. persons and the financial system presented by such swaps activities outside the United States with U.S. persons as counterparties, the Commission believes that U.S. persons' swap activities outside the United States have the requisite connection with or effect on U.S. commerce under section 2(i) to apply the swaps provisions of the CEA to such activities.<sup>138</sup>

<sup>134</sup> See Section III.B.2.vi. *supra*.

<sup>135</sup> See Section III.B.2.v. *supra*.

<sup>136</sup> The Commission's part 45 rules require non-swap dealers and non-MSPs to keep "full, complete and systematic records" with respect to each swap to which they are a counterparty. See 17 CFR 45.2. Such records must include those demonstrating that the parties to a swap are entitled to make use of the clearing exception in CEA section 2(h)(7). Non-swap dealers and non-MSPs must also comply with the Commission's regulations in part 46, which address the reporting of data relating to pre-enactment swaps and data relating to transition swaps.

<sup>137</sup> Nothing in this interpretive guidance should be construed to affect the ability of a foreign board of trade to offer swaps to U.S. persons pursuant to part 48 of the Commission's regulations.

<sup>138</sup> In further support of this interpretation, the Commission notes that the risks to U.S. persons and the U.S. financial system from swap activities of U.S. persons does not depend on the location of such swap activities of U.S. persons. Moreover, the Commission believes that section 2(i) does not require a transaction-by-transaction determination that a particular swap outside the United States has a direct and significant connection with activities in, or effect on, commerce of the United States in order to apply the swaps provisions of the CEA to such transactions; rather, it is the aggregate of such

Accordingly, with respect to swaps where one (or both) of the counterparties to the swap is a U.S. person, the Commission proposes to interpret section 2(i) in a manner so that the Dodd-Frank Act requirements relating to clearing, trade-execution, real-time public reporting, Large Trader Reporting, and SDR Reporting, and recordkeeping apply to such swaps. Conversely, where a non-U.S. person enters into a swap with another non-U.S. person outside the United States, and where neither counterparty is required to register as a swap dealer or MSP, the Commission would not apply the Dodd-Frank Act requirements to such swaps.<sup>139</sup>

As discussed above, the Commission is concerned that a non-U.S. affiliate or subsidiary could effectively operate as a "conduit" for the U.S. person. More specifically, the Commission is concerned that the non-U.S. affiliate or subsidiary of a U.S. person could be used to execute swaps with counterparties in foreign jurisdictions, outside the Dodd-Frank Act regulatory regime. The Commission is considering whether to propose measures to address this situation. However, at this time, the Commission makes clear that such non-U.S. affiliate or subsidiary would not be subject to the Dodd-Frank swap provisions, except pursuant to specific Dodd-Frank Act provisions (or Commission regulation adopted thereunder) or Commission orders.

#### B. Clearing, Trade Execution, Real-Time Public Reporting, Large Trader Reporting, and SDR Reporting, and Swap Data Recordkeeping

As described in greater detail above, the Dodd-Frank Act's clearing requirement mitigates counterparty risks and, in turn, fosters protection against systemic risk. In a similar vein, the trade execution and real-time public reporting requirements serve to promote both pre- and post-trade transparency which, in turn, enhance price discovery and decrease risk. Together, these requirements serve an important role in protecting U.S. market participants and the general market against financial losses. Accordingly, the Commission interprets section 2(i) to apply the Dodd-Frank Act's clearing, trade

activities and the aggregate connection of such activities with activities in the U.S. or effect on U.S. commerce that warrants application of the CEA swaps provisions to all such activities. See *F. Hoffmann-La Roche, Ltd.*, 542 U.S. at 164 (in response to respondents' argument that the court can take account of comity considerations on a case by case basis, the Court held that such approach is "too complex to be prove workable.").

<sup>139</sup> The exception involves Large Trader Reporting, as further discussed below.

execution, and real-time public reporting requirements to any swaps where one of the counterparties is a U.S. person (irrespective of the location of the transaction), without permitting substituted compliance with a foreign regulatory regime.

The Commission's part 20 rules regarding Large Trader Reporting require routine reports from clearing members, in addition to swap dealers and clearing organizations, with reportable positions in specified physical commodity swaps or swaptions. The Commission believes that such data is essential in order for the Commission to carry out its supervisory mandates concerning, among other things, increased transparency, market monitoring, and market abuse prevention. Therefore, the Commission proposes to interpret CEA section 2(i) to require non-U.S. clearing members to report all reportable positions under part 20. The part 20 rules also impose recordkeeping obligations on traders with reportable positions. The Commission proposes to interpret CEA section 2(i) so as to require non-U.S. persons with reportable positions under part 20 to comply with such obligations. Given the significance of these rules to the Commission's oversight of swaps and swaptions that are closely linked to the U.S. futures markets, the Commission would not allow substituted compliance.

With respect to transactions that are subject to the SDR Reporting and swap data recordkeeping requirements, the Commission proposes to interpret section 2(i) so as to permit substituted compliance, provided that the Commission has direct access to the swap data for these transactions that is stored at the foreign trade repository. The Commission has a strong supervisory interest in applying the SDR reporting and recordkeeping requirements to any transactions involving a U.S. counterparty in order to effectively monitor the swap activities of U.S. persons. Nevertheless, the Commission believes that substituted compliance is warranted where it would ease the burden on the counterparties that report their swaps data to a foreign trade repository and the Commission is assured of prompt access to the information critical to its oversight of the swaps market.

The Commission recognizes that applying the Dodd-Frank Act requirements to swaps conducted outside the United States involving a U.S. counterparty may result in two or more jurisdictions asserting authority over these swaps—with the

counterparties potentially facing conflicting or duplicative regulatory requirements. The Commission will continue its efforts to address these issues through close coordination and consultation with its regulatory counterparts in other jurisdictions. The Commission also anticipates that cooperative efforts would be reflected in the MOU or similar arrangement (whether bilateral and/or multilateral) discussed above which would provide a framework for regulatory coordination where two or more jurisdictions have authority over a swap.

#### Request for Comment

Q31. Please provide comments regarding all aspects of the Commission's interpretation of CEA section 2(i) with respect to the proposed application of the Transaction-Level Requirements. The Commission is particularly interested in commenters' views on the impact on U.S. persons as a result of the proposed application of the Dodd-Frank Act's trading requirements.

Q32. What, if any, competitive or economic effects on U.S. commerce, including U.S. persons, should the Commission consider when interpreting CEA section 2(i)? What, if any, competitive or economic effects on non-U.S. persons should the Commission consider when interpreting CEA section 2(i)?

#### Appendix A—Entity-Level Requirements

The Entity-Level Requirements relate to the management of risks to a swap dealer or MSP as a whole. Accordingly, these requirements apply on a firm-wide basis, inclusive of all swaps and irrespective of whether the counterparty is a U.S. person (or not) or where the transactions are executed.

