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Potential Extraterritorial Application of Regulations Issued Under Title VII of the Dodd-Frank Act

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Executive Summary: This paper discusses the potential extraterritorial application of Title VII of the Dodd-Frank Act and regulations promulgated thereunder. Part 1 of this paper provides an overview of the provisions in Title VII that govern extraterritoriality. Part 2 uses common cross-border fact patterns to explore how Title VII may apply extraterritorially.

Introduction

I. **Brief Introduction to U.S. Derivatives Reforms:** Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank Act**") establishes a comprehensive new regulatory framework for swaps[2] and security-based swaps ("**SBS**") by, among other things: (**1**) providing for the registration and regulation of market players defined as swap dealers and major swap participants ("**MSPs**"); (**2**) imposing clearing and trade execution requirements on standardized derivative products and (**3**) creating robust recordkeeping and transaction reporting regimes. Title VII's requirements can be broadly categorized into those that apply to all persons that engage in swaps (such as trade execution, mandatory clearing and trade reporting), those that apply only to swap dealers and MSPs (such as business conduct standards, capital and risk management) and those that apply to swap market infrastructures such as exchanges, trading platforms, clearinghouses and swap data repositories.

II. **Key Regulators under Title VII:** The Dodd-Frank Act provides that the Commodity Futures Trading Commission ("**CFTC**") will regulate swaps and the swap market, the Securities and Exchange Commission ("**SEC**" and, together with the CFTC, the "**Commissions**") will regulate SBS and the SBS market and the Commissions will jointly regulate mixed swaps. The swap/SBS distinction is artificial and is largely based on the historical jurisdictional divisions between the CFTC and the SEC. Under Title VII, federal banking and other regulators also have prudential supervisory rulemaking responsibilities with respect to banking entities that register as swap dealers or MSPs.[3]

III. **Potential Extraterritorial Application of Title VII:** The extent to which U.S. swap regulations will apply to cross-border activities is a critically important issue in light of the global nature of the swap market, the parallel OTC derivatives reforms that are taking place in the European Union

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("**EU**") and G-20 nations and the global operation of major users of and dealers in swaps. If Title VII regulations were given broad extraterritorial scope, then many cross-border swaps would be subject to both U.S. and foreign regulation, which could potentially give rise to duplicative or inconsistent compliance obligations. These rule conflicts are of particular concern for U.S. and foreign financial institutions with global swap dealing operations.

Part 1: Title VII's Provisions on Extraterritoriality

I. Title VII contains provisions that set forth the extraterritorial scope of provisions relating to CFTC-regulated swaps and SEC-regulated SBS.

- A. **Section 722 of Dodd-Frank provides:** Provisions relating to swaps do 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 the rules and regulations promulgated by the CFTC as necessary or appropriate to prevent evasion of the Dodd-Frank Act.
- B. **Section 772 of the Dodd-Frank Act provides:** Provisions relating to SBS do not apply to any person insofar as such person transacts a business in SBS without the jurisdiction of the United States, unless such person transacts a business in SBS in contravention of the rules and regulations that may be promulgated by the SEC to prevent evasion of the Dodd-Frank Act.

II. **Comparing the Provisions:** Both provisions begin by generally limiting Title VII's scope of application to the United States, followed by certain instances in which the Title would apply. Both permit the Commissions to adopt rules to prevent evasion of the Act. However, Section 722 (CFTC) also applies the Title to activities outside the United States that have a direct and significant connection with activities in, or effect on, commerce of the United States. Arguably, this additional application provides the CFTC with broader legal authority than the SEC to apply its swap regulations extraterritorially. However, market participants argue that the Commissions should adopt the same approach to extraterritoriality.

III. **Broad Discretion Regarding Extraterritorial Application**: Regardless of their differences, Sections 722 and 772 provide the Commissions with considerable discretion regarding the extraterritorial application of their Title VII regulations. Section 722 ("shall not apply") and Section 772 ("No provision . . . shall apply") are negative prohibitions that do not require Title VII to be applied to the maximum extraterritorial extent. These sections are also couched in general terms, providing the Commissions broad discretion to interpret their meaning and scope. Under the *Chevron* doctrine, judges generally defer to a federal administrative agency's interpretation of a statute in the agency's area of expertise if the statute is silent or ambiguous and the agency's interpretation is not unreasonable.[4] In practice, this means the CFTC and the SEC would have substantial discretion regarding the meaning and scope of Sections 722 and 772.

