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December 19, 2016

Via Electronic Submission

Chris Kirkpatrick
Secretary
U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Cross-Border Application of the Registration Thresholds Applicable to Swap Dealers and Major Swap Participants

Dear Mr. Kirkpatrick:

We appreciate the opportunity to submit this comment letter to the Commodity Futures Trading Commission (the "CFTC" or "Commission") as counsel to the Commodity Markets Council ("CMC") with regard to the proposed rulemaking on the cross-border application of the registration thresholds applicable to swap dealers and major swap participants (the "Proposed Rule").[1]

I. Introduction

CMC is a trade association that brings together exchanges and industry counterparts. Its members include commercial end-users that utilize the futures and swaps markets for agriculture, energy, metal, and soft commodities. Its industry member firms also include regular users and members of swap execution facilities (each, a "SEF") as well as designated contract markets (each, a "DCM"), such as the Chicago Board of Trade, Chicago Mercantile Exchange, ICE Futures US, Minneapolis Grain Exchange, and the New York Mercantile Exchange. Along with these market participants, CMC members also include regulated derivatives exchanges. The businesses of all CMC members depend upon the efficient and competitive functioning of the risk management products traded on DCMs, SEFs, and over-the-counter ("OTC") markets. As a result, CMC is well-positioned to provide a consensus view of commercial end-users on the impact of the Commission's proposed regulations on derivatives markets. Its comments, however, represent the collective view of CMC's members, including end-users, intermediaries, and exchanges.

[1] Cross-Border Application of the Registration Thresholds and External Business Conduct Standards Applicable to Swap Dealers and Major Swap Participants, 81 Fed. Reg. 71946 (Oct. 18, 2016).

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II. The Cross-Border Proposed Rule

CMC agrees with the Commission that codifying in a formal rulemaking its approach to regulating cross-border swaps under Section 2(i) of the Commodity Exchange Act ("CEA") may be appropriate in certain circumstances. However, CMC has serious concerns with certain aspects of this Proposed Rule.

Specifically, the proposed definition of a foreign consolidated subsidiary ("FCS"), and the proposed swap dealer and major swap participant ("MSP") registration requirements with respect to FCSs that are not guaranteed by their US parents, would have profoundly adverse effects on many US commercial companies, including CMC members. These adverse effects include registration of US commercial companies based solely on swaps between non-US persons, the operational burden to track and categorize such swaps (*e.g.,* dealing vs. non-dealing activity), and severe competitive disadvantages for US commercial companies and their FCSs.

The registration element of the Proposed Rule is a sweeping change in the Commission's current approach to such FCSs, under which a guarantee by the US parent generally is necessary to trigger any potential registration obligation. CMC respectfully submits that this new proposed approach: (1) exceeds the CFTC's statutory authority under the CEA; (2) is not supported by analogy to the Commission's treatment of FCSs for purposes of margin for uncleared swaps, as suggested by the Proposed Rule; (3) is inconsistent with the established principle of international comity that is a foundation for determining the appropriate cross-border scope of all statutes; and (4) unjustifiably departs from the Commission's approach to the registration of other foreign intermediaries. These deficiencies in the Proposed Rule are discussed, in turn, below.

a. The Proposed Treatment of FCSs Exceeds the Commission's Statutory Authority Under Section 2(i) of the CEA

Generally, the Proposed Rule defines an FCS as a *non-US person* that is consolidated with an ultimate US parent for accounting purposes.[2] Even if an FCS has no guarantee covering its swap obligations, and its US parent is not otherwise contractually or legally obligated to support the FCS's swap obligations, the Proposed Rule would require: (1) such FCS to count toward its swap dealer and MSP thresholds every qualifying swap (even if the counterparty to the swap is another non-US person); and (2) other non-US persons to count toward their own swap dealer and MSP thresholds every qualifying swap with an FCS (even if such non-US persons have no ties at all to the United States).[3] This would constitute a considerable and unwarranted expansion of the scope of entities globally that could now be required to register with the CFTC. CMC believes that this interpretation would exceed the Commission's statutory authority under Section 2(i) of the CEA.

[2] *See* Proposed Rule, 81 Fed. Reg. at 71950, 71973.

[3] *See id*. at 71955-56. A "qualifying" swap is one that, for example, constitutes swap dealing activity for purposes of the swap dealer registration requirement, is not traded anonymously on a DCM, SEF, or registered foreign board of trade and cleared, etc.

