



SEC Adopts Final Rules and Guidance Regarding the Cross-Border Application of “Security-Based Swap Dealer” and “Major Security-Based Swap Participant” Definitions

Nearly four years after the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), on June 25, 2014, the Securities and Exchange Commission (“SEC”) adopted its first in a series of final rules aimed at cross-border security-based swap activities. The final rules stem from an SEC proposal issued May 23, 2013, but do not address all of the issues raised in that proposal. Instead, the final rules address certain aspects of the 2013 proposal, principally the applicability of the security-based swap dealer (“SBSD”) and major security-based swap participant (“MSBSP”) definitions to cross-border security-based swap activities. Final rules addressing the other cross-border issues addressed in the May 23, 2013 proposal will be made in subsequent, separate rulemakings.

Overview

The final rules adopted by the SEC in its June 25 adopting release address such issues as when a cross-border security-based swap transaction (*e.g.*, a security-based swap between a U.S. and non-U.S. person counterparty) must be counted in order to determine whether a person has to register as an SBSBD or MSBSP. For these purposes, a definition of U.S. person is provided. The rule also adopts a procedural rule for the submission of substituted compliance requests to the SEC, although the substantive nature of such determinations will be made in subsequent rulemakings. Substituted compliance would permit parties that are in compliance with another jurisdiction’s comparable regulatory framework (as determined by the SEC) to which a transaction is also subject to be considered in compliance with SEC regulations. In addition, the final rules address the scope of the SEC’s antifraud authority in the cross-border context.

Compliance Date

While the rules become effective 60 days after publication in the Federal Register, the rules applicable to the SBSBD and MSBSP definitions and establishing the procedures for submitting substituted compliance requests will not impose requirements on market participants until after relevant substantive rulemakings, such as a rule setting forth the form and manner of registration for such entities, have been completed.

SEC Jurisdiction and Approach to Rulemaking Compared to CFTC

The SEC has jurisdiction over security-based swaps—swaps on a single security or loan, a narrow-based security index or certain events related to an issuer of a security or issuers of securities in a narrow-based security index—while the CFTC has jurisdiction over swaps based on most other underliers—*e.g.*, swaps on interest rates, currencies, commodities or broad-based security indices. The CFTC previously issued interpretive guidance and an exemptive order to address the cross-border applicability of the Dodd-Frank Act to swap transactions. As discussed in further detail below, the SEC’s approach has a number of differences from the CFTC’s, which may complicate the compliance efforts of market participants as they attempt to comply with two separate regulatory regimes. While recognizing these differences, the SEC states that its approach generally is narrower in scope than the CFTC’s and may provide greater flexibility, and believes that many of the steps that market participants have taken to comply with the CFTC’s cross-border guidance may be transferable to compliance with the SEC’s cross-border rules.

U.S. Persons

Under the SEC’s final rules and interpretive guidance, a U.S. person must include all of its security-based swap transactions (with both U.S. and non-U.S. persons) in assessing whether the U.S. person meets the definitions of SBSB or MSBSP. This is consistent with the CFTC’s interpretive guidance as applied to the parallel entities that trade instruments subject to the CFTC’s jurisdiction—swap dealers and major swap participants.

For purposes of the SBSB and MSBSP determinations, the SEC defines the term “U.S. person” as:

- Any natural person who resides in the United States;
- Any partnership, corporation, trust, investment vehicle, or other legal person organized, incorporated, or established under the laws of the United States or having its principal place of business in the United States;
- Any discretionary or non-discretionary account of a U.S. person; or
- Any estate of a decedent who was a resident of the United States at the time of death.

The final rules define “principal place of business” to mean “the location from which the officers, partners or managers of the legal person primarily direct, control and coordinate the activities of the legal person.”

The SEC’s definition of U.S. person, although similar to the CFTC’s, is narrower in scope. For example, the SEC expressly declined to include within the U.S. person definition collective investment vehicles that beneficially are majority-owned by U.S. persons, which the CFTC includes within its U.S. person definition. Similarly, the SEC does not include any legal person that is directly or indirectly majority-owned by one or more U.S. persons that bear unlimited responsibility for the obligations and liabilities of such legal person within its definition, which are included in the CFTC’s definition. The SEC also expressly excludes certain entities from the U.S. person definition not excluded by the CFTC: the International Monetary Fund, the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the United Nations, and their agencies and pension plans, and any other similar international organizations, their agencies and pension plans.