IV. **Indications from the Commissions:** The Commissions have provided some tentative suggestions regarding their interpretation of Sections 722 and 772 and how they intend to exercise their discretion regarding extraterritorial application:

A. In its proposal on swap data repositories ("**SDRs**"), the CFTC stated that "swap activity that is strictly of a 'non-U.S.' nature would be excluded from Commission registration and regulation" because "Section 722 of the Dodd-Frank Act, excludes from U.S. jurisdiction all swap activity that does not have a 'direct and significant connection with activities in, or effect on, commerce of the United States', or which contravene regulations necessary to prevent evasion."[5]

B. In its rule proposal on registration of swap dealers and MSPs ("**Registration Proposal**"), the CFTC indicated that in determining the "proper scope of extraterritorial application," it would be guided by considerations of international comity.[6] Under the principal of comity, a nation must refrain from *unreasonably* exercising jurisdiction over persons or activities that have connections with another nation.[7] Reasonableness is determined on the basis of factors such as connections with the regulating nation, harm to that nation's interests, the extent to which other nations regulate, and the potential for conflict of laws.[8]

C. The CFTC's General Counsel has stated that "direct and significant connection . . . or effect" in Section 722 is very similar to a provision in U.S. antitrust laws and that the CFTC has consulted the antitrust precedents to determine the reach of the CFTC's jurisdiction.[9] Regardless of the potential reach of Section 722, the General Counsel went on to observe that "[t]here is no bright-line rule that says that the statute applies to its fullest [extraterritorial] extent in every single possible application" and that extraterritoriality may be determined on a rule-by-rule basis.[10]

D. Section 772 (SEC) is closely modeled on Section 30(b) of the Securities Exchange Act of 1934 ("**Exchange Act**"), which refers to persons transacting a business in *securities* without the jurisdiction of the United States and contains the same anti-evasion exemption.[11] In its original Rule 15a-6 release, the SEC broadly interpreted "jurisdiction of the United States" in Section 30(b) to include the use of U.S. jurisdictional means to engage in broker-dealer activities from outside the United States.[12] However, as a policy matter, the SEC provided a conditional exception to foreign broker-dealers not physically present in the U.S. that engage in transactions with U.S. persons.[13]

V. **Impact of the Supreme Court's Decision in *Morrison* v. *National Australia Bank Ltd***[14]: In *Morrison*, the Supreme Court stated: "unless there is the affirmative intention of the Congress clearly expressed to give a statute extraterritorial effect, we must presume it is primarily concerned with domestic conditions."[15]

- A. If a court were asked to interpret Sections 722 and 772, it might apply *Morrison*'s presumption against extraterritoriality to narrowly construe the Commissions' cross-border authority.[16] For example, the phase "jurisdiction of the United States" in Section 772 would not cover every tangential jurisdictional contact with the United States, and the terms "direct and significant connection . . . or effect" would not sweep in theoretical or *de minimis* effects or connections to U.S. commerce.
- B. It seems unlikely that a court will be asked to interpret Sections 722 and 772. In any event, a court may defer to the Commissions' interpretation of these provisions.
- C. Moreover, it seems likely that the Commissions could adopt their regulations that affect cross-border trading under the anti-evasion authority of Sections 722 and 772, thus extending the reach of these regulations.

Part 2: Exploring Title VII's Potential Extraterritorial Reach Through Common Cross-Border Fact Patterns

Note: Many of the fact patterns discussed below are relevant for all persons that engage in swaps, although several of them are particularly relevant to U.S. and non-U.S. financial institutions with global swap dealing operations.

Fact Pattern A: Swaps Between a U.S. Person and a non-U.S. Person

At a high level of generality, the proposition that Title VII regulations will apply to swaps involving at least one U.S. person is not controversial.[17] The real issues lie in (**1**) how broadly or narrowly U.S. person should be defined and (**2**) whether all regulations should apply once a U.S. person is involved. These questions are of the first order of importance because, under the swaps business arrangements developed before the Dodd-Frank Act, swaps between a U.S. person and a non-U.S. person are very common.

Issue 1: Who is a U.S. Person?

VI. The full extraterritorial impact of applying Title VII to swaps between a U.S. person and a non-U.S. person depends in large part on how "U.S. person" is defined. Below are some existing and proposed definitions of U.S. person, followed by a discussion of their potential impact on common cross-border swaps.

A. SEC Precedents: There is no general definition of "U.S. person" in the securities context.

- 1. **Regulation S under the Securities Act:** For purposes of securities offerings, Regulation S defines "U.S. person" to include any natural person resident in the United States, any partnership or corporation organized or incorporated under the laws of the United States, and certain other entities such as any estate or trust of which the executor or trustee is a U.S. person.[18] The Regulation S definition excludes "any agency or branch of a U.S. person located outside the United States if: (**A**) The agency or branch operates for valid business reasons; and (**B**) The agency or branch is engaged in the business of insurance or banking and is subject to substantive insurance or banking regulation, respectively, in the jurisdiction where located."[19]
- 2. **Rule 15a-6 under the Exchange Act** provides conditional exemptions from registration for foreign broker-dealers that induce or attempt to induce the purchase or sale of any security by certain U.S. institutional investors.[20] Rule 15a-6(a)(4)(iv) also exempts from the registration requirement foreign broker-dealers that engage in certain securities activities with "[a]ny agency or branch of a U.S. person permanently located outside the United States, provided that the transactions occur outside the United States." This provision differs in scope from the exclusion contained in the Regulation S definition because it does not require a "valid business reason" or engaging in the business of insurance or banking.
- 3. **No-Action Letter Defining "Offshore Client":** In 1996, the SEC issued a no-action letter permitting certain foreign broker-dealers to effect transactions in foreign securities with U.S. resident fiduciaries for "offshore clients" without having to register as broker-dealers or effect such transactions in accordance with Rule 15a-6.[21] Significantly, the no-action letter defined "offshore client" as: "(**i**) any entity not organized or incorporated under the laws of the United States and not engaged in a trade or business in the United States for U.S. federal income tax purposes; (**ii**) any natural person who is not a U.S. resident; or (**iii**) any entity not organized or incorporated under the laws of the United States substantially all of the outstanding voting securities of which are beneficially owned by a person described in (i) or (ii) above." It is noteworthy that the "offshore client" definition is also different in scope from the exclusions contained in Regulation S.