In its current guidance regarding the cross-border application of its swaps regulations (the "Cross-Border Guidance"), the CFTC explained that it "construes section 2(i) to apply the swaps provisions of the CEA to activities outside the United States that have either: (1) A direct and significant effect on U.S. commerce; or, in the alternative; (2) a direct and significant connection with activities in U.S. commerce, and through such connection present the type of risks to the U.S. financial system and markets that Title VII directed the Commission to address.[4]

The Proposed Rule, however, does not make a showing that swaps entered into by (let alone with) a non-guaranteed FCS of a US commercial company would have a "direct and significant" effect on US commerce, or a "direct and significant" connection with activities in US commerce that presents risk to the US financial system and markets. Nor could it do so.

If a non-US entity's swap obligations are guaranteed by a US parent, for example, the US parent is necessarily "on the hook" for the non-US entity's shortfalls. That is not the case for a non-guaranteed FCS, however. Indeed, the Commission itself noted this critical distinction in its regulation regarding the cross-border application of margin requirements for uncleared swaps (the "Cross-Border Margin Rule").[5] The Commission explained there that "in the absence of a direct recourse guarantee from a U.S. person, an FCS should not be treated in the same manner as a U.S. CSE [covered swap entity] or U.S. Guaranteed CSE. In contrast with a U.S. Guaranteed CSE, in the event of the FCS's default, the U.S. ultimate parent entity does not have a legal obligation to fulfill the obligations of the FCS. *Rather that decision would depend on the business judgment of its parent.*"[6]

As foreshadowed in the Cross-Border Margin Rule, absent a guarantee or other contractual or legal obligation whereby the US parent is responsible to pay off an obligation of its FCS, the Proposed Rule predicates its registration requirement with respect to FCSs on the hypothetical possibility that: (1) the FCS (or its counterparty) will run into difficulty; and (2) the US parent of the FCS, due to a concern about reputational risk, might step in. But as the Commission has acknowledged, the liabilities of a legally separate subsidiary generally are not the responsibility of its parent (absent some sort of guarantee or other contractual commitment). A US parent has no obligation to support a subsidiary simply because its financial statements are consolidated with that subsidiary. Indeed, many US multinational enterprises make significant efforts to ensure that they and their subsidiaries are legally insulated from the obligations of one another. The Proposed Rule is particularly troublesome in failing to recognize these types of bankruptcy protections that are undertaken to prevent precisely the type of risk the Commission is concerned about.

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[4] Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations, 78 Fed. Reg. 45292, 45300 (July 26, 2013).

[5] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants – Cross-Border Application of the Margin Requirements, 81 Fed. Reg. 34818 (May 31, 2016).

[6] *Id.* at 34827 (emphasis added). The Proposed Rule purports to establish that swap activity by or with an FCS poses a "direct risk" to US parents by citing to *this very section* of the Cross-Border Margin Rule. *See* Proposed Rule, 81 Fed. Reg. at 71950. Clearly, this section of the Cross-Border Margin Rule does not support the Commission's proposition, nor does it support imposing on non-guaranteed FCSs and their US parents the substantial consequences that come with a registration requirement.

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The connection between the hypothetical possibility (described above) and the US financial system is especially remote in the context of FCSs of US commercial companies. A US commercial parent does not have the same type of interconnectedness with other entities that is present with financial institutions and, therefore, the swap activities of its FCS do not pose the same risk to the stability of the US financial system. And any connection to the US financial system from the swap activities of non-US counterparties that trade swaps with FCSs of US commercial parents is even several degrees less than that.

In short, the hypothetical possibility that the swap activities of an FCS – and particularly an FCS of a US commercial company – that is not guaranteed by its US parent could affect US commerce, or activities in US commerce, is neither "direct" nor "significant." The risk to the US financial system from such a hypothetical possibility is remote at best with respect to FCSs of US commercial parents, let alone their swap counterparties. To impose swap dealer and MSP registration requirements on FCSs (and, in particular, FCSs of US commercial companies) that do not present any direct or significant risk to the US financial system or markets, simply because their financial statements are consolidated with a US parent, exceeds the CFTC's extra-territorial authority under Section 2(i) of the CEA.

b. The Proposed Rule Would Cause Substantial Harm to Many US Commercial Companies

The Proposed Rule attempts to justify its expansive approach regarding FCSs by stating that "the nature of modern finance is such that large modern *financial institutions* typically conduct their business operations through a highly integrated network of business lines and services conducted through multinational branches or subsidiaries. . . ."[7] It adds that a "failure to treat these entities the same [as US Persons and guaranteed affiliates] in this context could provide a *U.S. financial group* with an opportunity to avoid [swap dealer] or MSP registration."[8] Indeed, in its discussion of "Current Market Structure" in Section I.B, the Proposed Rule refers to a "financial group" no less than four times – in addition to referring to "financial institutions" and "financial services firms" once each.[9]

But while the Proposed Rule states that its proposed registration requirements applicable to FCSs are intended to address risks posed by US financial institutions and financial groups, the proposed definition of an FCS is not limited to subsidiaries of US financial institutions or financial groups. Instead, it would sweep in, and thus have a significant and detrimental effect on, FCSs that are subsidiaries of US commercial companies as well. Many US commercial companies treat their subsidiaries in a consolidated fashion for accounting purposes, for tax or other business reasons wholly unrelated to their derivatives trading. And many of those subsidiaries otherwise have little or no connection with the United States.