*Capital:* CEA section 4s(e) directs the Commission to set capital requirements for swap dealers and MSPs that are not subject to the capital requirements of prudential regulators (*i.e.*, non-bank swap entities). The Commission has proposed rule, § 23.101, which would apply FCM capital requirements if the nonbank swap dealer or MSP is also registered as an FCM, and would apply other capital requirements for those that are not also FCMs. Certain of these non-FCM, nonbank swap entities would be required to meet capital requirements established by the Federal Reserve Board; specifically, SIFIs and nonbank subsidiaries of U.S. bank holding companies.<sup>140</sup>

<sup>140</sup> SIFIs that are not FCMs would be exempt from the Commission's capital requirements, and would comply instead with Federal Reserve Board requirements applicable to SIFIs, while nonbank (and non-FCM) subsidiaries of U.S. bank holding companies would calculate their Commission capital requirement using the same methodology specified in Federal Reserve Board regulations

*Chief Compliance Officer:* CEA Section 4s(k) requires that each swap dealer and MSP to designate a chief compliance officer ("CCO") and specify certain duties by the CCO. Pursuant to section 4s(k), the Commission adopted § 3.3, which requires swap dealers and MSPs to designate a CCO responsible for administering the firm's compliance policies and procedures, reporting directly to the board of directors or a senior officer of the swap dealer, as well as preparing and filing (with the Commission) a certified report of compliance with the CEA.

*Risk Management:* CEA Section 4s(j) requires each swap dealer and MSP to establish internal policies and procedures designed to, among other things, address risk management, monitor compliance with position limits, prevent conflicts of interest, and promote diligent supervision, as well as maintain business continuity and disaster recovery programs. The Commission adopted implementing regulations (§§ 23.600, 23.601, 23.602, 23.603, 23.605, 23.606, and 23.607). The Commission also adopted: (A) § 23.609, which requires certain risk management procedures for swap dealers or MSPs that are clearing members of a DCO; and (B) § 23.608, which prohibits swap dealers providing clearing services to customers from entering into agreements that would: (i) Disclose the identity of a customer's original executing counterparty; (ii) limit the number of counterparties a customer may trade with; (iii) impose counterparty-based position limits; (iv) impair a customer's access to execution of a trade on terms that have a reasonable relationship to the best terms available; or (v) prevent compliance with specified time frames for acceptance of trades into clearing.

*Swap Data Recordkeeping:* CEA section 4s(f)(1)(B) requires swap dealers and MSPs to keep books and records for all activities related to their business. Section 4s(g)(1) requires swap dealers and MSPs to maintain trading records for each swap transaction and all related records, as well as a complete audit trail for comprehensive trade reconstructions. Pursuant to these provisions, the Commission adopted §§ 23.201 and 23.203, which require swap dealers and MSPs to keep records including complete transaction and position information for all swap activities, including documentation on which trade information is originally recorded. Swap dealers and MSPs also have to comply with Part 46 of the Commission's regulations, which addresses the recordkeeping requirements for swaps entered into before the date of enactment of the Dodd-Frank Act ("pre-enactment swaps") and data relating to swaps entered into on or after the date of enactment but prior to the part 45 compliance date ("transition swaps").

*SDR Reporting:* CEA section 2(a)(13)(G) requires all swaps, whether cleared or uncleared, to be reported to a registered swap data repository ("SDR"). CEA section 21 requires SDRs to collect and maintain data related to swap transactions as prescribed by the Commission, and to make such data

applicable to the bank holding company, as if the subsidiary itself were a bank holding company.

electronically available to regulators. Swap dealers and MSPs would be required to comply with Part 45 of the Commission's regulations, which set forth the specific transaction data that reporting counterparties and registered entities must report to a registered SDR; and Part 46, which addresses the recordkeeping requirements for pre-

enactment swaps and data relating to transition swaps.

*Physical Commodity Swaps Reporting (Large Trader Reporting):* CEA section 4t authorizes the Commission to establish a large trader reporting system for significant price discovery swaps, of which the economically equivalent swaps subject to part 20 reporting are a subset, and in order

to implement the statutory mandate in CEA section 4a for the Commission to establish position limits, as appropriate, for physical commodity swaps. The Commission published part 20 rules requiring swap dealers, among other entities, to submit routine position reports on certain physical commodity swaps and swaptions.

ENTITY-LEVEL REQUIREMENTS

U.S.-Based Swap Dealer .....	Apply.
Foreign Branches/Agencies of U.S.-Based Swap Dealer** .....	Apply.
Foreign Affiliates of U.S. Person:	
—Swaps Booked in U.S. ....	Apply.*
Foreign Affiliate of U.S. Person:	
—The Affiliate is the Legal Counterparty But All Swaps Guaranteed by U.S. Person .....	Substituted Compliance.***
Foreign Affiliate of U.S. Person:	
—Swaps Not Booked in U.S. ( <i>i.e.</i> , Affiliate is Legal Counterparty); and Swaps Not Guaranteed by U.S. Person.	Substituted Compliance.
Non-U.S.-Based Swap Dealer:	
—Swaps neither Booked in U.S. nor Guaranteed by U.S. Person .....	Substituted Compliance.

\* Where swaps are solicited or negotiated by a foreign affiliate of a U.S. person but directly booked in the U.S. person, the U.S. person must comply with all of the swap dealer duties and obligations related to the swaps, including registration, capital and related prudential requirements.

\*\* Both Entity-Level and Transaction-Level Requirements are the ultimate responsibilities of the U.S.-based swap dealer.

\*\*\* With respect to the SDR reporting requirement, the Commission may permit substituted compliance only if direct access to swap data is provided to the Commission.

Appendix B—Transaction-Level Requirements

The Transaction-Level Requirements cover a range of Dodd-Frank requirements: some of the requirements more directly address financial protection of swap dealers (or MSPs) and their counterparties; others address more directly market efficiency and/or price discovery. Further, some of the Transaction-Level Requirements can be classified as Entity-Level Requirements and applied on a firm-wide basis across all swap transactions or activities. Nevertheless, in the interest of comity principles, the Commission believes that the Transaction-Level Requirements may be applied on a transaction-by-transaction basis.

Category A: Risk Mitigation and Transparency

*Clearing and Swap Processing:* CEA section 2(h)(1) requires a swap to be submitted for clearing to a derivatives clearing organization (“DCO”) if the Commission has determined that the swap is required to be cleared, unless one of the parties to the swap is eligible for an exception under section 2(h)(7) from the clearing requirement and elects not to clear the swap. Finally, the Commission adopted § 23.506, which requires swap dealers and MSPs to submit swaps promptly for clearing and comply with § 23.610, which establishes certain standards for swap processing by swap dealers and MSPs that are clearing members of a DCO.

*Margin (and Segregation) Requirement for Uncleared Swap Transactions:* Section 4s(e) explicitly requires the adoption of rules establishing margin requirements for swap dealers and MSPs, and applies a bifurcated approach that requires each swap dealer and MSP for which there is a prudential regulator to meet the margin requirements established by the applicable prudential regulator, and

each swap dealer and MSP for which there is no prudential regulator to comply with Commission's margin regulations. In contrast, the “segregation” requirements in 4s(1) don't use a bifurcated approach—all swap dealers and MSPs are subject to the Commission's rule regarding notice and third party custodians for margin collected for uncleared swaps.