B. **CFTC Precedents:** In the futures context, there also is no general definition of "U.S. person." In a number of instances, however, the CFTC regards an entity as "foreign" or non-U.S. if it is "located outside the United States, its territories or possessions." For example, the CFTC defines "foreign broker" as "any person located outside the United States, its territories or possessions" that solicits or accepts orders "only from persons located outside the United States, its territories or possessions" for transactions on or subject to the rules of a U.S. designated contract market or derivatives transaction execution facility and accepts customer assets to margin any trades.[22]

C. **Definitions in Title VII Rule Proposals:** For purposes of SBS data reporting, the SEC proposed a broad definition of "U.S. person" that includes branches and offices of a U.S. person,[23] a natural person that is a U.S. citizen or U.S. resident and a legal person that is organized under the corporate laws of any part of the United States or has its principal place of business in the United States. For purposes of public reporting of swap data, the CFTC proposed to define "U.S. person" as any U.S.-based swap dealer, MSP, eligible contract participant ("**ECP**"), end-user or other U.S.-based entity or person that transacts in a swap.[24] The CFTC did not discuss how the definition would apply to branches and offices of a U.S. person.

- 1. These definitions were proposed in the context of swap data reporting where the Commissions share a strong interest in applying the reporting requirements broadly to enhance post-trade transparency. The Commissions may not use the same definitions for other Title VII requirements.
- 2. The Commissions did not propose identical definitions of "U.S. person." These inconsistencies could lead to swap and SBS regulations having different extraterritorial application. This would be problematic for users and dealers that engage in both swap and SBS transactions.

VII. **Impact of Various "U.S. Person" Definitions on Common Cross-border Swaps Involving:**

A. **A U.S.-Incorporated Entity with Significant Operations/Offices in the United States.** Such a corporation would fall within the Regulation S definition, the definitions proposed by the Commissions in their Title VII rule proposals and any conceivable definition of "U.S. person."

B. **A Foreign Branch or Office of a U.S.-Incorporated Entity.** For SBS data reporting purposes, the SEC proposed that "U.S. person" should include the foreign branch or office of a U.S. person "because a branch or office has no separate legal existence under corporate law [and] would be an integral part of the U.S. person itself."[25] The "U.S. person" definition in Regulation S generally includes branches and offices. However, there is an exception for a branch located outside the United States that operates for valid business reasons, is engaged in the business of insurance or banking and is subject to local insurance or banking regulation.[26] Rule 15a-6 also exempts from the registration requirement foreign broker-dealers that engage in certain securities activities outside the United States with offshore branches and offices of U.S. persons.[27] In certain circumstances, U.S. banking regulators treat U.S. branches of foreign banks as if they were separate legal entities.[28] In a number of no-action letters, the CFTC has treated a bank in one country as a separate legal entity from its branches in another country.[29] The SEC also treats U.S. branches of a foreign bank as distinct from the foreign bank for purposes of Section 3(a)(2) of the Securities Act of 1933.[30] In comment letters to the Commissions concerning the extraterritorial application of Title VII's swap dealer provisions, several financial institutions have relied on these favorable precedents to argue that the Commissions should not treat foreign branches of U.S. corporations as U.S. persons. Specifically, commenters have argued that: (**1**) a foreign entity dealing in swaps with a foreign branch of a U.S. bank should not have to register as a swap dealer on that basis alone and (**2**) a foreign branch of a U.S. bank dealing in swaps with other non-U.S. persons should not have to register as a swap dealer solely on that basis.

C. **A Non-U.S. Affiliate of a U.S. Person:** A non-U.S. affiliate generally refers to a separate legal entity incorporated in a foreign country that is affiliated with a U.S. person such as a U.S.-incorporated entity. A foreign incorporated entity is generally not considered a U.S. person although some definitions require that the entity also not have its principal operations in the United States. In its Registration Proposal, the CFTC sought comments on "when swap dealing activity with or by non-U.S. affiliates of U.S. persons has a 'direct and significant connection with activities in, or effect on' U.S. commerce for purposes of [Section 722]."[31] In response, commenters have generally argued that in situations where (**1**) a foreign swap dealer transacts with a non-U.S. affiliate of a U.S. person or (**2**) a non-U.S. affiliate of a U.S. person deals in swaps with a foreign counterparty, the connection or effect on U.S. commerce is not sufficiently direct or significant to trigger application of Title VII.

Issue 2: Which Title VII Regulations Would Apply to a Cross-Border Swap Involving at Least One U.S. Person.

