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Understanding the CFTC's Anti-Evasion Authority and Its Application

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Today's Agenda

CFTC's Anti-Evasion authority is back in the spotlight; recent press reports of some Swap Dealers de-guaranteeing foreign affiliates caught the attention of the CFTC and raised anti-evasion questions.

Webinar will cover:

- Overview of the Anti-Evasion Rules and accompanying interpretive guidance
- Likely application and enforcement
 - Legitimate Business Purpose Test
 - Understanding Willful Intent
 - Explaining Avoidance
- Applicable penalties depending on the evasive actions and actors
- Q&A

What is Evasion?

- **If product structure found to be evasive of Dodd-Frank, then product is a swap** – an agreement, contract, or transaction that is **willfully structured to evade** Subtitle A of Dodd-Frank (regulation of swaps markets) or amendments to the Commodity Exchange Act (CEA) thereby shall be **deemed a swap** (§1.3(xxx)(6)(i)).
- **If product structured to meet the Treasury Exclusion in order to evade Dodd-Frank, then product is a swap** – an interest rate swap or currency swap (including cross-currency swap, currency option, forex currency option, forex exchange rate option and non-deliverable forward involving forex) **willfully structured as a forex forward or forex swap** (excluded by Treasury Department) **to evade the CEA** shall be **deemed a swap** (§1.3(xxx)(6)(ii)).

What is Evasion? (cont.)

- **If bank product structured to evade Dodd-Frank, then product is a swap** — an agreement, contract, or transaction of a bank that is not under the regulatory jurisdiction of an appropriate Federal Banking Agency (defined in Section 1(a)(2)) where that agreement, contract, or transaction is **willfully structured as an identified banking product to evade** the CEA shall be **deemed a swap** (§1.3(xxx)(6)(iii)).
- **“Clever draftsmanship” of the documentation is not dispositive in the analysis of evasion** – form, label, and written documentation of an agreement, contract, or transaction shall not be dispositive in determining if the agreement, contract, or transaction has been willfully structured to evade as provided by §1.3(xxx)(6)(i)-(iii) (§1.3(xxx)(6)(iv)).

What is Evasion? (cont.)

- **Consequence:** If determined an evasive swap, then it will count towards whether a company meets the threshold for **Swap Dealer or Major Swap Participant determination** – an agreement, contract, or transaction that has been willfully structured to evade as provided by §1.3(xxx)(6)(i)-(iii) shall be considered in determining whether a person that so willfully structured to evade is a swap dealer (SD) (e.g. *de minimis*) or major swap participant (MSP) (e.g. “substantial position”) (§1.3(xxx)(6)(v)).
- **Evasion rule not applicable if product structured as a security or security-based swap** – (§1.3(xxx)(6)(vi)).

Evasion Activities Occurring Outside the U.S.

- **Cannot take actions outside the United States to evade or attempt to evade Dodd-Frank** – It is unlawful to conduct activities outside the U.S., including entering into agreements, contracts, and transactions and structuring entities, to **willfully evade or attempt to evade** any provision of CEA (as enacted by subtitle A of Dodd-Frank) or rules (§1.6(a)).
- **“Clever draftsmanship”** is also applicable to actions taken outside the United States to evade Dodd-Frank – (§1.6(b)).

Evasion Activities Occurring Outside U.S. (cont.)

- **If act outside the U.S. to evade Dodd-Frank, then product will be subject to the CEA** – activity conducted outside the United States to evade as provided in §1.6(a) shall be subject to the provisions of Subtitle A (CEA regarding swaps) (**§1.6(c)**).
- **This evasion rule is also not applicable if product structured as a security or security-based swap** – (**§1.6(d)**).

Anti-Evasion Application

- CFTC taking a “**principles-based**” approach to the anti-evasion rules.
- No bright-line test of non-evasive conduct; CFTC believes such an approach may provide potential wrongdoers with a roadmap for structuring evasive transactions.
- However, market participants must face the challenge of determining what types of conduct could later be determined by the CFTC to be evasive in what appears to be a more prescriptive post-Dodd-Frank enforcement atmosphere.

Areas of Focus Noted by Anti-Evasion Guidance

“The CFTC will carefully scrutinize the facts and circumstances associated with forward contracts.”

- **Anti-Evasion and the Forward Exclusion** – the CFTC provided specific guidance that transactions that qualify for the forward exclusion shall not be considered evasive.
- However, the CFTC then made it clear that a transaction that does not qualify for the forward exclusion could be reviewed to determine if it would be evasion under a relevant facts and circumstances analysis.
- The CFTC may see the forward exclusion as an area that could foster evasion of Dodd-Frank.