*Mandatory Trade Execution:* CEA section 2(h)(8) provides that unless a non-financial end-user exemption applies, a swap that is subject to clearing requirement and made available to trade must be traded on a DCM or SEF.

*Swap Trading Relationship Documentation:* CEA Section 4s(i) requires each swap dealer and MSP to conform to commission standards for the timely and accurate confirmation, processing, netting documentation and valuation of swaps. Pursuant thereto the Commission has proposed § 23.504(a), which would require swap dealers and MSPs to “establish, maintain and enforce written policies and procedures” to ensure that the swap dealer or MSP executes written swap trading relationship documentation. Under proposed §§ 23.505(b)(1), 23.504 (b)(3), and 23.504(b)(4), the swap trading relationship documentation must include, among other things: all terms governing the trading relationship between the swap dealer and its counterparty; credit support arrangements; investment and rehypothecation terms for assets used as margin for uncleared swaps and custodial arrangements.<sup>141</sup> Further, the swap trading relationship documentation

requirement applies to *all* transactions with registered swap dealers and MSPs.

*Portfolio Reconciliation and Compression:* CEA section 4s(i) directs the Commission to prescribe regulations for the timely and accurate processing and netting of all swaps entered into by swap dealers and MSPs. Pursuant to CEA section 4s(i), the Commission proposed regulations (§§ 23.502 and 23.503), which would require swap dealers and MSPs to perform portfolio reconciliation and compression, respectively, for all swap transactions. Portfolio reconciliation is a post-execution risk management tool to ensure accurate confirmation of a swap's terms and to identify and resolve any discrepancies between counterparties regarding the valuation of the swap. Portfolio compression is a post-trade processing and netting mechanism that is intended to ensure timely accurate processing and netting of swaps. Proposed § 23.503(c) would require all swap dealers and MSPs to participate in bilateral compression exercises and/or multilateral portfolio compression exercises conducted by their SROs or DCOs of which they are members. Further, participation in multilateral portfolio compression exercises is mandatory for dealer to dealer trades.

*Real-Time Public Reporting:* CEA section 2(a)(13) directs the Commission to promulgate rules providing for the public availability of swap transaction data in real time basis. The Commission promulgated part 43 rules, which provides that all “publicly reportable swap transactions” must be reported and publicly disseminated.

*Trade Confirmation:* CEA section 4s(i) requires that each swap dealer and MSP must comply with the Commission's regulations prescribing timely and accurate confirmation of transactions. The Commission has proposed § 23.501, which requires, among other things, a timely and accurate confirmation of all swaps and life cycle

<sup>141</sup> The requirements under section 4s(i) relating to trade confirmations is a Transaction-Level Requirement. Accordingly, proposed 17 CFR 23.504(b)(2), which requires a swap dealer's and MSP's swap trading relationship documentation to include all confirmations of swap transactions, will apply on a transaction-by-transaction basis.



events for existing swaps. In addition, proposed § 23.504(b)(2) requires a swap dealer's and MSP's swap trading relationship documentation to include all confirmations of swap transactions.

*Daily Trading Records:* Pursuant to section CEA 4s(g)(1), the Commission adopted § 23.202, which requires swap dealers and MSPs to maintain daily trading records,

including records of trade information related to pre-execution, execution, and post-execution data that is needed to conduct a comprehensive and accurate trade reconstruction for each swap. The final rule also requires that records be kept of cash or forward transactions used to hedge, mitigate the risk of, or offset any swap held by the swap dealer or MSP.

**Category B: Sales Practices**

*External Business Conduct Standards:* Pursuant to CEA section 4s(h), the Commission has adopted external business conduct rules, which establish business conduct standards governing the conduct of swap dealers and MSPs in dealing with their counterparties in entering into swaps.

**CATEGORY A**

	U.S. Person	Non-U.S. person guaranteed by U.S. person**	Non-U.S. person not guaranteed by U.S. person
U.S.-Based Swap Dealer .....	Apply .....	Apply .....	Apply.
Foreign Affiliate/Swaps Booked in U.S.* .....	Apply .....	Apply .....	Apply.
Foreign Branches/Agencies of U.S.-Based Swap Dealer .....	Apply .....	Substituted Compliance*** .....	Substituted Compliance.***
Foreign Affiliate of U.S. Person:			
—The Affiliate is the Legal Counterparty But All Swaps Guaranteed by U.S. Person.	Apply .....	Substituted Compliance .....	Do Not Apply.
Foreign Affiliate of U.S. Person:			
—Swaps Not Booked in U.S. (i.e., Affiliate is Legal Counterparty); and Swaps Not Guaranteed by U.S. Person.	Apply .....	Substituted Compliance .....	Do Not Apply.
Non-U.S.-Based Swap Dealer:			
—Swaps neither Booked in U.S. nor Guaranteed by U.S. Person.	Apply .....	Substituted Compliance .....	Do Not Apply.

\* Where swaps are solicited or negotiated by a foreign affiliate but directly booked in the U.S. person, the U.S. person must comply with all of the swap dealer duties and obligations, including all Transaction-Level Requirements. The foreign affiliate, if separately required to register as a swap dealer, must comply with those requirements applicable to its swap dealing activities.

\*\* The Transaction-Level Requirements apply to swaps in which: (i) a non-U.S. counterparty is majority-owned, directly or indirectly, by a U.S. person; (ii) the non-U.S. counterparty regularly enters into swaps with one or more U.S. affiliates or subsidiaries of the U.S. person; and (iii) the financials of such non-U.S. counterparty are included in the consolidated financial statements of the U.S. person.

\*\*\* Under limited circumstances, where there is not a comparable foreign regulatory regime, foreign branches and agencies of U.S. swap dealers may comply with the local transaction-level requirements rather than the Transaction-Level Requirements, subject to specified conditions.

**Notes:**

1. The swap trading relationship documentation requirement applies to all transactions with registered swap dealers and MSPs.
2. Participation in multilateral portfolio compression exercises is mandatory for dealer to dealer trades.

**CATEGORY B**

	U.S. person	Non-U.S. person guaranteed by U.S. person**	Non-U.S. person not guaranteed by U.S. person
U.S.-Based Swap Dealer .....	Apply .....	Apply .....	Apply.
Foreign Affiliate of U.S. Person:			
—Swaps are Booked in U.S.* .....	Apply .....	Do Not Apply ....	Do Not Apply.
Foreign Branches/Agencies of U.S.-Based Swap Dealer .....	Apply .....	Do Not Apply ....	Do Not Apply.
Foreign Affiliate of U.S. Person:			
—The Affiliate is the Legal Counterparty But All Swaps Guaranteed by U.S. Person	Apply .....	Do Not Apply ....	Do Not Apply.
Foreign Affiliate of U.S. Person:			
—Swaps Not Booked in U.S. (i.e., Affiliate is Legal Counterparty); and Swaps Not Guaranteed by U.S. Person.	Apply .....	Do Not Apply ....	Do Not Apply.
Non-U.S.-Based Swap Dealer:			
—Swaps neither Booked in U.S. nor Guaranteed by U.S. Person .....	Apply .....	Do Not Apply ....	Do Not Apply.