The CFTC staff has indicated a willingness to consider extraterritoriality on a rule-by-rule basis.[32] Commenters have generally supported such an approach because blanket application of Title

VII's requirements to a cross-border swap between a U.S. person and a non-U.S. person could subject the counterparties to duplicative or inconsistent U.S. and foreign rules. In exploring the extraterritorial application of Title VII regulations below, regulations that apply to all swap participants and those that only apply to swap dealers and MSPs will be discussed separately.

VIII. **Regulations Affecting All Swap Counterparties**: Title VII's mandatory clearing, trade execution and swap data reporting requirements would impact swap counterparties, regardless of whether they are swap dealers or MSPs.

A. **Parallel Reforms in Other Jurisdictions:** The United States is not alone in considering these requirements for OTC derivative transactions. At the 2009 G-20 summit, the G-20 Leaders agreed that "[a]ll standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories."[33] Japan and the EU as well as other G-20 nations have proposed or are in the process of implementing laws to give effect to the G-20 commitments.

B. **Potential for Rules Conflicts:** In view of global efforts to require clearing, trading and reporting of OTC derivatives, broad extraterritorial application of Title VII's parallel requirements could result in clashes between U.S. and foreign rules. Accordingly, many commenters have asked the Commissions to tailor Title VII's mandatory clearing, trading and trade reporting requirements to account for and avoid conflicts with OTC derivatives rules in other major financial jurisdictions. Examples of these conflicts are discussed briefly below.

1. **Mandatory Clearing and Trade Execution:** Subject to certain exceptions, Section 723(a)(3) of the Dodd-Frank Act requires counterparties to submit a swap for clearing to a derivatives clearing organization that is registered with the CFTC or that is exempt by the CFTC from registration.[34] Title VII's mandatory clearing requirement may conflict with foreign laws that require swaps to be cleared through locally registered or recognized clearinghouses.

- (a) Local clearing is an element of the European Commission's Proposal on OTC Derivatives, Central Counterparties and Trade Repositories, also known as the European Market Infrastructure Regulation ("**EMIR**"). Specifically, counterparties subject to EMIR's clearing requirement would be required to clear their trades through a clearinghouse that is established in the EU or a foreign clearinghouse that is recognized by the European Securities and Markets Authority ("**ESMA**") based on specified criteria.[35]
- (b) If a cross-border swap between a U.S. person and an EU counterparty were subject to Title VII's clearing requirement in addition to EMIR's clearing requirement, the swap may need to be cleared twice or different sides of the swap may need to be cleared at different clearinghouses, to the extent that the clearinghouse is not registered with or otherwise recognized by both U.S. and EU regulators. To avoid this outcome, some commenters have asked the Commissions to exercise their authority under Sections 723 and 763 of the Dodd-Frank Act to make a determination that a swap that is required to be cleared under foreign law need not also be cleared under Title VII.
- (c) A similar clash would result between Title VII's trade execution requirement and any foreign law that requires execution at a locally registered or recognized trading platform. Even though Title VII permits the Commissions to exempt a foreign trading platform from registering as a swap execution facility ("**SEF**")

if it is "subject to comparable, comprehensive supervision and regulation on a consolidated basis by . . . the appropriate governmental authorities in the home country of the facility,"[36] the exemption would only apply to a platform that falls within Title VII's "multiple-to-multiple" definition of SEF.[37] However, a recent report on trading of OTC derivatives released by the Technical Committee of the International Organisation of Securities Commissions ("**IOSCO**") revealed that U.S. and European regulators are not in agreement on whether trading platforms must permit participants to trade with multiple liquidity providers within a centralized system.[38]

2. **Trade Reporting:** Title VII generally requires transaction data relating to swaps to be reported to an SDR that is registered with the CFTC, and transaction data relating to SBS to be reported to a securities-based SDR that is registered with the SEC.

- (a) The Commissions' proposed rules would require a swap to be reported to an SDR if there is at least one U.S. counterparty. Even where there are no U.S. counterparties, the SEC *would* require, and the CFTC *may* require, the swap to be reported if it is executed in the United States or through any means of interstate commerce, or is cleared through a clearing agency having its principal place of business in the United States.[39]
- (b) EMIR requires financial and certain non-financial counterparties established in the EU to report OTC derivatives to a trade repository that is registered with ESMA.[40] In order to be registered, trade repositories must be established in the EU.[41] However, a trade repository established in a third country may be recognized by ESMA if certain requirements are satisfied. Such recognition may be a lengthy process because it would require ESMA to first enter into a cooperation agreement with the third country regulator.[42] Title VII does not have a similar regime for exempting foreign SDRs from registration with the Commissions.[43]
- (c) Accordingly, a cross-border swap between a U.S. person and an EU counterparty could be subject to the trade reporting requirements under both EMIR and Title VII, meaning that it may need to be reported to two different trade repositories. To avoid the simultaneous application of duplicative EU and U.S. regulations, some commenters have asked the Commissions to exclude from Title VII trade reporting requirements any swap that is required under foreign law to be reported to a foreign SDR that is not registered with the Commissions. Commenters have also suggested that the Commissions explore ways to obtain swap data from foreign SDRs.

