

# CHANGES TO THE US PERSON DEFINITION AND THE ISDA CROSS-BORDER SWAPS REPRESENTATION LETTER

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## DERIVATIVES AND TRADING

*Please note that this note covers US law issues, and is therefore distributed only to give an overview of this subject. For a proper analysis of your own situation, US counsel should be approached for advice. We would be happy to arrange this for you.*

### BACKGROUND – WHY ARE WE CIRCULATING THIS?

As you may be aware, in July of this year, the Commodity Futures Trading Commission (CFTC) approved its final guidance (the Guidance) on the cross-border application of various requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). At the same time, the CFTC delayed the implementation of certain of these requirements under an exemptive order.

This had the result that the CFTC's final interpretation of the defined term "US Person" will not become effective until 9 October 2013.

This term is used to define the scope of some of the obligations under Dodd-Frank, and until 9 October, the industry will have been transacting on the basis of a relatively narrow interpretation of "US Person" set out by the CFTC in January of this year. As this definition will change, you should consider how you will be affected.

### "US PERSON" – HOW HAS IT CHANGED?

Essentially there are three important changes to the definition that will come into force on 9 October. The full Guidance can be found [here](#) but in summary the key changes for non-US managers and funds are:

- ◆ If a fund or other collective investment vehicle is **majority-owned** by US Persons it will now be considered a US Person itself regardless of its place of establishment unless it is publically offered only to non-US Persons and is not offered to US Persons.

The Guidance states that the CFTC will interpret "majority-owned" to mean the beneficial ownership of 50 per cent or more of the equity or voting interests in the fund.

For the purpose of working out "ownership", you do not need to look through to indirect owners except where an investor is under common control, in which case that investor's beneficial owners do need to be taken into account.

In other words, a master fund needs to check the US Person status of investors in any feeder funds if the feeder funds are under common control with the master.

- ◆ If a fund (or other business entity) has its **principal place of business** in the US, it will be a US Person.

Under the previous guidance, collective investment vehicles were excluded from this limb. This exclusion no longer applies. In addition, the CFTC have stated that they will now generally consider the principal place of business of a collective investment vehicle to be in the US if the senior personnel responsible for either:

- the formation and promotion of the vehicle; or
- the implementation of the vehicle's investment strategy, are located in the United States.

This is because they consider the principal place of business to be the fund's "centre of direction, control and co-ordination of [its] business activities", and this will not necessarily be the registered office of the fund or the place where it holds board meetings or maintains its books and records.

So, if the investment manager of a Cayman fund is in the US, then there is a risk that the fund itself will be deemed to be a US Person. This needs to be evaluated on a case-by-case basis as the CFTC have gone into some detail in considering different contractual arrangements and analysing who a fund's decision-makers are. As such, if you have an establishment or investment advisor in the US, you should discuss with US counsel whether this will be sufficient to render your fund a US Person.

- ◆ In relation to Swap Dealers, their **foreign branches** are now to be considered US Swap Dealers for certain purposes.

Previously, the industry was generally comfortable that transactions with, for example, Bank of America NA, London Branch, or Citibank NA, London Branch would not be caught by the transaction-level requirements of Dodd-Frank. As such, non-US Persons contracting with such branches avoided having to adhere to either of the two ISDA Dodd-Frank Protocols (August 2012 and March 2013).

The CFTC have now qualified that such branches are an integral part of the US principal entity without separate legal existence, and so are themselves US Swap Dealers and therefore US Persons. However, they have also said that in circumstances where a non-US Person is transacting with a US Swap Dealer that is a foreign branch, then substituted compliance is potentially available. In other words, local requirements such as EMIR in Europe may be sufficient for the Dodd-Frank requirements to be deemed met if those requirements are comparable to those under Dodd-Frank. Further guidance on this is expected from the regulators.