\* Where swaps are solicited or negotiated by an affiliate of a U.S. person but directly booked in the U.S. person, the U.S. person must comply with all of the swap dealer duties and obligations, including all Transaction-Level Requirements. The foreign affiliate, if separately required to register as a swap dealer, must comply with those requirements applicable to its swap dealing activities.

\*\* The Transaction-Level Requirements apply to swaps in which: (i) A non-U.S. counterparty is majority-owned, directly or indirectly, by a U.S. person; (ii) the non-U.S. counterparty regularly enters into swaps with one or more U.S. affiliates or subsidiaries of the U.S. person; and (iii) the financials of such non-U.S. counterparty are included in the consolidated financial statements of the U.S. person.

**Appendix C—All Other (Non-Swap Dealer/MSP) Market Participants \***

	U.S. person	Non-U.S. person guaranteed by U.S. person	Non-U.S. person not guaranteed by U.S. person
U.S. Person .....	Apply .....	Apply .....	Apply.
Non-U.S. Person <i>Guaranteed</i> by U.S. Person .....	Apply .....	Do Not Apply ....	Do Not Apply.

	U.S. person	Non-U.S. person guaranteed by U.S. person	Non-U.S. person not guaranteed by U.S. person
Non-U.S. Person Not Guaranteed by U.S. Person .....	Apply .....	Do Not Apply ....	Do Not Apply.

\* The relevant Dodd-Frank requirements are those relating to: clearing, trade execution, real-time public reporting, Large Trader Reporting, SDR reporting and swap data recordkeeping.

Issued in Washington, DC, on June 29, 2012, by the Commission.

**David A. Stawick,**  
*Secretary of the Commission.*

**Appendices to Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act—Commission Voting Summary and Statements of Commissioners**

**Note:** The following appendices will not appear in the Code of Federal Regulations

**Appendix 1—Commission Voting Summary**

On this matter, Chairman Gensler and Commissioners Sommers, Chilton, O’Malia and Wetjen voted in the affirmative; no Commissioner voted in the negative.

**Appendix 2—Statement of Chairman Gary Gensler**

I support the proposed guidance on the cross-border application of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd Frank Act). The Commission is not required to solicit public comment on interpretive guidance, but we are particularly interested in the public’s input and look forward to comments on the proposed guidance.

In 2008, swaps, and in particular credit default swaps, concentrated risk in financial institutions and contributed to the financial crisis, the worst economic crisis Americans have experienced since the Great Depression. Eight million Americans lost their jobs, millions of families lost their homes, and small businesses across the country folded. Congress and the President responded with the Dodd-Frank Act, bringing common-sense rules of the road to the swaps marketplace.

Section 722(d) of the Dodd-Frank Act states that swaps reforms shall 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.” In interpreting Section 722(d), we must not forget the lessons of the 2008 crisis and earlier. Swaps executed offshore by U.S. financial institutions can send risk straight back to our shores. It was true with the London and Cayman Islands affiliates of AIG, Lehman Brothers, Citigroup and Bear Stearns. A decade earlier, it was true, as well, with Long-Term Capital Management.

The nature of modern finance is that large financial institutions set up hundreds, if not thousands of “legal entities” around the globe.

They do so in an effort to respond to customer needs, funding opportunities, risk management and compliance with local laws. They do so as well, though, to lower their taxes, manage their reported accounting, and to minimize regulatory, capital and other requirements, so-called “regulatory arbitrage.” Many of these far-flung legal entities, however, are still highly connected back to their U.S. affiliates.

During a default or crisis, the risk that builds up offshore inevitably comes crashing back onto U.S. shores. When an affiliate of a large, international financial group has problems, the markets accept this will infect the rest of the group. This was true with AIG. Its subsidiary, AIG Financial Products, brought down the company and nearly toppled the U.S. economy. It was run out of London as a branch of a French-registered bank, though technically was organized in the United States.

Lehman Brothers was another example. Among its complex web of affiliates was Lehman Brothers International (Europe) in London. When Lehman failed, the London affiliate had more than 130,000 outstanding swaps contracts, many of them guaranteed by Lehman Brothers Holdings back in the United States.

Yet another example was Citigroup, which set up numerous structured investment vehicles (SIVs) to move positions off its balance sheet for accounting purposes, as well as to lower its regulatory capital requirements. Yet, Citigroup had guaranteed the funding of these SIVs through a mechanism called a liquidity put. When the SIVs were about to fail, Citigroup in the United States assumed the huge debt, and taxpayers later bore the brunt with two multi-billion dollar infusions. The SIVs were launched out of London and incorporated in the Cayman Islands.

Bear Stearns is another case. Bear Stearns’ two sinking hedge funds it bailed out in 2007 were incorporated in the Cayman Islands. Yet again, the public assumed part of the burden when Bear Stearns itself collapsed nine months later.

A decade earlier, the same was true for Long-Term Capital Management. When the hedge fund failed in 1998, its swaps book totaled in excess of \$1.2 trillion notional. The vast majority were booked in its affiliated partnership in the Cayman Islands.

The recent events of JPMorgan Chase, where it executed swaps through its London branch, are a stark reminder of this reality of modern finance.

The proposed guidance interpreting Section 722(d), intended to be flexible in application, includes the following key elements:

First, it provides the guidance that when a foreign entity transacts in more than a de minimis level of U.S. facing swap dealing activity, the entity would register under the Dodd-Frank Act swap dealer registration requirements.

Second, it includes a tiered approach for foreign swap dealer requirements. Some requirements would be considered entity-level, such as for capital, chief compliance officer, swap data recordkeeping, reporting to swap data repositories and large trader reporting. Some requirements would be considered transaction-level, such as clearing, margin, real-time public reporting, trade execution, trading documentation and sales practices.

Third, entity-level requirements would apply to all registered swap dealers, but in certain circumstances, foreign swap dealers could meet these requirements by complying with comparable and comprehensive foreign regulatory requirements, or what we call “substituted compliance.”

Fourth, transaction-level requirements would apply to all U.S. facing transactions. For these requirements, U.S. facing transactions would include not only transactions with persons or entities operating or incorporated in the United States, but also transactions with their overseas branches. Likewise, this would include transactions with foreign affiliates that are guaranteed by a U.S. entity, as well as the foreign affiliates operating as conduits for a U.S. entity’s swap activity. Foreign swap dealers, as well as overseas branches of U.S. swap dealers, in certain circumstances, may rely on substituted compliance when transacting with foreign affiliates guaranteed by or operating as conduits of U.S. entities.

Fifth, for certain transactions between a foreign swap dealer (including an overseas affiliate of a U.S. person) and counterparties not guaranteed by or operating as conduits for U.S. entities, Dodd-Frank transaction-level requirements may not apply. For example, this would be the case for a transaction between a foreign swap dealer and a foreign insurance company not guaranteed by a U.S. person. There are some in the financial community who might want the CFTC to ignore the hard lessons of the crisis and before.

