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SEC Proposes Rules on Cross-Border Security-Based Swap Activities

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 41-13
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 35-13
ICI GLOBAL MEMBERS
INVESTMENT ADVISER MEMBERS No. 30-13
INTERNATIONAL MEMBERS No. 24-13
SEC RULES MEMBERS No. 46-13 RE: SEC PROPOSES RULES ON CROSS-BORDER SECURITY-BASED SWAP ACTIVITIES

Recently, the Securities and Exchange Commission ("SEC") unanimously voted to propose rules and interpretive guidance for parties to cross-border security-based ("SB") swap transactions. [1] The Proposal addresses the application of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") to market intermediaries, participants, and infrastructures for SB swaps and certain transaction-related requirements under Title VII in connection with reporting and dissemination, clearing, and trade execution for SB swaps. Concurrently, the SEC re-opened for comment all of its currently pending rule proposals related to Title VII of the Dodd-Frank Act in light of the proposed cross-border rules. [2]

The Proposal describes which Title VII requirements would apply when a transaction occurs partially within and partially outside the United States. The Proposal also outlines a "substituted compliance" framework that would avoid subjecting market participants to conflicting or duplicative requirements by permitting non-U.S. market participants, under certain circumstances, to comply with some or all of the requirements of their home country regulatory regime in lieu of Title VII requirements.

The SEC's approach to the regulation of cross-border activities differs in significant ways from the approach proposed by the Commodity Futures Trading Commission ("CFTC") in its interpretive guidance regarding the cross-border application of the swaps provisions of the Commodity Exchange Act ("CEA"). [3] This memorandum briefly summarizes some of the key provisions of the Proposal that may be of interest to U.S. funds that are regulated under the Investment Company Act of 1940 and non-U.S. regulated funds publicly offered to investors. Comments on the Proposal are due 90 days after publication in the Federal Register.

Scope of Application of Title VII

The SEC proposes to take a "territorial" approach to the regulation of cross-border transactions. This approach would apply with respect to each of the major Title VII registration categories and requirements in connection with reporting and public dissemination, clearing, and trade execution for SB swaps. Generally, the proposal would subject SB swap transactions to the requirements of Title VII if they are (1) entered into with a U.S. person or (2) otherwise conducted within the U.S. [4] For example, the Proposal would require a non-U.S. person engaged in SB swap dealing activity to register with the SEC as an SB swap dealer if the notional amount of SB swap transactions connected with its dealing activity with U.S. persons (other than with foreign branches of U.S. banks) [5] or otherwise conducted within the United States exceeds the de minimis threshold in the SB swap dealer definition. [6]

Proposed Definition of "U.S. Person"

The proposed definition generally follows the approach in Regulation S under the Securities Act of 1933 but departs from the Regulation S in certain respects. [7] The Proposal would define "U.S. person" to mean: (1) any natural person resident in the United States; (2) any partnership, corporation, trust, or other legal person organized or incorporated under the laws of the United States or having its principal place of business in the United States; or (3) any account (whether discretionary or non-discretionary) of a U.S. person. [8]

Under the second part of the proposed definition, an entity that is organized or incorporated in a jurisdiction outside the United States would be a U.S. person if it has its principal place of business in the United States. An entity's status as a U.S. person would be determined at the legal entity level. The Proposal, however, does not define or provide guidance on the term "principal place of business," which may not be clear particularly with respect to funds.

Under the third part of the proposed definition, the term would include accounts of U.S. persons. The status of accounts, wherever located, would turn on whether any owner of the account is itself a U.S. person and not on the status of the fiduciary or other person managing the account, the discretionary or non-discretionary nature of the account, or the status of the entity at which the account is held or maintained.

Proposed Definition of "Transaction Conducted Within the United States"

The Proposal defines "transaction conducted within the United States" to mean any SB swap transaction that is "solicited, negotiated, executed, or booked within the United States, by or on behalf of either counterparty to the transaction, regardless of the location, domicile, or residence status of either counterparty to the transaction." In the context of the de minimis threshold for SB swap dealers, the SEC states that submitting a transaction for clearing in the United States or reporting a transaction to a swap data repository ("SDR") in the United States would not cause the transaction to be "conducted within the United States." Moreover, activities related to collateral management (e.g., exchange of margin payments) that may occur in the United States or involve U.S. banks or custodians would not be considered activities conducted within the United States.