Areas of Focus Noted by Anti-Evasion Guidance

No Evasion if Self-Certified by a SEF

- **Transactions Executed on a Swap Execution Facility (SEF)** – Market participants that enter into transactions that are self-certified by a SEF (or a Designated Contract Market (DCM)) or that has received prior approval from the CFTC, will not be considered evasive.
- However, a SEF or DCM must self-certify that any products they list for trading are in compliance with the CEA.
- No evasion for the market participant, but the SEF or DCM could be found to have falsely self-certified.

Areas of Focus Noted by Anti-Evasion Guidance

A True Innocent Party

- **Evasive Transaction with an “Innocent Party”** – in a circumstance where a party willfully structures a transaction to evade, but the counterparty does not -- then the evasive transaction will be subject to all provisions of CEA and the regulations thereunder, as applied to the willful evader.
- One counterparty may be a wrongdoer while the other deemed an innocent victim.
- A true “innocent party” will **likely be the victim of fraud or misrepresentation by the evading party** -- CFTC stated it will impose appropriate sanctions only on the willful evader for the violations of the CEA and CFTC regulations.

Anti-Evasion Analysis and the Business Purpose Test

Evasion is a “facts and circumstances” analysis

- CFTC stated it recognizes that transactions may be structured, and entities may be formed, in particular ways **for legitimate business purposes**, without any intention of circumventing the requirements of the Dodd-Frank Act with respect to swaps.
- Thus, in evaluating whether a person is evading or attempting to evade the swap requirements with respect to a particular instrument, entity, or transaction, the CFTC will consider the extent to which the person has a legitimate business purpose for structuring the instrument or entity or entering into the transaction in that particular manner.

Anti-Evasion Analysis and the Business Purpose Test

Structuring Transactions and Entities solely for a legitimate business purpose will not constitute evasion.

- CFTC fully expects that a person acting for legitimate business purposes will naturally weigh the **costs and benefits** associated with different types of financial transactions, entities, or instruments, including the applicable regulatory obligations. In that regard, a person's specific **consideration of regulatory burdens, including the avoidance thereof, is not dispositive** that they are without a legitimate business purpose in a particular case.

Anti-Evasion Analysis and the Business Purpose Test

Possible False Claims of a Legitimate Business Purpose

- The CFTC will evaluate the legitimate business purpose under a facts and circumstances analysis.
- Example - a person may attempt to **disguise a product that may be a swap by employing accounting practices that are not appropriate for swaps**. Whether or not the accounting method or accounting practices are determined to be for legitimate business purposes, that alone will not be dispositive in determining whether it is willfully evasive according to either rule 1.3(xxx)(6) or 1.6.

“Willful” Evasion

Anti-Evasion violations require willfulness, i.e. scienter

- **“Willful Conduct”** – The CFTC stated it will interpret this consistent with how it has in the past. Person acts “willfully” when she acts either **intentionally or with reckless disregard**.
- **Fraud, Deceit or Unlawful Activity** - Although it is **likely** that fraud, deceit, or unlawful activity will be present where willful evasion has occurred, these factors are not a requirement or a prerequisite to a finding of evasion.
 - Concept derived from IRS’s delineation of what constitutes tax evasion.

Avoidance v. Evasion

Analogy of “Tax Avoidance” vs. “Tax Evasion”

- **IRS Explanation** - “Any attempt to reduce, avoid, minimize, or alleviate taxes by legitimate means is permissible. **The distinction between avoidance and evasion is fine, yet definite.**” One who avoids tax does not conceal or misrepresent. Evasion, on the other hand, involves deceit, subterfuge, camouflage, concealment, some attempt to color or obscure events or to make things seem other than they are.

Avoidance v. Evasion

Appropriate Avoidance is Lawful, Evasion is Illegal

- Specific language will be scrutinized, so be mindful during discussions of regulatory considerations
- Consider the use of “avoid” in this example from the **Products Release** - “...if the market for foreign exchange forwards on a particular currency settles on a T+ 4 basis, but two counterparties agree to expedite the settlement of an foreign exchange forward on such currency to **characterize the transaction falsely** as a spot transaction in order to **avoid reporting the transaction**, rule 1.3(xxx)(6)(i) would define the transaction as a swap. In this example, **both parties may be subject to sanctions if they both have the requisite intent (i.e., willfully evaded).**”

Anti-Evasion Specific to Swaps Clearing

Clearing Requirement

- **Person cannot evade the swap clearing requirements** – it is unlawful for any person to **knowingly or recklessly evade**, participate in, or facilitate an evasion of any of the requirements of Section 2(h) of the CEA or any CFTC rule or regulation promulgated thereunder (**§50.10(a)**).
- **Abuse of the End-User Exception prohibited** – it is unlawful for any person to **abuse the exception** to the clearing requirement as provided under section 2(h)(7) or an exception or exemption under this chapter (**§50.10(b)**).
- **Abuse of Any Exemption or Exception under Section 2(h) prohibited** – it shall be unlawful for any person to **abuse any exemption or exception** to the requirements of section 2(h), including any exemption or exception CFTC may provide by rule, regulation or order (**§50.10(c)**).