They might comment that swap trades entered into in London branches of U.S. entities do not have a direct and significant connection with activities in, or effect on U.S. commerce.

They might comment that affiliates guaranteed by a U.S. mother ship do not have a direct and significant connection with activities in, or effect on U.S. commerce.

They might comment that affiliates acting as conduits for swaps activity back here in

the United States do not have a direct and significant connection with activities in, or effect on U.S. commerce.

If we were to follow these comments, though, American jobs and markets might move offshore, yet the risk associated with such overseas swaps activities, particularly in times of crisis, would still have a direct and significant connection with activities in, or effect on U.S. commerce.

### Appendix 3—Statement of Commissioner Jill Sommers

Over a year ago, the Commission finally acknowledged that we needed to address the growing uncertainty brewing among swap market participants who were trying to decipher the extraterritorial reach of the Dodd-Frank Act. We held a two-day roundtable last August and have received numerous comments since then from market participants and other regulators asking us to consider a global approach to the regulation of these global markets. We were encouraged to coordinate with our foreign and domestic partners and urged not to implement our regulatory approach in a silo.

CFTC staff has worked diligently to address the challenging issues associated with the statutory language of Section 2(i) of the Commodity Exchange Act (CEA). Unfortunately, when the Proposed Interpretive Guidance and Policy Statement (“Interpretive Guidance”) was finally shared with the rest of the Commission on June 1, 2012, we learned that staff had been guided by what could only be called the “Intergalactic Commerce Clause” of the United States Constitution, in that every single swap a U.S. person enters into, no matter what the swap or where it was transacted, was stated to have a direct and significant connection with activities in, or effect on, commerce of the United States. This statutory and constitutional analysis of the extraterritorial application of U.S. law was, in my view, nothing short of extra-statutory and extra-constitutional.

While the many revisions over the last several weeks have tempered the outer limits of our initial approach, the Interpretive Guidance nonetheless continues to ignore the Commission’s successful history of mutual recognition of foreign regulatory regimes spanning 20-plus years. We have worked for decades to establish relationships with our foreign counterparts built on respect and trust, and should not be so eager and willing to disregard their capabilities. All G20 nations agreed to comprehensive regulation of swap markets and we should rely on their regional expertise. The current document acknowledges the concept of “substituted compliance,” but it is extremely vague with respect to what the Commission will be considering in making these determinations. In my view, a very broad and high level review of regulatory regimes is appropriate versus a word-for-word comparison of rule books.

While the market failures described in the “Background” section of the Interpretive Guidance recount why the G20 nations together agreed to a common set of principles for regulation of a global marketplace, recounting those market failures does not

justify the expansive view the Commission has taken of its jurisdictional reach, and does not justify the implication that other nations are not capable of effective regulation.

As Commissioner O’Malia points out in his concurrence, not only have we failed to coordinate with foreign regulators on a global cross-border approach, we have failed to coordinate with our fellow domestic regulators. As I have said for many months, we should be proposing a rule defining the cross-border application of Dodd-Frank that is harmonized with the SEC’s approach, both in substance and in timing. Unfortunately we are not doing that. Instead, we are proposing Interpretive Guidance that ultimately has the effect of a rule. No matter what it is called, the Interpretive Guidance is so inextricably linked to the entity definitions and the registration rules that it is a part of those rules themselves. Because it is not titled a “Notice of Proposed Rulemaking,” we skirt the requirements of the Administrative Procedure Act and the requirement under Section 15(a) of the CEA that the Commission conduct a cost-benefit analysis. I believe this approach, yet again, needlessly exposes the Commission to litigation.

Over the last two years, while considering many proposed and final rules, I have been very clear that I cannot support an approach that creates an un-level playing field for market participants. I am concerned that the different compliance dates in the Proposed Exemptive Order may unnecessarily disadvantage U.S.-based swap dealers and MSPs from the moment the document is published in the **Federal Register**. I encourage comment on this issue and hope that if we determine to harmonize the compliance dates for entities in the U.S. and abroad, that we can do so before too much damage is done to U.S.-based market participants.

As I reviewed the documents currently under consideration, it occurred to me that two choices are presented. One is that the Commission decline to issue the Interpretive Guidance and Proposed Exemptive Order and leave market participants in a continued state of uncertainty. The other is that the Commission issue these documents and provide market participants with the certainty that we are advancing a flawed policy. Neither is appealing.

My decision to support putting these proposals out for comment was not easily reached. From the beginning I have supported a much simpler approach to the extraterritorial reach of Dodd-Frank. I am hopeful that the comment letters will encourage the Commission to adopt a final rule that will rely on mutual recognition of all global regulatory regimes in a manner that avoids costly, burdensome duplicative regulations.

### Appendix 4—Statement of Commissioner Scott D. O’Malia

I respectfully concur with the Commodity Futures Trading Commission’s (the “Commission” or “CFTC”) approval of its proposed interpretive guidance and policy statement (“Proposed Guidance”) regarding section 2(i) of the Commodity Exchange Act

(“CEA”)<sup>142</sup> and its notice of proposed exemptive order (“Proposed Order”). While I have strong reservations about the statutory authority and disagree with the Commission’s decision to issue interpretive guidance instead of a formal rulemaking, I believe that the timely release of these proposals is critical for firms to have some sense of what U.S. standards will apply to their cross-border transaction, and how those standards will comport with international standards. We expect that these proposals will improve as a result of input from market participants, as well as an open dialogue with global regulators.

These two proposals are complementary in that the Commission’s long-awaited Proposed Guidance establishes our view of the application of the swaps provisions of the CEA to cross-border swaps transactions, while the Proposed Order will delay compliance with certain entity-level and transaction-level swaps requirements in the CEA pending the final adoption of the Proposed Guidance. The Proposed Order also borrows definitions and concepts from the Proposed Guidance, such as the proposed definition of “U.S. person.” While I believe that the Commission’s issuance of the Proposed Guidance and the Proposed Order are overdue, I have a number of general concerns with the former.

I have been assured that the Proposed Guidance is a draft and, although it is not required, will follow the normal notice-and-comment process under the Administrative Procedure Act.<sup>143</sup> After the comment period, the Commission will review public comments and subsequently will incorporate those comments into final guidance. I would like to make it clear that if I were asked to vote on the Proposed Guidance as final, my vote would be no.

#### The Proposed Guidance

My concerns with the Proposed Guidance relate generally to the Commission’s unsound interpretation of section 2(i) of the CEA. In particular, I believe that the Commission’s analysis: (i) misconstrues the language of section 2(i); (ii) is inconsistently applied to different activities; (iii) loosely considers international law and comity; (iv) lacks meaningful collaboration with foreign and domestic regulators; and (v) blurs the lines between interpretive guidance and legislative or interpretive rulemaking. I discuss each of these concerns below.