IX. **Regulations Governing Swap Dealers:** Subject to certain exceptions, Title VII defines a swap dealer as a person that: holds itself out as a dealer in swaps; makes a market in swaps; regularly enters into swaps with counterparties in the ordinary course of business; or engages in any activity causing it to be commonly known in the trade as a dealer or market maker in swaps.[44] Requirements governing swap dealers can be conceptually divided into: **(1)** the registration requirement; **(2)** rules that apply to swap dealers at the entity level (such as capital and risk management) and **(3)** transaction-level rules that regulate particular swap transactions (such as business conduct standards, documentation requirements, collateral segregation). The types of cross-border activities that trigger swap dealer registration and the conceptual distinction between transaction-level and entity-level rules feature in a number of comment letters submitted to the Commissions by financial institutions with significant global swap dealing operations.

A. **Swap Dealer Registration Requirement:** Title VII makes it unlawful for any person to act as a swap dealer unless that person is registered as a swap dealer.[45] A threshold question for many global financial institutions is what cross-border swap dealing activities, in light of the extraterritorial provisions in Sections 722 and 772, would trigger the swap dealer registration requirement.

- 1. **Dealing with U.S. Persons:** Although the Commissions have not provided definitive guidance on this issue, it is reasonable to expect that, as a general matter, swap dealing activities with U.S. persons would trigger swap dealer registration. Commenters have generally acknowledged that an entity that deals fully in swaps with U.S. persons would need to register as a swap dealer but have presented various arguments, discussed above, on how "U.S. person" should be defined and what level of dealing should trigger registration. Commenters further argue that swaps between two non-U.S. persons should not trigger registration for the counterparty acting in a dealer capacity because such transactions do not have a direct and significant connection to or effect on U.S. commerce. In addition, the industry submitted comments regarding inter-dealer swaps, back-to-back arrangements and activity-based swap dealer designation.
  - (a) **Inter-dealer Swaps:** Commenters have suggested that a foreign swap dealer whose only U.S. swap activity is with a U.S.-registered swap dealer would not meet the definition of "swap dealer" and would not have to register as such. They argue that cross-border inter-dealer swaps significantly benefit U.S. swap dealers, which benefit could be undermined if foreign swap dealers were deterred by the registration requirement from entering into such transactions.
  - (b) **Back-to-Back Arrangements:** It is common for a swap dealer to enter into a swap with a customer followed by a back-to-back transaction with a swap dealer affiliate for risk-hedging purposes. The Commissions noted in their joint proposal on the definition of swap dealer and MSP ("**Joint Definitions Proposal**") that in determining whether a person is a swap dealer, it would be appropriate to consider whether the swaps the person engages in "simply represent an allocation of risk within a corporate group" or whether they "involve the interaction of unaffiliated persons" that is the hallmark of certain elements of the swap dealer definition. In light of these remarks, some commenters have advocated that: (**1**) if a U.S. swap dealer transacts swaps with customers and then back-to-backs the swaps with a foreign affiliate, the foreign affiliate should not have to register as a swap dealer solely on the basis of these swaps; and (**2**) if a foreign dealer enters into swaps with a non-U.S. person and then enters into back-to-back transactions with an affiliated U.S.-registered swap dealer, the foreign dealer should not have to register as a swap dealer solely on the basis of these swaps.
  - (c) **Activity-based Swap Dealer Designation:** The Dodd-Frank Act states that "[a] person may be designated as a swap dealer for a single type or single class or category of . . . *activities* and considered not to be a swap dealer for other types, classes, or categories of . . . *activities*."[46] Relying on this provision, some global financial institutions have argued that they should be permitted to register a U.S. affiliate as a swap dealer solely with respect to its swap dealing activities with U.S. persons and to register themselves or a foreign branch or separately identified department or division as a swap dealer solely with respect to its activities as a booking center for swaps with U.S. persons.

- (d) **Certain Requirements May Still Apply to Non-Registrants:** The CFTC noted in its Registration Proposal that even where a person is not required to register as a swap dealer, "[s]uch persons, however, may be subject to other requirements imposed on swap dealers, such as reporting obligations. Further, the provisions of the CEA and the Commission's regulations applicable to "any person" will apply as well, such as those prohibiting fraud and manipulation."[47]

B. **Transaction-Level Rules:** Commenters argue that while registration with the Commissions is a basis for U.S. jurisdiction, this should not result in *all* of Title VII's transaction-level requirements applying to *all* of the registrant's swap dealing activities.

- 1. A number of foreign financial institutions have argued that Title VII's transaction-level requirements should not apply to a foreign-registered swap dealer's transactions with non-U.S. persons. Their concern is that extraterritorial application of Title VII's transaction-level requirements in those situations would subject the foreign swap dealer to duplicative or potentially irreconcilable U.S. and foreign rules. They argue that the comity principle would militate against extraterritorial application to a swap between a foreign swap dealer and a non-U.S. person because a foreign nation would have greater interest in regulating the transaction, and the non-application of U.S. rules would avoid rule conflicts and would be consistent with the counterparties' expectations.
- 2. Relying on comity principles, a number of U.S. banks have also advocated similar treatment for their foreign affiliates and branches that engage in swap activities overseas with non-U.S. counterparties. The Commissions have also been asked by commenters to consider, in view of the potential for conflicts of U.S. and foreign rules, whether certain U.S. transaction-level rules should apply to swaps between U.S. swap dealers and non-U.S. persons.
- 3. Financial institutions that addressed the transaction-level and entity-level distinction in their comment letters generally regard Title VII's business conduct standards, documentation requirements, collateral segregation, swap data reporting, mandatory clearing, trade execution and certain record-keeping obligations as transaction-level rules.