Anti-Evasion Analysis for Clearing Requirement

Clearing Requirement

- **Standard of Intent** – CFTC states it will interpret the “knowingly or recklessly” standard in §50.10(a) to be the same as the “abuse” standard in §50.10(b) and (c).
- The CFTC said it believes that a “knowingly or recklessly” standard is consistent with, and an appropriate standard of intent for, any “abuse” standard of any exemption or exception to the requirements of section 2(h).
 - It is not evasion under §50.10 if a party submits a swap for clearing in **good faith** and the party has a **reasonable expectation** of the swap being cleared.

Anti-Evasion Analysis for Clearing Requirement

CFTC should follow similar “facts and circumstances” analysis for the Clearing Requirement

- **Business Purpose Test** – CFTC expects a person acting for legitimate business purposes will **naturally weigh many costs and benefits** associated with different transactions, including different swap classes and swap specifications that may or may not be subject to the clearing requirement.
 - Circumventing the costs of clearing may be a consideration, **but cannot be the principal consideration** in order to satisfy the legitimate business purpose test.
- **Fraud, Deceit or Unlawful Activity** – Although it is **likely** that fraud, deceit, or unlawful activity will be present where willful evasion has occurred, these factors are not a requirement or a prerequisite to a finding of evasion.

Anti-Evasion in the Volcker Rule

CFTC Can Enforce its Anti-Evasion Authority against Banks' Proprietary Trading or Interest in Covered Funds

- **Evasion Under the Volcker Rule** -- Banking entity engages in activity or investment in violation of the Bank Holding Company Act (BHC Act) or Part 75 of CFTC Rules, **or** acts in a manner that functions as an evasion of the requirements ..., including through an abuse of Proprietary Trading and Covered Fund Activities and Investments, **or** otherwise violates the restrictions and requirements ..., **shall, upon discovery, promptly terminate the activity and, as relevant, dispose of the investment (§75.21(a)).**
- **CFTC's Authority Under the Volcker Rule** -- If the CFTC finds **reasonable cause to believe** any banking entity has engaged in activity or made investment in violation of the BHC Act or Part 75, **or** engaged in any activity or made any investment that functions as an evasion...the CFTC may take action to enforce compliance with the BHC Act and Part 75, including directing the banking entity to restrict, limit, or terminate any or all activities under this part and dispose of any investment **(§75.21(b)).**

Penalties for Anti-Evasion in CEA

- **Regular Monetary Penalties for Evasive Swaps Same as Other CEA Violations** – Civil monetary penalties (CMP) of \$140,000 or triple monetary gain (depending on provision violated after deemed a swap) or \$1,000,000 or triple monetary gain (if manipulation) (**Section 6(c)**).
- **Double Monetary Penalties for DCO that Evades Clearing Requirement** – any DCO that knowingly or recklessly evades or participates in or facilitates an evasion of section 2(h) shall be liable for a CMP in twice the amount otherwise available for a violation of section 2(h) (**Section 6(e)(4)**).
- **Double Monetary Penalties for SD/MSP that Evades Clearing Requirement** – any SD or MSP that knowingly or recklessly evades or participates in or facilitates an evasion of section 2(h) shall be liable for a CMP in twice the amount otherwise available for a violation of section 2(h) (**Section 6(e)(5)**).
- **Criminal Penalties** – felony fine of not more than \$1 million or imprisonment for not more than 10 years...for any person to willfully violate the CEA or rule or regulation and for any person to abuse the end-user clearing exemption under section 2(h)(4) (**Section 9(a)(5) and(6)**).

What will the CFTC Scrutinize for Evasion?

– In what circumstances would the CFTC consider the possibility of “evasion”?

- **Answer** – Most any time there is an issue involving a swap transaction.

Questions the CFTC may ask:

- Does the person/entity meet this exclusion, exemption or exception?
- Does the person/entity qualify as a Swap Dealer or Major Swap Participant?
- Are the activities within or outside the U.S.?
- Is the person/entity an End-User?
- Why is the person/entity no longer trading in U.S. swap markets?
- Are U.S. margin requirements for uncleared swaps applicable?

Questions?

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