##### i. Statutory Misconstruction

Section 2(i) of the CEA provides, in part, that the Commission’s swap authority does not apply to foreign activities unless those activities “have a direct and significant connection with activities in, or effect on, commerce of the United States \* \* \*.”<sup>144</sup> When Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”),<sup>145</sup> it intended that

<sup>142</sup> See 7 U.S.C. 1 *et seq.*

<sup>143</sup> See 5 U.S.C. 551 *et seq.*

<sup>144</sup> 7 U.S.C. 2(i) (2012).

<sup>145</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010).

section 2(i) act as a limitation on the Commission's authority. Under section 2(i), the Commission is required to demonstrate how and when its jurisdiction applies to activities that take place outside of the United States. Instead, the Commission's Proposed Guidance ignores the literal statutory construction of section 2(i) and prejudicially switches the analysis. In other words, the Proposed Guidance now places the burden on market participants to explain why their foreign swaps activities are outside of the Commission's regulatory oversight. By placing the burden on market participants to determine whether their swaps activities are subject to the swaps provisions of the CEA—and without providing more guidance to these participants—the Commission inappropriately broadens the scope of swaps activities that will fall within the Commission's jurisdiction. The Commission could more clearly delineate which activities it believes will have a direct and significant connection with U.S. commerce in order to ensure that our regulatory interests are preserved.<sup>146</sup>

#### *ii. Inconsistent Application of CEA Section 2(i)*

In addition, the Commission's Proposed Guidance inconsistently applies, and sometimes ignores, its own section 2(i) analysis. For instance, the Commission sets forth in detail its belief that "the level of swap dealing that is substantial enough to require a person to register as a swap dealer when conducted by a U.S. person, also constitutes a 'direct and significant connection' within the meaning of section 2(i)(1) of the CEA."<sup>147</sup> As a result, a non-U.S. person would have a direct and significant connection with the United States and therefore have to register with the Commission as a swap dealer only once it engages in more than the de minimis level of swap dealing with U.S. persons.<sup>148</sup> In contrast to this somewhat extensive analysis for swap dealers, the Commission provides a sparse explanation of why it believes each

<sup>146</sup> For example, in the case of non-interdealer swap transactions, the Commission could focus its analysis on the solicitation activities of swap dealers. In the case of other swap transactions, the Commission could examine the location of where performance of the primary obligations under a swap agreement takes place.

<sup>147</sup> The Commission's analysis in the Proposed Guidance relies on its analysis in the final entities rule. See Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant," 77 FR 30596 (May 23, 2012).

<sup>148</sup> See 77 FR at 30634 ("[T]he Commissions believe that the appropriate threshold for the phase-in period is an annual gross notional level of swap dealing activity of \$8 billion or less. In particular, the \$8 billion level should still lead to the regulation of persons responsible for the vast majority of dealing activity within the swap markets."). The Commission ties the direct and significant connection analysis to the crude analysis in the final entities rule. I voted against the final entities rule for several reasons, including its flawed reasoning. I expressed my support, however, with respect to the positive outcome that resulted from the establishment of the \$8 billion de minimis threshold.

and every swap transaction between one or more U.S. persons or counterparties other than a swap dealer or major swap participant ("MSP") satisfies the direct and significant connection analysis in section 2(i).<sup>149</sup> Swap transactions that fall under this analysis would be subject to certain transaction-level swaps requirements, including clearing, exchange trading, reporting to a swap data repository under part 45 of the Commission's regulations, real-time public reporting and large swaps trader reporting under part 20 of the Commission's regulations.

Similarly, in another instance, the Commission has divined an exception to the application of certain Commission regulations for situations where a foreign branch of a U.S. swap dealer engages in swap dealing activities in emerging markets or other jurisdictions without comparable swaps regimes.<sup>150</sup> Although the policy result of this exception is well intended, its bare analysis pales in comparison to the Commission's section 2(i) analysis in other places of the Proposed Guidance.<sup>151</sup>

In yet another section of the Proposed Guidance, the Commission does not adequately explain why almost all transaction-level requirements (*i.e.*, clearing, margining for uncleared swaps, real-time public reporting and certain business conduct standards) equally satisfy the direct and significant connection analysis under CEA section 2(i). In my view, two transaction-level requirements related to pre- and post-trade transparency—namely, trade execution and real-time public reporting requirements—do not raise the same level of

<sup>149</sup> See section V of this Proposed Guidance ("In light of the significant extent of U.S. persons' swap activities outside of the United States in today's global marketplace, and the risks to U.S. persons and the financial system presented by such swaps activities outside of the United States with U.S. persons as counterparties, the Commission believes that U.S. persons' swap activities outside the United States have the requisite connection with or effect on U.S. commerce under section 2(i) to apply the swaps provisions of the CEA to such activities."). In a footnote in the Proposed Guidance, the Commission then reasons without persuasive legal support that the aggregate of outside activities and the aggregate connection with U.S. commerce warrant the application of the CEA swaps provisions to all such foreign activities.

The Commission's analysis ignores and minimizes two important points. First, it ignores the fact that multinational entities also may have major operations and business relationships in foreign jurisdictions and may be considered persons within those jurisdictions. Second, its analysis minimizes the fact that there are an appreciable number of U.S. persons who engage in a relatively small number of swaps transactions. Even if those U.S. persons' transactions were aggregated, it is questionable whether their swaps in the aggregate would meet the "significant" element in the section 2(i) analysis.

<sup>150</sup> See section III.D.1 of this Proposed Guidance ("To be eligible for this exception, the aggregate notional value (expressed in U.S. dollars and measured on a quarterly basis) of the swaps of all foreign branches in such countries may not exceed five percent of the aggregate notional value (expressed in U.S. dollars and measure on a quarterly basis) of all of the swaps of the U.S. swap dealer.").

<sup>151</sup> See, *e.g.*, the MSP discussion in section II.C.2 of this Proposed Guidance.

systemic risk concerns as clearing and margining for uncleared swaps. I believe the Commission should better explain its rationale for requiring foreign swap dealers transacting with non-U.S. persons to meet the trade execution and real-time public reporting requirements under Title VII of the Dodd-Frank Act and Commission regulations.

#### *iii. Loose Consideration of Principles of International Comity*

Moreover, the Commission's interpretation of CEA section 2(i) is overly broad to the point where the extent of the Commission's jurisdiction is virtually endless. The Proposed Guidance takes the position that all transactions involving a U.S. person fall within the Commission's jurisdiction, regardless of the location of the transaction or the regulations in effect within the relevant jurisdiction.

While section 2(i) gives the Commission jurisdiction to reach activities that take place outside of the United States, the Commission's Proposed Guidance loosely considers principles of international comity that are essential for determining the extraterritorial applicability of U.S. law. Although the Proposed Guidance expressly states that the Commission will exercise its regulatory authority over cross-border activities in a manner consistent with principles of international comity, the Commission's proposed approach could be described as unilateral and dismissive of foreign law, even when those laws may achieve the same results sought by the Commission.<sup>152</sup>

I strongly believe that the Commission instead must honor these principles in order to respect the legitimate interests of other sovereign nations. This approach would serve to complement, and not limit, the ability of the Commission to effectively regulate swaps markets. The Commission does not have the resources to register and regulate all market participants and swaps activities. By relying on comparable foreign regulatory regimes to address the trading activities of foreign market participants, the Commission could better allocate resources domestically in a more effective manner.