The SEC believes that its definition of U.S. person is sufficient to identify those persons for whom it is reasonable to infer that a significant portion of their financial and legal relationships are likely to exist within the United States and thus that the risk arising from their activities could manifest itself within the U.S., regardless of the location of their counterparties in light of the ongoing nature of security-based swap obligations.

The SEC does permit, similar to the CFTC, a person to rely upon a representation from its counterparty that the counterparty is not a U.S. person as defined by the SEC, unless the person knows or has reason to know the

presentation is not accurate. For purposes of the final rules, a person would have reason to know the representation is not accurate if a reasonable person should know, under all the facts of which the person is aware, that it is not accurate.

Conduit Affiliates of U.S. Persons

Similar to a U.S. person, a conduit affiliate of a U.S. person must count all of its security-based swap transactions in making the SBSB and MSBSP determinations, which also is consistent with the CFTC's approach. The SEC defines a conduit affiliate of a U.S. person as a non-U.S. affiliate of a U.S. person that enters into security-based swaps with non-U.S. persons or with certain foreign branches of a U.S. bank on behalf of its U.S. affiliates (other than U.S. affiliates that are registered as SBSBs or MSBSPs) and enters into offsetting transactions with its U.S. affiliates to transfer the risks and benefits of those security-based swaps. This definition differs in part from, and is narrower than, the CFTC's definition, which includes consideration of the non-U.S. person's financial statement treatment with a U.S. person.

Non-U.S. Persons

For a non-U.S. person, there are different, generally more complex requirements for counting transactions in assessing whether the non-U.S. person meets the definitions of SBSB and MSBSP. We discuss these requirements below.

Security-Based Swap Dealer Definition

For purposes of assessing whether the non-U.S. person meets the definition of SBSB, the SEC requires that the non-U.S. person must count towards the *de minimis* threshold all security-based swaps with counterparties that are U.S. persons, including foreign branches or offices of U.S. banks, unless those banks are registered as SBSBs, or the transactions are entered into prior to 60 days following the earliest date on which the registration of SBSBs is first required pursuant to SEC rules, and the security-based swap transactions are arranged, negotiated and executed on behalf of the foreign branch solely by persons located outside the United States. With respect to the persons located outside the U.S. requirement, the SEC will permit a person to rely on a representation from its counterparty that the security-based swap transaction is arranged, negotiated, and executed on behalf of the foreign branch by persons located outside the United States, unless such person knows or has reason to know that the representation is not accurate. In addition, the non-U.S. person must count security-based swap transactions with non-U.S. person counterparties that have rights of recourse against a U.S. person affiliate of the non-U.S. person (*i.e.*, is controlling, controlled by, or under common control with the non-U.S. person) for the non-U.S. person's obligations under a security-based swap. A non-U.S. person may exclude from the determination security-based swap transactions that are entered into anonymously on an execution facility or national securities exchange and cleared through a clearing agency.

This approach differs from the CFTC's in several important respects. The CFTC requires guaranteed affiliates of U.S. persons to include all of their swap transactions toward the swap dealer *de minimis* threshold (whether with U.S. or non-U.S. persons). Further, such affiliates are considered guaranteed under the CFTC's guidance not just through formal guarantees with rights of financial recourse, but also any financial support commitment irrespective of recourse rights. By contrast, the SEC only requires counting by a non-U.S. person if its non-U.S. person counterparty has recourse rights against a U.S. person that is an affiliate of the non-U.S. person. Moreover, the CFTC requires non-U.S. persons that are not guaranteed or conduit affiliates of U.S. persons to count swaps with guaranteed affiliates of U.S. persons toward the swap dealer *de minimis* threshold, with certain exceptions. By contrast, the SEC does not require non-U.S. persons (that are not the subject of a recourse guarantee against a U.S. affiliate of the non-U.S. person) to count non-U.S. persons that are guaranteed by U.S. persons. While noting these differences, the SEC did not explain why it chose a different approach from the CFTC in this regard, except to state that these non-U.S. persons would incur compliance costs associated with assessing whether their counterparties are guaranteed affiliates if the SEC adopted the CFTC's approach.

Major Security-Based Swap Participant Definition

For purposes of assessing whether a non-U.S. person meets the definition of MSBSP, like the SBSB definition, a non-U.S. person must count all security-based swaps with U.S. persons, other than foreign branches of registered SBSBs or the transactions are entered into prior to 60 days following the earliest date on which the registration of SBSBs is first required pursuant to SEC rules, where the transactions are arranged, negotiated and executed on behalf of the foreign branch solely by persons located outside the United States. Security-based swap transactions with U.S. persons include those that are cleared through a U.S. person clearing agency. In addition, the non-U.S. person must count security-based swaps with non-U.S. persons if the non-U.S. person has rights of recourse against a U.S. person. This may be any U.S. person, and not just a U.S. person affiliate of the non-U.S. person as under the SBSB definition.