#### **IF MY STATUS CHANGES, WHAT ARE THE CONSEQUENCES?**

The change to this definition will have various implications for the buy-side, as:

- ◆ if an entity that was previously not a US Person is now a US Person, it will become subject to a range of entity-level obligations under Dodd-Frank, including clearing, reporting and data reconciliation. At the least, it will need to adhere to the two ISDA Dodd-Frank Protocols. For the full requirements of being a US Person under Dodd-Frank, US counsel should be contacted;
- ◆ if an entity is trading with a non-US branch of a US Swap Dealer that is now deemed to be a US Person, it will become subject to certain transaction-level obligations under Dodd-Frank (including US clearing), unless it is subject to a domestic regulatory regime that the CFTC agrees constitutes "substituted compliance". It too may need to adhere to the two ISDA Dodd-Frank Protocols; and
- ◆ in any event, US sell-side dealers are likely to ask buy-side entities to confirm whether or not their status has changed by giving a "cross-border representation".

#### **HOW DO I NOTIFY MY COUNTERPARTIES OF MY STATUS – THEY ARE STARTING TO ASK?**

Our views on this are as follows:

- ◆ If an entity has already signed up to the ISDA Dodd-Frank Protocols, then "extending" the protocols to cover the cross-border representation through the ISDA Amend platform seems the sensible way to deal with the counterparty requests, particularly since making the required extension is free. Please see Step 3 of the Markit guide [here](#) for instructions on doing this. If the entity is now a US Person, the representation to be given is simply that the entity is a US Person.

- ◆ If an entity has not already signed up to an ISDA Dodd-Frank protocol, that is presumably because it did not consider itself to be a US Person under the previous definition. That entity therefore needs to consider whether it is now a US Person under the Guidance (as per the above).
  - If the entity has become a US Person by virtue of the changed definition, then its (US) counterparties will require it to adhere to both ISDA Dodd-Frank Protocols. As such it can deal with the cross-border representation through the ISDA Amend platform as noted above. Please see our earlier notes [here](#) and [here](#) for instructions on adhering to the Dodd-Frank Protocol.
  - If an entity remains a non-US Person under the Guidance, then the reason it needs to enter into a cross-border representation is for counterparty reasons, not regulatory reasons - i.e. the entity is doing it because its counterparty needs it to do so for its own regulatory requirement, not because that entity is obliged to make the representation under Dodd-Frank. If this is the case, then the entity has three broad options:
    - i. use the ISDA Cross-Border Swaps Representation Letter (the CBR Letter) to provide the "non US Person" rep to the relevant counterparty. The form of the CBR Letter (available [here](#)) is not contentious. It does involve a series of representations being given to the other party - but the entity only has to "reasonably believe" it does or does not fulfil the relevant criteria. The reps are not absolute. The reps are then repeated each time a transaction is entered into, unless the entity notifies its counterparty to the contrary "in a timely manner" (i.e. the facts have changed); or
    - ii. add the relevant representations to another document. For example, if you are mid-negotiation of a trading document with a US counterparty, the wording can be added to the document. This would give scope to depart from the wording in the CBR Letter, but as such may involve more time and cost. Alternatively, a counterparty may ask for its own form of letter or questionnaire to be used. In these circumstances the wording should be compared to the CBR Letter; or

- iii. notify the counterparty separately of the entity's status. It may be possible with some counterparties to notify them informally (e.g., by email) of the entity's status. The benefit of this is that it can be done simply, without involving the underlying entity giving a representation. However, a) most counterparties will want it to be formally documented and b), at least under English law, if it is reasonable for the counterparty to rely on the informal notification (e.g., it comes from an entity's investment manager who is authorised to give such information) and the counterparty suffers any loss as a result of that reliance then the person giving the information might risk being held to owe a duty of care to the recipient, unless the informal notification is carefully worded.

- ◆ If however you are supported by a guarantee given by a US Person, then two further representations must be made. These are whether:
  1. the entity giving the guarantee is or is not a "Financial Entity" (defined in Section 2(h)(7)(C) of the Commodity Exchange Act, as amended, and set out in Appendix 2 to our March 2013 Dodd-Frank Protocol note (see [here](#))); and
  2. the entity itself is an Affiliate of a Swap Dealer (and if it is, that it is not large enough to warrant Swap Dealer registration itself).
- ◆ The point of these is that even if you are not a US Person yourself, by being an Affiliate Conduit or being guaranteed by a US Person, then your trades will be covered by certain elements of Dodd-Frank.