#### *iv. The Commission Should Engage in Real and Meaningful Cooperation With Foreign and Domestic Regulators*

The Proposed Guidance references a series of well-known large financial institution failures—such as Lehman Brothers and Long Term Capital Management—to support the Commission's over-expansive interpretation and application of Title VII of the Dodd-Frank Act. I agree that those failures had a detrimental effect on the U.S. economy. We must not forget, however, that the swaps

<sup>152</sup> The Proposed Guidance correctly cites judicial and executive branch precedent and guidance addressing the application of international law and comity concepts in determining the extraterritorial applicability of federal statutes. See section III.A. of this Proposed Guidance. These concepts are found in sections 403(1) and (2) of the Third Restatement of Foreign Relations Law. See Restatement (Third) of Foreign Relations Law of the United States §§ 403(1), 403(2) (1986).

markets are truly global and the Commission's swaps regulations will not operate in a vacuum. For that reason, the Commission should consider the interaction of its swaps regulations with the regulations of other jurisdictions, all of which have legitimate regulatory interests in the trading of swaps by multinational organizations. Thus, the Commission's swaps regulation should be concordant with foreign swaps regulations in order to avoid duplication, conflict and unnecessary uncertainty.

In light of today's highly interdependent, global financial markets, the Commission needs to engage in real cooperation with foreign regulators and to coordinate its swaps regulations with the regulations of other sovereign nations. Concepts of comparability and mutual recognition are essential.

The Commission should follow the example of international cooperation and coordination seen in the efforts of the Basel Commission on Banking Supervision ("BCBS") and the International Organization of Securities Commissions ("IOSCO") in developing harmonized international standards for the margining of uncleared swaps. BCBS and IOSCO plans to publish a consultation paper outlining these standards. Notwithstanding the Commission's own efforts to propose rules for the margining of uncleared swaps for swap dealers and MSPs,<sup>153</sup> the Commission plans to consider the final policy recommendations set forth by BCBS and IOSCO when adopting the Commission's final rules for the margining of uncleared swaps and may adapt those final rules to conform with BCBS and IOSCO's final policy recommendations. The Commission should follow the lead of BCBS and IOSCO in harmonizing many of its other rules. In my view, either the G20 or another international body or consortium of nations could act as a springboard for the coordination of swaps regulation.<sup>154</sup>

On June 22, 2012, European Union Commissioner Michel Barnier echoed this position in a statement to the *Financial Times*.<sup>155</sup> Mr. Barnier made clear that

<sup>153</sup> See Capital Requirements of Swap Dealers and Major Swap Participants, 76 Fed. Reg. 27802 (May 12, 2011).

<sup>154</sup> On June 18–19, 2012, the leaders of the G20 convened in Los Cabos, Mexico to reaffirm their commitments with respect to the regulation of the over-the-counter ("OTC") derivatives markets. Specifically, the G20 leaders reaffirmed their commitment that all standardized OTC derivatives be traded on exchanges or electronic platforms and be centrally cleared by the end 2012. See the G20 Declaration (June 2012), para. 39, p. 7, at: [http://www.g20.org/images/stories/docs/g20/conclu/G20\\_Leaders\\_Declaration\\_2012.pdf](http://www.g20.org/images/stories/docs/g20/conclu/G20_Leaders_Declaration_2012.pdf).

The Commission should follow the spirit of the G20's cooperative efforts by working with foreign regulators to determine the applicability of its swaps regulations to cross-border swaps.

<sup>155</sup> See statement by Commissioner Michel Barnier of the European Union, *Financial Times*, June 22, 2012 ("Where the rules of another country are comparable and consistent with the objectives of U.S. law, it is reasonable to expect U.S. authorities to rely on those rules and recognize activities regulated under them as compliant. We in the EU can do exactly the same \* \* \* This is reasonable because it accepts legal boundaries and the need for regulators to trust and rely on each other. It is effective because it achieves our common

effective international regulation involves regulators coordinating their efforts to implement mandatory clearing, trading and reporting of over-the-counter derivatives. A coordinated approach would ensure that swaps do not evade regulation. Mr. Barnier also made clear that regulatory regimes that assert jurisdiction over trading activity already within the jurisdiction of another competent regulator is both unnecessary and costly. I agree with Mr. Barnier's view that our goal as regulators should be to establish regulatory regimes that prevent swaps from slipping through the cracks without applying our laws to activity that is better regulated by our trusted colleagues abroad.

Unfortunately, the Proposed Guidance overreaches in many respects and, as a result, steps on the toes of other sovereign nations. Today's Proposed Guidance will likely provoke these nations to develop strict swaps rules in retaliation that unfairly and unnecessarily burden U.S. firms.<sup>156</sup>

Interestingly, we not only fail to harmonize internationally, we also fail to harmonize domestically. In other words, I believe that the Commission should take a page from the Securities and Exchange Commission's ("SEC") playbook regarding implementation and the application of swaps requirements to cross-border activities. Recently, the SEC issued a statement of general policy (the "SEC's Statement") on the sequencing of compliance dates for final rules applicable to the security-based swaps market.<sup>157</sup> The SEC's Statement presents a commonsense sequencing of the compliance dates for the SEC's final rules implementing the provisions of Title VII of the Dodd-Frank Act to domestic and cross-border swaps activities.

In stark contrast, the Commission is engaging in what amounts to high-frequency regulation. I am very critical of this regulatory approach because it generally

objective of mandatory clearing, trading and reporting of OTC derivatives: no trade will escape the regulation. It is efficient because it avoids subjecting the same trades and businesses to two different sets of rules simultaneously and expensively.<sup>158</sup>

<sup>156</sup> Some jurisdictions have provisions that are similar to CEA section 2(i). For example, Article 13 of European Market Infrastructure Regulation ("EMIR") provides that the European Securities and Markets Authority must prescribe technical standards specifying the contracts that are considered to have a direct, substantial and foreseeable effect on the European Union, or in cases where it is necessary or appropriate to prevent the evasion of any general applicability provisions in EMIR. See Regulation of the European Parliament and of the Council on OTC Derivatives, Central Counterparties and Trade Repositories, European Market Infrastructure Regulation (Mar. 29, 2012), available at: [http://ec.europa.eu/internal\\_market/financial-markets/derivatives/index\\_en.htm](http://ec.europa.eu/internal_market/financial-markets/derivatives/index_en.htm). The Commission's overreaching interpretation of CEA section 2(i) may inspire ESMA and other regulators to interpret their provisions in a similar manner.