C. **Entity-Level Rules:** Title VII imposes risk-based capital as well as a number of risk management and governance requirements on swap dealers. By definition, these entity-level rules apply to a registered swap dealer as a whole and cannot be disapplied with respect to the registrant's non-U.S. activities. Many foreign financial institutions that wish to register as swap dealers are currently regulated by their home country regulators on matters such as capital and risk management.

- 1. Foreign financial institutions are concerned about potentially having to comply with two sets of potentially inconsistent entity-level rules – those imposed by their home country regulators and those promulgated by the Commissions under Title VII. They argue that the prospect of having to comply with two sets of irreconcilable entity-level rules might cause some foreign financial institutions with U.S. swap dealing operations to abandon their current centralized booking model and to set up jurisdiction-specific, separately capitalized entities to conduct swaps business. This fragmented approach, they argue, would be inefficient from a capital perspective and would take away the benefits of netting and centralized risk management, which are essential for systemic-risk mitigation. Some U.S. banks have expressed similar concerns with respect to their foreign branches and affiliates, which are already regulated at the entity level in their respective foreign jurisdictions.
- 2. **Deference to Foreign Regulator:** Commenters have generally argued that U.S. regulators should defer where appropriate to the foreign supervisor's entity-level regulation of a foreign swap dealer registrant.
  - (a) With respect to capital, commenters have argued that the deference to for-

eign supervision is consistent with Federal Reserve precedent[48] and is especially appropriate in view of the greater uniformity in global capital standards that will result from Basel III.

(b) With respect to other entity-level rules, they have proposed a "comparability" standard pursuant to which the Commissions would defer to the foreign regulator's entity-level regulation if it is comparable to the Commission's entity-level regulation of U.S.-based swap dealers. Comparability, it has been argued, would be broadly determined by looking at whether U.S. and foreign entity-level regulations pursue similar objectives or outcomes, and not whether the technical rules in the two jurisdictions are identical. The CFTC has adopted an objectives-based comparability standard in granting no-action relief to foreign boards of trade and issuing Rule 30.10 exemptions to foreign intermediaries. Under this approach, "the CFTC may conclude that the regulatory program is comparable even though the offshore program does not contain elements precisely identical to that of the Commission's regulatory program."[49]

X. **Regulations Governing MSPs:** Although MSPs are subject to largely the same substantive requirements as swap dealers, the CFTC noted in its Registration Proposal that registration of MSPs raises different extraterritorial jurisdiction issues because the statutory definition of MSP[50] specifically focuses on the degree of risk that an entity's swaps pose to U.S. counterparties and the U.S. market.[51]

A. The CFTC stated that "the analysis of whether a non-U.S. entity should register as an MSP would turn upon, among other things, swap positions with U.S. counterparties (including the use of a U.S. clearing agency or swap execution facility) or that involve U.S. mails or any means or instrumentality of interstate commerce."[52] This appears to suggest that even where a foreign entity does not have substantial swap positions with U.S. counterparties, it may need to register as an MSP if its swaps with non-U.S. counterparties are traded or cleared in the United States.

B. In the Joint Definitions Proposal, the Commissions requested comments on whether "sovereign wealth funds or other entities linked to foreign governments should be excluded from the major participant definitions, *particularly in light of the provisions of the Dodd-Frank Act governing its territorial reach . . . .*"[53] The Commissions specifically sought comments on the relevance of "whether the entity's obligations are backed by the full faith and credit of the foreign government." The implicit reasoning behind this statement appears to be that entities fully supported by foreign governments are less likely to fail and therefore pose less risk to U.S. counterparties and U.S. markets.

Fact Pattern B: Swap Referencing a U.S. Asset

XI. As a general matter, a swap between two non-U.S. counterparties is unlikely to be subject to Title VII if its sole U.S. nexus is that it will be settled in U.S. dollars or the instrument references a U.S. asset. However, the Commissions may exercise expansive jurisdiction over such a swap in a fraud or market manipulation case, consistent with past practice. For example, Section 929P(b) of the Dodd-Frank Act extends the extraterritorial reach of the antifraud provisions of the securities laws with respect to actions by the United States or the SEC. This was intended to prevent any extension of the holding in *Morrison* to actions by the U.S. or the SEC.[54]

Fact Pattern C: Swap Cleared in the United States, Traded in the United States or Reported to a U.S.-Registered SDR

XII. The CFTC stated in its Registration Proposal that it "generally would not require a person to register as a swap dealer if their only connection to the U.S. was that the person uses a

U.S.-registered swap execution facility, designated clearing organization or designated contract market in connection with their swap dealing activities, or reports swaps to a U.S.-registered swap data repository."[55]

A. However, the CFTC suggested that such a person "may be subject to other requirements imposed on swap dealers, such as reporting obligations" as well as Title VII regulations applicable to "any person," such as those prohibiting fraud and manipulation.