**I AM TRYING TO MAKE A NON-US PERSON REPRESENTATION ON ISDA AMEND OR IN THE CBR LETTER. WHAT ARE THESE OTHER QUESTIONS?**

- ◆ The CBR Letter, and the equivalent sections on ISDA Amend include additional representations to be made by a non-US Person. These are that you are not:
  1. an **"Affiliate Conduit"** - broadly speaking an affiliate (in the common control sense) of a US Person that undertakes certain hedging or trading activities on behalf of that US Person, so that the risks or benefits of the hedging or trading are actually borne by the US Person (in other words, a quasi-anti avoidance type concept). This does not apply to swap dealers; or
  2. a **"Guaranteed Affiliate"** – an entity whose swap obligations to your counterparties are supported by a guarantee given by a US Person – for example a parent guarantee where your parent is a US Person.

For this purpose, the CFTC have stated that they consider guarantees to not only include typical payment or performance guarantees, but also other agreements that, in the circumstances, support the non-US Person's ability to perform its obligations under the relevant swap. The CFTC has stated that the term "guarantee" will be interpreted to include any different financial arrangements and structures that transfer risk directly back to the US and that they look at the substance rather than the form of the arrangement.

**MY STATUS HASN'T CHANGED, BUT MY SWAPS WITH UK DEALER X BENEFIT FROM A PARENT GUARANTEE FROM US ENTITY Y – DOES THE NEW GUARANTEE GUIDANCE MENTIONED ABOVE AFFECT MY TRADES?**

The CFTC does not distinguish between the application of the transaction-level requirements (such as clearing) to a non-US dealer that is a Guaranteed Affiliate and a non-US dealer that is not a Guaranteed Affiliate.

Therefore, based on the current guidance, we consider that whether transaction-level requirements apply (including clearing) will be determined based on the status of dealer's counterparty. If the counter-party (i.e., your fund) is not itself a Guaranteed Affiliate or a US Person, then the requirements will not apply. If the fund is a Guaranteed Affiliate, clearing would apply but the parties may be able to avail themselves of substituted compliance and comply instead with EMIR.

For example a UK dealer with a US parent acting as its guarantor in respect of its swap obligations to the fund will be regarded as a Guaranteed Affiliate of the US parent for the purposes of the CFTC's cross-border rules. If the fund is a non-US Person that is not itself a Guaranteed Affiliate of a US Person, the UK dealer remains a non-US Person (despite the fact that it is a guaranteed affiliate) and so will not be caught by Dodd-Frank clearing.

Alternatively, if the UK dealer is itself also a registered non-US swap dealer (e.g. GSI, MLI), it will be subject to Dodd-Frank requirements in the same way that a US swap dealer would be. However, if that UK dealer is facing a non-US Person that is also not itself a Guaranteed Affiliate, the CFTC's transaction-level requirements (which include clearing) would not apply to the swap.

#### **CONTACT DETAILS**

If you would like further information or specific advice please contact:

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#### **MY STATUS HASN'T CHANGED, BUT MY COUNTERPARTIES THAT ARE LONDON BRANCHES OF US BANKS ARE TELLING ME THEY ARE NOW US PERSONS – WHAT DO I HAVE TO DO?**

London branches of US swap dealers (e.g., Citibank NA, London branch) will, as noted above, be considered US Persons from 9 October 2013 and therefore Dodd-Frank entity-level requirements will apply. However, where the foreign branch of a US Person faces a non-US Person, substituted compliance may be available as noted above. This means that certain transaction-level requirements, such as clearing will apply to the swap. However, assuming the CFTC determines that EU clearing rules are equivalent, the London branch could instead comply with relevant EMIR clearing rules in place of the CFTC rules. Further guidance is expected.

#### **CONCLUSION**

Whether or not your status will change as a result of the Guidance, it is likely that your counterparties will be asking you to consider the issues above. As such, please do contact us if you would like to discuss them. If you think that your status will change, then US counsel should also be instructed to ensure the ramifications of being a US Person are properly considered.

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This note is intended to provide general information about some recent and anticipated developments which may be of interest. It is not intended to be comprehensive nor to provide any specific legal advice and should not be acted or relied upon as doing so. Professional advice appropriate to the specific situation should always be obtained.

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