<sup>157</sup> See Statement of General Policy on the Sequencing of the Compliance Dates for Final Rules Applicable to Security-Based Swaps Adopted Pursuant to the Securities Exchange Act of 1934 and the Dodd-Frank Wall Street Reform and Consumer Protection Act, to be published under 17 CFR Part 240 (June 11, 2012), available at: <http://www.sec.gov/rules/policy/2012/34-67177.pdf>.

results in regulatory uncertainty and unintended, adverse consequences. In my view, failure to achieve real and meaningful harmonization of the implementation and application of swaps and security-based swaps rules will result in inconsistencies and added compliance challenges and costs for market participants who trade in both markets.

*v. Interpretive Guidance or an Interpretive Rule?*

Several times while reading drafts of the Proposed Guidance, I had to stop, put it down, and recall that I was reading the Commission's proposed interpretation of CEA section 2(i)—not a prescriptive rule. Although the Commission has taken great pains to clarify that it is publishing guidance and a policy statement regarding the cross-border application of the swaps provisions of the CEA, certain elements of the Proposed Guidance are written similar to legislative or interpretive rules instead of interpretive guidance. For example, the Proposed Guidance states that subsequent to registration with the Commission:

[T]he Commission expects that a non-U.S. swap dealer or non-U.S. MSP would notify the Commission of any material changes to information submitted in support of a comparability finding (including, but not limited to, changes in the relevant supervisory or regulatory regime) as the Commission's comparability determination may no longer be valid.<sup>158</sup>

The Commission's artful use of the terms "expect" and "expectation" in the Proposed Guidance does not disguise the fact that it is requiring applicants to satisfy significant ongoing monitoring and compliance obligations in order to maintain its comparability finding. If the Commission wanted to require a non-U.S. swap dealer or non-U.S. MSP applicant to submit these additional documents in connection with such applicant's ongoing registration-related obligations, the Commission should have included these requirements in the swap dealer and MSP registration rulemaking, which the Commission finalized in January of this year.<sup>159</sup> Instead, the Commission is issuing today's Proposed Guidance in a manner that is outside of the requirements set forth in the Administrative Procedure Act.<sup>160</sup>

### The Proposed Order

Notwithstanding my general concerns with the Proposed Guidance, I believe that the Commission's Proposed Order appropriately provides both U.S. and foreign firms with transition periods in which to comply with the Commission's interpretation of CEA section 2(i). As noted above, the Proposed Order would permit foreign swap dealer and MSP registrants to delay compliance with certain entity-level requirements and transaction-level requirements under Title VII of the Dodd-Frank Act pending the adoption of the Commission's final

<sup>158</sup> Section IV.A.2 of this Proposed Guidance.

<sup>159</sup> See Registration of Swap Dealers and Major Swap Participants, 77 FR 2613 (Jan. 19, 2012).

<sup>160</sup> See 5 U.S.C. 551 *et seq.*

interpretive guidance regarding section 2(i). My concurrence today comes after several days of negotiations with my fellow commissioners. I am relieved that we are protecting the competitiveness of U.S. firms in the Proposed Order.<sup>161</sup> Although I am generally supportive of the Proposed Order, I do have a couple of more pragmatic concerns regarding the manner in which foreign swap dealers and MSPs will comply with the Commission's registration requirements.

First, I believe the Commission should tie the expiration of this relief to the adoption of a final exemptive order. Currently, the Proposed Order unjustifiably ties the expiration of the relief to the date on which the Proposed Order is published in the **Federal Register**. The Proposed Order's current expiration does not make sense in light of the fact that potential registrants will not know the contours of the final relief until the Commission approves a final exemptive order. If we do not tie the expiration of relief to the publication of the final exemptive order, are we truly providing adequate notice and a period of time in which registrants can comply?

Second, the Proposed Order should at least include questions regarding how the Commission proposes to address practical considerations regarding the registration of foreign swap dealers and MSPs. The Commission should set out its preliminary thinking regarding how these foreign swap dealers and MSPs will register their associated persons and principals, in addition to addressing concerns regarding the transfer of, and withdrawal from, Commission registration.

I have included a few questions at the end of my statement to address these practical concerns.

<sup>161</sup> Under the Proposed Order, U.S. swap dealers and MSPs will only be required to register with the Commission and to meet the requirements under parts 20 (large swap trader reporting) and 45 (swap data recordkeeping and reporting) until December 31, 2012 before other entity-level requirements will become effective.

### **Do Not Ignore the Significant Cost Implications**

I would like to make one closing but important point regarding the potential costs of today's Proposed Guidance. While I understand that the CEA only requires the Commission to consider the costs and benefits of its regulations and orders—not interpretive guidance—the Proposed Guidance, once finalized will result in significant costs to the swaps industry. The implications of the Commission's adoption of interpretive guidance on cross-border swaps activities will be nothing at which to laugh. Firms will incur significant operational, legal and administrative expenses in connection with the registration and ongoing compliance with the Commission's swaps regulations. Not to mention, many firms that operate through branches may feel compelled to convert into, and separately capitalize, affiliates in order to limit the impact of the Commission's interpretation.

Accordingly, I encourage the Commission to prepare a report separate from its adoption of the Proposed Guidance, which analyzes the costs attributable to the breadth of the Commission's new authority under CEA section 2(i). This report will help inform market participants who seek guidance as to the potential costs of trading swaps in the United States. More importantly, the report will help inform the Commission in connection with the issuance of future rulemakings under Title VII of the Dodd-Frank Act.

### **Conclusion**

I am relieved that the Commission is finally issuing today's proposals. Commission staff has spent well over one year preparing the proposals before us today. The publication of the Commission's interpretation of CEA section 2(i) is crucial. I hope that the release of these proposals will enable market participants to determine how the international rules and expansive international oversight of the Dodd-Frank Act might impact their activities in the United States and internationally. I want to ensure that U.S. firms are placed on a fair and

competitive playing field that offers no opportunity for regulatory arbitrage. I am mindful that a seamless regulatory net can only be achieved through international cooperation and coordination.

In summary, I believe the Commission's final interpretive guidance should reflect: (1) Principles of international law and comity; (2) a clear understanding of the implications of the Proposed Guidance so that the Commission can make an informed decision regarding the various policy alternatives; and (3) parity to ensure that U.S. firms are not unfairly disadvantaged vis-à-vis their foreign competitors. I fear that if we adopt the Proposed Guidance as final, the Commission will take an imperialistic view of the swaps market. I also remain concerned regarding the Commission's shaky legal analysis.

I look forward to reviewing the myriad of comments submitted in response to today's proposals. I implore market participants, as well as domestic and foreign regulators, to share their views and let us know how to harmonize our efforts so that we collectively can develop an internationally consistent and complementary approach to address the cross-border regulation of the swaps markets.

### **Questions**

1. Please share your views regarding the Commission's proposed effective date for the relief set forth in the Proposed Order. Should the expiration of the effective date be extended or shortened?

2. Should the Commission permit swap dealer and MSP registrants to conditionally de-register following the expiration of the effective date of the Proposed Order? If so, under what conditions should the Commission allow de-registration?

3. Should the Commission permit swap dealer and MSP registrants to transfer their registration to a majority-owned affiliate or subsidiary? If so, under what circumstances should the Commission allow such a transfer?

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