B. Under the SEC's proposal, this level of U.S. contact would also be sufficient to subject an SBS to Title VII's trade reporting requirements. Proposed Rule 908(a) would require an SBS to be reported if the SBS: (**1**) has at least one counterparty that is a U.S. person; (**2**) was executed in the United States or through any means of interstate commerce; or (**3**) was cleared through a registered clearing agency having its principal place of business in the United States.[56]

Fact Pattern D: Involvement of U.S.-based Employees in a Swap between a Foreign Dealer and a Non-U.S. Person

XIII. It is common for a swap transaction between a foreign dealer and a non-U.S. person to involve, for administrative or expertise reasons, a U.S.-based employee assisting with the transaction. In this scenario, the only jurisdictional contact with the United States would be the U.S.-based employee(s) and the fact that a portion of the swap dealing activity could be said to be conducted inside the United States.

- A. **SEC Precedent:** In the broker-dealer context, the SEC adopts a territorial approach to broker-dealer registration.[57] Under this approach, all broker-dealers physically operating within the United States that effect, induce, or attempt to induce any securities transactions would be required to register as broker-dealers with the SEC, even if these activities were directed only to foreign investors outside the United States. Subject to certain exemptions, foreign broker-dealers that, from outside of the United States, induce or attempt to induce securities transactions by a person in the United States, or that use the means or instrumentalities of interstate commerce of the United States for this purpose, also must register.
- B. **CFTC Precedent:** The CFTC noted in a 1984 policy statement that "registration has been required by the Commission if: (i) The individual or firm engaged in the prescribed activities is based in the United States; or (ii) the individual or firm engages in the prescribed activities with customers in the United States; or (iii) the prescribed activities engaged in by the individual or firm *take place or originate in the United States*."[58]

C. **Title VII**: The SEC has indicated an interest in regulating activities conducted within the United States: "even if both counterparties are not U.S. persons, U.S. regulators have a *strong interest* in having knowledge of and *being able to regulate any activity conducted within the United States or through any means of interstate commerce*."[59] However, this remark was made in the context of trade reporting, where the SEC appears to have adopted an expansive extraterritorial approach. It is unclear whether the SEC intends to subject "any activity conducted within the United States," irrespective of the identities of the swap counterparties, to all of Title VII's requirements.

NOTES

1 Prepared by Robert L.D. Colby, Partner and Andrew S. Fei, Associate, Davis Polk & Wardwell LLP.

2 Unless the context otherwise requires, references herein to "swaps" will include security-based swaps.

3 For example, each registered swap dealer and MSP for which there is a prudential regulator (as defined in Section 712(a)(17) of the Dodd-Frank Act) shall meet such minimum capital requirements and minimum initial and variation margin requirements as are prescribed by its prudential regulator. *See* Dodd-Frank Act §§ 731 and 764.

4 *Chevron U.S.A., Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

5 75 Fed. Reg. 80898, 80900 (Dec. 23, 2010).

6 75 Fed. Reg. 71379, 71382 (Nov. 23, 2010).

7 Restatement (Third) of Foreign Relations Law of the United States ("**Restatement**") § 403(1).

8 Restatement § 403(2).

9 CFTC Global Markets Advisory Committee, Meeting, Oct. 5, 2010, Tr. at 98 (Dan Berkovitz, CFTC Gen. Counsel).

10 *Id.* at 99-100.

11 Section 30(b) of the Exchange Act, U.S.C. § 78dd(b) ("The provisions of [the Title of the United States Code containing the Exchange Act] or of any rule or regulation thereunder shall not apply to any person insofar as he transacts a business in securities without the jurisdiction of the United States, unless he transacts such business in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate to prevent the evasion of this title").

12 Registration Requirements for Foreign Broker-Dealers, 54 Feg. Reg. 30013, 30016 n.41 (July 13, 1989) ("The Commission's position on the application of section 30(b) historically has been, and continues to be, that the phrase 'without the jurisdiction of the United States' in that section does not refer to the territorial limits of this country. Moreover, even if Section 30(b) were read to incorporate a territorial approach, the Commission does not believe that section 30(b) would exempt from broker-dealer registration the activities suggested by the commenters. In particular, directed selling efforts to U.S. investors in the United States hardly could be considered activities not traversing the U.S. territorial limits. A broker-dealer operating outside the physical boundaries of the United States, but using the U.S. mails, wires, or telephone lines to trade securities with U.S. persons located in this country, would not be, in the words of section 30(b), 'transact[ing] a business in securities without the jurisdiction of the United States.") (citations omitted).

13 *Id.*

14 130 S. Ct. 2869 (2010).

15 *Id.* at 2877 (citations and internal quotations omitted).

16 Although *Morrison* arose in the securities fraud context, some courts have extended its presumption against extraterritoriality beyond that context. *See e.g. Norex Petroleum Limited* v. *Access Industries, Inc.*, No. 07-4553-cv, 2010 U.S. App. LEXIS 19982 (2d Cir. Sept. 28, 2010).