Nevertheless, based on the fact of consolidated financials, the Proposed Rule would require such FCSs to count all qualifying swaps towards their swap dealer and MSP registration thresholds (which would be aggregated with the parent's thresholds) – even swaps that these non-US persons enter into with other non-US persons. This approach would have two

[7] Proposed Rule, 81 Fed. Reg. at 71950 (emphasis added).

[8] *Id.* at 71951 (emphasis added).

[9] *Id.* at 71947-48.

significant, adverse consequences for many US commercial companies. First, the Proposed Rule would impact these companies directly by imposing substantial operational burdens in monitoring and tracking swap activity across the globe, and raising the real prospect of having to register with the CFTC based solely on swaps that occur entirely outside of the United States.

Moreover, the Proposed Rule also would damage the competitiveness of US companies by creating a significant disincentive for non-US entities to do business with their non-US FCSs because they have US parents. That, in turn, would seriously harm the non-US subsidiary's ability to compete overseas. Below is an example of the harm to FCSs of US commercial companies that inherently would result from the Proposed Rule:

> Energy Trader A, a non-US entity with no ties to the US, offers a swap to European Gas Producer X, which is a consolidated subsidiary on the financial statements of its US parent but is not guaranteed by, or otherwise contractually or legally supported by, the US parent company. Under the Cross-Border Guidance, this transaction has no US jurisdictional consequences for Energy Trader A. Under the Proposed Rule, however, Energy Trader A would have to consider whether it would need to register with the CFTC as a result of trading with European Gas Producer X. There can be little doubt that many companies like Energy Trader A will decide simply not to engage in that transaction, and to trade instead with a non-US company that is not an FCS of a US parent and which therefore poses no CFTC registration risk.

The CFTC's swap dealer and MSP registration regime has been in place for four years now, and its Cross-Border Guidance has been in place for 3.5 of those years. The Proposed Rule presents no evidence that the Commission's current approach – which does not apply the swap dealer and MSP registration requirements to non-guaranteed FCSs of US commercial companies – has caused any actual problems or resulted in any foreign derivatives risk "washing up on US shores." Absent such evidence, there is no basis for the Commission to subject US commercial companies to the costs, operational burdens, and competitive disadvantages of the Proposed Rule.

c. The Cross-Border Margin Rule is Not a Precedent for Registration Requirements for FCSs

As explained above, the Proposed Rule's registration requirements relating to FCSs rely heavily on the fact that the Commission's Cross-Border Margin Rule applies to FCSs. Respectfully, though, this is a flawed analogy because it is an "apples-to-oranges" comparison since the treatment of FCSs in the Cross-Border Margin Rule was substantially narrower than under the Proposed Rule.

The definition of an FCS in the Cross-Border Margin Rule is limited to non-US *covered swap entities* ("CSEs," *i.e.*, swap dealers and MSPs for which there is no prudential regulator) that are consolidated with a US parent. FCSs under the Cross-Border Margin Rule are, by

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definition, *swap dealers or major swap participants*.[10] The Commission has a much greater supervisory interest in FCSs that are CSEs than in other consolidated subsidiaries.

Under the Proposed Rule, by contrast, an FCS can include any non-US *person* that is consolidated with a US parent.[11] An FCS subject to CFTC registration requirements under the Proposed Rule can include any entity, even if it is a commercial company (and any counterparty to the FCS even if it, too, is a commercial company, and has no independent connection to the United States), just so long as the FCS happens to have its financial statements consolidated with those of its US parent.

The Commission's treatment of FCSs under the Proposed Rule would be substantially broader than its treatment of FCSs under the Cross-Border Margin Rule. Therefore, the Commission's prior determination that CSE FCSs should be subject to certain margin requirements does not afford a foundation for subjecting FCSs of US commercial parents to swap dealer and MSP registration requirements – and certainly not for subjecting a non-US person that is a counterparty to an FCS to such requirements.[12]

d. The Proposed Rule is Inconsistent with Principles of International Comity and the Commission's Own Approach to Cross-Border Registration

The U.S. Supreme Court "ordinarily construes ambiguous statutes to avoid unreasonable interference with the sovereign authority of other nations."[13] Such international comity reflects the "principle that statutes should be read in accord with the customary deference to the application of foreign countries' laws within their own territories."[14]

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[10] *See* 17 C.F.R. § 23.160(a)(1) ("Foreign Consolidated Subsidiary means a non-U.S. CSE in which an ultimate parent entity that is a U.S. person has a controlling financial interest, in accordance with U.S. GAAP, such that the U.S. ultimate parent entity includes the non-U.S. CSE's operating results, financial position and statement of cash flows in the U.S. ultimate parent entity's consolidated financial statements, in accordance with U.S. GAAP.").