The SEC proposes to permit parties to rely on a representation received from a counterparty indicating that no person within the United States is directly involved in soliciting, negotiating, executing, or booking a given transaction on behalf of the

counterparty. Under the Proposal, a party may rely on such a representation by its counterparty unless the party knows the representation is not accurate.

Non-U.S. Funds

To determine the implications of the Title VII requirements on a non-U.S. fund under the Proposal, the non-U.S. fund must consider the two-part analysis discussed above. First, a fund that is incorporated outside the United States would not be a U.S. person unless its "principal place of business" is in the United States. The Proposal, however, does not describe how a fund would analyze its principal place of business for these purposes. Second, a non-U.S. fund must consider whether its derivatives transactions are conducted within the United States. A non-U.S. fund must analyze whether its SB swap transactions are solicited, negotiated, executed, or booked within the United States, by or on behalf of either counterparty to the transactions.

Regulation of SB Swap Dealers

Title VII requirements with respect to SB swap dealers apply both at a transaction level (i.e., SB transactions with specific counterparties) and at an entity level (i.e., to the dealing entity as a whole). These proposed requirements may affect U.S. regulated funds and non-U.S. regulated funds as counterparties to SB swap dealers.

Transaction-Level Requirements

Transaction-level requirements primarily focus on protecting counterparties by imposing certain obligations on SB swap dealers, including standards of business conduct and segregation of customer funds. Under the Proposal, a registered foreign SB swap dealer and a foreign branch of a registered U.S. SB swap dealer with respect to their "Foreign Business" will not be required to comply with most of the external business conduct standards. [9] "Foreign Business" is proposed to be defined as SB swap transactions entered into, or offered to be entered into, by or on behalf of a foreign SB swap dealer that do not include its "U.S. Business." The proposed rule would define "U.S. Business" as (i) any transaction entered into, or offered to be entered into, by or on behalf of such foreign SB swap dealer, with a U.S. person (other than with a foreign branch), [10] or (ii) any transaction conducted within the United States. [11] All other requirements in Section 15F of the Exchange Act would apply although substituted compliance will be permitted under certain circumstances.

The SEC also proposes to allow a foreign SB swap dealer not to have to comply with the segregation requirements set forth in Section 3E of the Exchange Act and the rules and regulations thereunder with respect to SB swap transactions with non-U.S. person counterparties in certain circumstances. The segregation requirements would apply to a foreign SB swap dealer depending on whether the SB swap dealer holds assets to secure cleared SB swap transactions or non-cleared SB swap transactions and whether such foreign SB swap dealer is a registered broker-dealer, a foreign bank with a branch or agency in the United States or neither of the above. Therefore, under the Proposal, non-U.S. person counterparties of foreign SB swap dealers that are not registered broker-dealers would not have "customer" status with respect to their assets to margin a non-cleared SB swap transaction and these foreign SB swap dealers would not be required to comply with the segregation requirements for those assets. Moreover, a foreign SB swap dealer that is not a registered broker-dealer and is not a foreign bank with a branch or agency in the United States would be required to comply with the segregation requirements

for U.S. and non-U.S. person customer assets only if the SB swap dealer receives collateral from U.S. person counterparties to secure cleared SB swaps. Finally, a foreign SB swap dealer that is not a registered broker-dealer and is a foreign bank that has a branch or agency in the United States would not be required to comply with the segregation requirements with respect to any assets received from, for or on behalf of a counterparty who is a non-U.S. person to margin, guarantee, or secure a cleared SB swap.

Entity-Level Requirements

Entity-level requirements focus on the safety and soundness of the entity and include requirements related to capital and margin, risk management, recordkeeping and reporting, internal system and controls, diligent supervision, conflicts of interest, and chief compliance officer. In contrast to the CFTC's proposed cross-border guidance, the SEC proposes to treat margin as an entity-level requirement because of its view that margin plays an important role in an integrated program of financial responsibility requirements. The SEC does not propose to provide specific relief for foreign SB swap dealers from Title VII entity-level requirements although a foreign SB swap dealer may be able to satisfy certain requirements by substituting compliance with corresponding requirements under a foreign regulatory system.