17 In its Registration Proposal, the CFTC indicated that "a person outside the U.S. who engages in swap dealing activities and regularly enters into swaps with U.S. persons would likely be required to register as a swap dealer." 75 Fed. Reg. 71379, 71382 (Nov. 23, 2010). CFTC Chairman Gensler has made similar remarks in public. *See* Remarks Before the Institute of International Bankers (October 21, 2010); Senate Agriculture Committee Hearing (March 3, 2011).

18 Rule 902(k) of the SEC's Regulation S under the Securities Act of 1933, 17 C.F.R. § 230.902(k).

19 17 C.F.R. § 230.902(k)(2)(v).

20 17 C.F.R § 240.15a-6.

21 Letter from Catherine McGuire, Chief Counsel, Division of Market Regulation, to Giovanni P. Prezioso, Cleary Gottlieb, Steen & Hamilton (Jan. 30, 1996).

22 17 C.F.R. § 1.3(xx).

23 Proposed 17 C.F.R. § 242.900.

24 Proposed 17 C.F.R. § 43.2(ff).

25 75 Fed. Reg. 75208, 75240 (Dec. 2, 2010).

26 17 C.F.R. § 230.902(k)(2)(v).

27 17 C.F.R 240.15a-6(a)(4)(iv).

28 *See e.g.* 12 C.F.R. §§ 223.61; 225.90.

29 *See e.g.*, CFTC No-Action Letter No. 00-44, Comm. Fut. L. Rep. (CCH) ¶28,095 (Mar. 31, 2000).

30 *See* SEC Release 33-6661 (Sept. 23, 1986).

31 75 Fed. Reg. 71379, 71382.

32 CFTC Global Markets Advisory Committee, Meeting, Oct. 5, 2010, Tr. at 98 (Dan Berkovitz, CFTC Gen. Counsel).

33 G-20, "Leaders' Statement: The Pittsburgh Summit," ¶ 13 (24–25, Sept. 2009).

34 Section 763(a) contains a parallel provision requiring clearing of SBS.

35 Proposed EMIR Art. 23(1).

36 Dodd-Frank Act § 733.

37 Dodd-Frank Act § 721(a)(21).

38 Technical Committee, IOSCO, Report on Trading of OTC Derivatives at 49 (February 18, 2011) available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD345.pdf.

39 See Proposed 17 C.F.R. § 240.908(a).

40 Proposed EMIR Art. 6(1) and Art. 7(1).

41 Proposed EMIR Art. 51(2).

42 Proposed EMIR Art. 63(2)(c).

43 The CFTC noted in its rule proposal on SDRs that "[the Commodity Exchange Act] does not provide the Commission with the authority to exempt any entity performing the functions of an SDR from the registration requirements or any other regulatory duties established by the Dodd-Frank Act." 75 Fed. Reg. 80898, 80900 (Dec. 23, 2010). Interestingly, with reference to Section 722 of the Dodd-Frank Act, the CFTC went on to state that "swap activity that is strictly of a 'non-U.S.' nature would be excluded from Commission registration and regulation." *Id.*

44 Dodd-Frank Act §§ 721(a)(21); § 761(a)(6).

45 Dodd-Frank Act §§ 731 and 764.

46 Dodd-Frank Act § 721(a)(21)(emphasis added); § 761(a)(6) (parallel provision for SBS dealers).

47 75 Fed. Reg. 71379, 71382 n.34.

48 For example, to determine capital adequacy of a foreign bank that is seeking financial holding company status, the Federal Reserve relies on the foreign bank's capital ratios calculated in accordance with home country standards, rather than requiring that it recalculate under U.S. capital standards, as long as its home country supervisor has adopted risk-based capital standards that are comparable to the Basel Accords.

49 Joint Report of the SEC and the CFTC on Harmonization of Regulation, 82 (Oct. 16, 2009). Recently, the CFTC has proposed to continue to use this established comparability analysis to determine whether to register a foreign board of trade under Section 738 of Dodd-Frank. 75 Fed. Reg. 70,974, 70,977 (Nov. 19, 2010).

50 Under Title VII, a person or entity is an MSP if it is not a swap dealer and: maintains a "substantial position" in any of the major swap categories; holds outstanding swaps that create "substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets"; or is a non-financial firm that is not regulated by a federal banking agency that is "highly leveraged" and that maintains a "substantial position" in any of the major Swap categories.

51 75 Fed. Reg. 71379, 71382.

52 *Id.*

53 75 Fed. Reg. 80174, 80203.

54 In *Morrison*, the Supreme Court held, in the context of a private securities fraud action, that Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder apply only in connection with a purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States.

55 75 Fed. Reg. 71379, 71382.

56 Proposed 17 C.F.R. § 240.908(a).

57 *See* 54 Feg. Reg. 30013, 30016 (July 13, 1989).

58 *See* Statement of Policy, *Exercise of Commission Jurisdiction Over Reparation Claims That Involve Extraterritorial Activities by Respondents*, 49 Fed. Reg. 14721 (Apr. 13, 1984).

59 75 Fed. Reg. 75208, 75240 (Dec. 2, 2010).