The SEC declined to follow the CFTC's approach that requires guaranteed affiliates of U.S. persons to count all of their swap positions with non-U.S. persons, with certain exceptions. In this regard, the SEC believes that it is not necessary for a non-U.S. person to include transactions where it has a right of recourse against a U.S. guarantor on the basis that the non-U.S. person's failure will not trigger any obligation by the U.S. person's guarantor (by contrast, the U.S. guarantor would have to count the positions under the SEC's attribution rules discussed below). Also, the SEC's approach appears to differ from the CFTC's in that, while the CFTC does not require a non-U.S. person to include swap transactions where its obligations are guaranteed by a U.S. person and instead attributes those positions to the U.S. person, the SEC requires the non-U.S. person to include such positions for purposes of the MSBSP definition. While recognizing that this may result in double counting because the U.S. person guarantor must also count the positions under the SEC's attribution rules discussed below, the SEC believes that both the non-U.S. person and U.S. person pose risk to the U.S. financial system.

Certain security-based swap positions under the SEC's rules are attributed to counterparties of security-based swaps for purposes of the MSBSP definition. For U.S. persons, they must count any security-based swap position of a non-U.S. person for which the non-U.S. person's counterparty has rights of recourse against that U.S. person. For non-U.S. persons, any security-based swap position of a U.S. person for which that person's counterparty has rights of recourse against the non-U.S. person are counted toward the major participant thresholds. Moreover, a non-U.S. person that provides a recourse guarantee of the security-based swap obligations of another non-U.S. person must count toward its major participant thresholds security-based swaps entered into between that non-U.S. person and a U.S. person counterparty who has rights of recourse against the first non-U.S. person, except where the U.S. person is a non-U.S. branch of a registered SBSB or the transaction is entered into prior to 60 days following the earliest date on which the registration of SBSBs is first required pursuant to SEC rules, and the transactions are arranged, negotiated and executed on behalf of the foreign branch solely by persons located outside the United States.

Excluded from the MSBSP calculation are security-based swaps guaranteed by a non-U.S. person where the person guaranteed is subject to capital regulation by the SEC or CFTC, regulated as a bank in the United States, subject to capital standards adopted by the person's home country supervisor that are consistent in all respects with the Capital Accord of the Basel Committee on Banking Supervision, or is deemed not to be an MSBSP under Exchange Act rule 3a67-8(a).

Aggregation

For all persons, the SEC has adopted a rule that a person shall not include the security-based swap transactions of an affiliate controlling, controlled by or under common control with such person, where the affiliate is registered as an SBSB or is deemed not to be an SBSB under Exchange Act rule 3a71-2(b). This approach is consistent with the CFTC's aggregation rule for purposes of the swap dealer definition.

Transactions between Non-U.S. Persons Conducted within the United States

Notably, the final rules do not include a requirement from the proposing release that non-U.S. persons count against the *de minimis* threshold under the SBSB definition their dealing activity involving transactions conducted within the United States. The SEC states that it anticipates soliciting additional public comment regarding approaches by which the cross-border application of the SBSB definition can reflect activity between two non-US persons where one or both are conducting dealing activity within the United States.

Substituted Compliance Procedural Rule

The SEC also adopted a procedural rule regarding the submission of a request for a substituted compliance determination. The SEC indicates that such a request may be submitted by any party that potentially must comply with SEC requirements or by a relevant foreign regulator. It must include supporting documentation, including information regarding applicable requirements established by a foreign financial regulatory authority as well as the methods used by the authority to monitor and enforce compliance with its rules.

Antifraud Rule

The final rules also address the scope of the SEC's cross-border antifraud civil enforcement authority. It clarifies that the antifraud authority applies where sufficient conduct in furtherance of the fraud occurs, or sufficient effects of the fraud are felt, within the United States.

The SEC's final rules are available here: <http://www.sec.gov/rules/final/2014/34-72472.pdf>.

Authors

Julian Hammar
Washington, D.C.
(202) 887-1679
JHammar@mofocom

Michael Sorrell
Washington, D.C.
(202) 887-8795
MSorrell@mofocom

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