Regulation of SB Major Swap Participants

The SEC proposes to require a U.S. person to consider all SB swap transactions entered into by it, while a non-U.S. person would consider only transactions entered into with U.S. persons, when determining whether the person falls within the major SB swap participant definition. All SB swap transactions by a non-U.S. person with other non-U.S. person counterparties, regardless of whether they are conducted within the United States or whether the non-U.S. person counterparties are guaranteed by a U.S. person, would be excluded from the major SB swap participant analysis.

Under the Proposal, registered foreign major SB swap participants would not have to comply with most of the business conduct standards with respect to their transactions with non-U.S. persons except for the rules and regulations relating to diligent supervision. Moreover, registered foreign major SB swap participants that are not registered broker-dealers would not have to comply with respect to their transactions with non-U.S. persons with requirements related to the segregation of assets held as collateral. Registered foreign major SB swap participants, however, would be required to comply with the entity-level requirements (regardless of the U.S. person status of a counterparty). In addition, the SEC is not proposing, at this time, to permit substituted compliance by foreign major SB swap participants for either the transaction-level or entity-level requirements.

Transactional Requirements

The SEC also proposes rules and interpretive guidance regarding the application of Title VII to cross-border activities with respect to certain transactional requirements in connection with reporting and dissemination, clearing and trade execution for SB swaps. These requirements apply to persons independent of their registration status.

Under the proposed approach, these transaction-level requirements generally would not apply to transactions conducted outside the United States between, among others: (1) a foreign branch of a U.S. bank and an unregistered non-U.S. person that does not receive a

guarantee from a U.S. person on its performance of its SB swap obligations; and (2) a non-U.S. person that is a registered SB swap dealer and a non-U.S. person that does not receive a guarantee from a U.S. person on its performance of its SB swap obligations.

Regulatory Reporting and Public Dissemination

The SEC is re-proposing the rules with respect to regulatory reporting and public dissemination and addressing regulatory reporting separately from public dissemination. Specifically, an SB swap transaction would be subject to regulatory reporting if (1) the SB swap is a transaction conducted within the United States; (2) there is a direct or indirect counterparty [12] that is a U.S. person on either side of the transaction; (3) there is a direct or indirect counterparty that is an SB swap dealer or major SB swap participant on either side of the transaction or (4) the SB swap is cleared through a clearing agency having its principal place of business in the United States.

Under the Proposal, an SB swap transaction would be subject to public dissemination if (1) the SB swap transaction is conducted within the United States; (2) there is a direct or indirect counterparty that is a U.S. person on each side of the transaction; (3) at least one direct counterparty is a U.S. person (except in the case of a transaction conducted through a foreign branch); (4) one side includes a U.S. person and the other side includes a non-U.S. person that is an SB swap dealer; or (5) the SB swap is cleared through a clearing agency having its principal place of business in the United States.

The SEC also proposes some modifications to the original proposed rules that specify who must report the SB swap. The revisions are designed to assign the responsibility to report an SB swap transaction to persons that the SEC believes have greater capacity to fulfill that responsibility. [13] The only time that the domicile of the counterparties could determine who must report is if neither side include an SB swap dealer or major SB swap participant. For example, if a U.S. fund executes an SB swap in London with a foreign bank that is registered as a dealer in its home jurisdiction but is not an SB swap dealer or major SB swap participant, the U.S. fund would have the obligation to report because it is the only U.S. person.

Clearing

The SEC proposes a rule to specify when a person engaging in cross-border SB swap transactions would be required to comply with an SEC mandatory clearing determination. Generally, the SEC proposes to apply the mandatory clearing requirement to any person that engages in an SB swap transaction in which at least one of the counterparties to the transaction is a U.S. person or a non-U.S. person whose performance under the SB swap is guaranteed by a U.S. person or if the transaction is “conducted within the United States.”