[11] Proposed Rule, 81 Fed. Reg. at 71973 (to be codified at 17 C.F.R. § 1.3(aaaaa)(1)) ("Foreign Consolidated Subsidiary means a non-U.S. person in which an ultimate parent entity that is a U.S. person ('U.S. ultimate parent entity') has a controlling financial interest, in accordance with U.S. generally accepted accounting principles, such that the U.S. ultimate parent entity includes the non-U.S. person's operating results, financial position and statement of cash flows in the U.S. ultimate parent entity's consolidated financial statements, in accordance with U.S. generally accepted accounting principles.").

[12] The margin regulations for uncleared swaps do not apply to non-financial entities. *See*, *e.g.*, 17 C.F.R. § 23.152(b). As a result, there was no need for commercial companies to comment on the Commission's proposed application of these requirements to FCSs in the Cross-Border Margin Rule. The fact that the Commission received few comments on its FCS definition in the margin context from the large portion of market participants that are commercial companies is a further reason that it should not apply an even broader version of that definition in the registration context. Rather, the Commission should take a fresh look at the issue in the specific context of the Proposed Rule – and its deficiencies, as highlighted in this letter.

[13] *F. Hoffman-LaRoche Ltd. v. Empagran S.A.,* 542 U.S. 155, 164 (2004), *citing* Restatement (Third) of Foreign Relations Law of the United States §§ 403(1), 403(2) (1986) (limiting the unreasonable exercise of prescriptive jurisdiction with respect to a person or activity having connections with another State).

[14] *Id.* at 176 (Scalia, J., concurring in the judgment).

The CFTC recently adhered to the principle of international comity when it proposed to amend its Part 3 regulations to exempt from registration certain non-US intermediaries acting on behalf of non-US clients, even when such intermediaries transact in the United States.[15] The Commission explained that it was proposing such registration exemptions, notwithstanding the presence of trading with a US person or on a US execution platform, because "[w]here a Foreign Intermediary's customers are located outside the U.S., . . . the jurisdiction where the customer is located has the preeminent interest in protecting such customers."[16]

The same is true here. When a non-guaranteed subsidiary of a US company is trading with a non-US counterparty, the jurisdictions where the entities are located have the preeminent interest in deciding whether to impose registration requirements on one or both of those entities. And many jurisdictions are requiring entities to register in connection with their derivatives activities in circumstances the foreign jurisdictions determine to be appropriate.[17]

The treatment of FCSs for registration purposes in the Proposed Rule fails to accord the deference to foreign countries' laws in their own territories that the Supreme Court has said is embodied in the principle of international comity. And it represents an unwarranted departure from the Commission's reliance on international comity in other registration contexts. Therefore, it should not be adopted, at least for FCSs of US commercial companies.

III. Conclusion

For the reasons discussed above, applying the CFTC's swap dealer and MSP registration requirements with respect to FCSs that are not guaranteed by a US parent (especially FCSs of US commercial companies), and even more so to non-US persons that trade swaps with such FCSs, would be beyond the scope of the Commission's statutory authority under CEA Section 2(i). Moreover, such registration requirements would have profound and substantially harmful impacts on FCSs and their US parents from both a compliance and a competitive standpoint, are not justified by the application of the Cross-Border Margin Rule to FCSs, violate the principle of international comity, and wrongly depart from the Commission's approach to cross-border registration requirements for intermediaries.

CMC therefore respectfully requests that the Commission not adopt the proposed registration requirements relating to FCSs (*i.e.*, in keeping with its approach in the existing Cross-Border Guidance), or at least tailor them so that they are limited to FCSs of financial groups (*i.e.*, in keeping with the approach in the Cross-Border Margin Rule).

Thank you for the opportunity to comment on the commercial impacts of the Proposed Rule. If you have any questions, please do not hesitate to contact me at 202.662.0223 or at Terry.Arbit@nortonrosefulbright.com.

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[15] *See* Exemption From Registration for Certain Foreign Persons; Proposed Rule, 81 Fed. Reg. 51824 (Aug. 5, 2016).

[16] *Id.* at 51826.

[17] To our knowledge, however, no other jurisdiction requires a US subsidiary to register with it merely because it has a non-US parent (even if their financial statements are consolidated).

Very truly yours,

Terry Arbit
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Counsel to the Commodity Markets Council

cc: Gregg Doud, Commodity Markets Council

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