The SEC proposes two exceptions to the mandatory clearing requirement. First, with respect to an SB swap transaction that is not conducted within the United States, the proposed rule would not apply the mandatory clearing requirement if: (1) one counterparty to the transaction is (i) a foreign branch of U.S. bank or (ii) a non-U.S. person whose performance under the SB swap is guaranteed by a U.S. person and (2) the other counterparty to the transaction is a non-U.S. person (i) whose performance under the SB swap is not guaranteed by a U.S. person and (ii) who is not a foreign SB swap dealer. Second, with respect to an SB swap transaction that is conducted within the United States, the proposed rule would not apply the mandatory clearing requirement if (1) neither counterparty to the transaction is a U.S. person; (2) neither counterparty’s performance

under the SB swap is guaranteed by a U.S. person; and (3) neither counterparty to the transaction is a foreign SB swap dealer. Under the second exception, the mandatory clearing requirement would not apply to a transaction between non-U.S. persons solely because the transaction is conducted within the United States.

Trade Execution

Under the Proposal, the mandatory trade execution requirement would apply to any person that engages in an SB swap transaction if: (1) at least one of the counterparties to the transaction is (i) a U.S. person or (ii) a non-U.S. person whose performance under the SB swap is guaranteed by a U.S. person or (2) the transaction is conducted within the United States. The SEC proposes two exceptions to the mandatory trade execution requirement depending on where the SB swap transaction is conducted.

First, with respect to an SB swap transaction that is not conducted within the United States, the proposed rule would not apply the mandatory trade execution requirement if: (1) one counterparty to the transaction is (i) a foreign branch of a U.S. bank or (ii) a non-U.S. person whose performance under the SB swap is guaranteed by a U.S. person and (2) the other counterparty to the transaction is a non-U.S. person (i) whose performance under the SB swap is not guaranteed by a U.S. person and (ii) who is not a foreign SB swap dealer. Second, with respect to an SB swap transaction that is conducted within the United States, the proposed rule would not apply the mandatory trade execution requirement if (1) neither counterparty to the transaction is a U.S. person; (2) neither counterparty's performance under the SB swap is guaranteed by a U.S. person; and (3) neither counterparty to the transaction is a foreign SB swap dealer.

Substituted Compliance

The SEC proposes a "substituted compliance" framework under which it would consider written applications to permit compliance with requirements in a foreign regulatory system to substitute for compliance with certain requirements of the Exchange Act relating to SB swaps, provided that the corresponding requirements in the foreign regulatory system are comparable to the relevant provisions of the Exchange Act. The SEC would make the substituted compliance determinations with respect to four separate categories of requirements. These categories include: requirements applicable to registered non-U.S. SB swap dealers; requirements relating to regulatory reporting and public dissemination of SB swap data; requirements relating to mandatory clearing for SB swaps; and requirements relating to mandatory trade execution for SB swaps.

Under the Proposal, the SEC would make a determination that a foreign jurisdiction has comparable requirements pursuant to the proposed procedures for considering applications for substituted compliance determinations. The determination would be made based on whether the foreign jurisdiction's requirements achieve regulatory outcomes comparable to those of Title VII in the four major categories of requirements rather than based on a rule-by-rule comparison.

The SEC proposes to impose certain conditions under which substituted compliance would be permitted. With respect to reporting and public dissemination, an SB swap would be eligible for substituted compliance if at least one direct counterparty to an SB swap is a non-U.S. person (or a foreign branch of a U.S. bank) and no person within the United States is directly involved in executing, soliciting or negotiating the terms of the SB swap on behalf of that counterparty. Therefore, substituted compliance could apply even in the instance of

an SB swap with a direct counterparty that is operating from within the United States so long as the other direct counterparty is a non-U.S. person and no person within the United States is directly involved in executing, soliciting or negotiating the terms of the SB swap on behalf of that non-U.S. person. An SB swap transaction between two U.S. persons would not be eligible for substituted compliance even if the SB swap is solicited, negotiated, and executed outside the United States.

Similarly, the SEC's proposed approach for substituted compliance for mandatory clearing would be limited to foreign clearing agencies that have no U.S. person members or activities in the United States. For the trade execution requirement, substituted compliance would only be available for SB swap transactions where at least one counterparty to the transaction is either a non-U.S. person or foreign branch of a U.S. bank and the SB swap transaction is not solicited, negotiated, or executed by a person within the United States on behalf of such counterparty.

Title VII Infrastructures

Finally, the Proposal provides interpretive guidance regarding when a particular market infrastructure (SB swap clearing agencies, execution facilities, and data repositories) would be required to register with the SEC. The proposed guidance generally would take a territorial approach to registration, requiring each entity to determine whether it performs the relevant infrastructure function within the United States.

The focus of this analysis for each type of entity would include, among other things, the following: (1) for clearing agencies, whether they have one or more U.S. persons as members; (2) for swap execution facilities, whether they provide U.S. persons, or non-U.S. persons located in the U.S., with the direct ability to trade or execute SB swaps on the foreign SB swap market; and (3) for swap data repositories, whether they receive SB swap data from U.S. persons and whether they operate within the United States.

The Proposal also provides interpretive guidance regarding availability of exemptions for non-resident infrastructure entities when, among other things, they are subject to comparable regulation in their home countries.

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endnotes

[1] Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, Release No. 34-69490 (May 1, 2013), available at http://www.sec.gov/rules/proposed/2013/34-69490.pdf ("Proposal").

[2] Reopening of Comment Periods for Certain Rulemaking Releases and Policy Statement Applicable to Security-Based Swaps Proposed Pursuant to the Securities Exchange Act of 1934 and the Dodd-Frank Wall Street Reform and Consumer Protection Act, Release No. 34-69491 (May 1, 2013), available at http://www.sec.gov/rules/proposed/2013/34-69491.pdf. The re-opened comment period for

these pending proposals closes 60 days after publication in the Federal Register.

[3] See Further Proposed Guidance regarding Compliance with Certain Swap Regulations, 78 FR 909 (Jan. 7, 2013), available at http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-31734a.pdf; Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, 77 FR 41214, available at http://www.gpo.gov/fdsys/pkg/FR-2012-07-12/pdf/2012-16496.pdf (July 12, 2012).

[4] The SEC's approach differs from the CFTC's proposed guidance, which does not consider whether the transaction is conducted inside or outside the United States.

[5] The SEC is not proposing to require foreign swap dealers to count toward the de minimis threshold SB swap transactions with non-U.S. persons that are guaranteed by U.S. persons.

[6] Under the Proposal, a U.S. person engaged in SB swap dealing activity would be required to count all SB swap transactions connected with its dealing activity toward the de minimis threshold, including transactions conducted through a foreign branch.

[7] Under Regulation S, the foreign branch of a U.S. bank is not treated as a U.S. person while the U.S. branch of a foreign bank is treated as a U.S. person. Under the Proposal, the foreign branch of a U.S. bank would be treated as part of a U.S. person.

[8] The proposed rule would exclude from the definition of U.S. person: (1) the International Monetary Fund; (2) the International Bank for Reconstruction and Development; (3) the Inter-American Development Bank; (4) the Asian Development Bank; (5) the African Development Bank; (6) the United Nations; (7) and their agencies and pension plans, and (8) any other similar international organizations, their agencies and pension plans.

[9] Foreign SB swap dealers, however, would be required to comply with Section 15F(h)(1)(B) of the Securities Exchange Act of 1934 ("Exchange Act") to conform with such business conduct standards relating to diligent supervision with respect to their Foreign Business.

[10] The proposed rule provides that a U.S. SB swap dealer would be considered to have conducted an SB swap transaction through a foreign branch if the foreign branch is the counterparty to such SB swap transaction and no person within the United States is directly involved in soliciting, negotiating, or executing the SB swap transaction on behalf of the foreign branch or its counterparty. The proposed rule also includes a definition of "foreign branch." See Proposed Rules 3a71-3(a)(1) and 3a71-3(a)(4) under the Exchange Act.

[11] With respect to a U.S. SB swap dealer, "U.S. Business" includes any transaction by or on behalf of such U.S. SB swap dealer, wherever entered into or offered to be entered into, other than a transaction conducted through a foreign branch with a non-U.S. person or another foreign branch.

[12] Under the Proposal, the SEC introduces the term "indirect counterparty" to mean a person that guarantees the performance of a direct counterparty to an SB swap or that otherwise provides recourse to the other side for the failure of the direct counterparty to perform any obligation under the SB swap.

[13] See Proposed Rule 901(a).

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