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SEC Adopts Final Definitional Rules for Cross-Border Security-Based Swap Activities

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 24-14
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 44-14
ICI GLOBAL MEMBERS No. 23-14
INTERNATIONAL MEMBERS No. 23-14
INVESTMENT ADVISER MEMBERS No. 24-14
SEC RULES MEMBERS No. 29-14 RE: SEC ADOPTS FINAL DEFINITIONAL RULES FOR CROSS-BORDER SECURITY-BASED SWAP ACTIVITIES

Recently, the Securities and Exchange Commission ("SEC") adopted final rules and issued interpretive guidance ("Final Rules") regarding the application of the definitions of "security-based swap dealer" ("SBSD") and "major security-based swap participant" ("MSBSP") in the cross-border context. [1] In particular, the Final Rules address the application of the de minimis registration exceptions to these definitions in the cross-border context. As part of the Final Rules, the SEC further defined "U.S. person," including its application to externally managed investment vehicles. The SEC also adopted a procedural rule for the submission of applications for substituted compliance, and a rule addressing the scope of the SEC's antifraud authority in the cross-border context. The Final Rules, which differ in several respects from the rules the SEC proposed last year on cross-border security-based ("SB") swap activities, [2] are summarized in relevant part below.

Background and Scope

The Final Rules are the first of a series of rules by the SEC regarding the application of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") to cross-border SB swap activities and persons engaged in those activities. The Final Rules, like the Proposed Rules, take a territorial approach to the regulation of cross-border SB swap transactions.

The Proposed Rules, in determining the applicability of Title VII of the Dodd-Frank Act to SB swap dealing activity, would consider whether a transaction was (1) entered into with a U.S. person or (2) otherwise conducted in the United States. The Final Rules, however, do not

focus on the “conducted in the United States” element, as the SEC intends to address that element in a subsequent rulemaking.

The Proposed Rules also addressed many other cross-border issues that are not addressed in the Final Rules, including requirements applicable to SBSDs and MSBSPs, and requirements relating to mandatory clearing, trade execution, regulatory reporting, and public dissemination. The SEC expects to address those issues as part of subsequent rulemakings. The Final Rules also do not address the cross-border application of the dealer definition to activity between two non-U.S. persons where one or both are conducting dealing activity within the United States.

While the Final Rules are effective on September 8, 2014, the rules addressing the application of the SBSD and MSBSP definitions to cross-border SB swap activities will not become effective until the applicable dates in the SEC’s final rules regarding SBSD and MSBSP registration requirements.

Definition of "U.S. Person"

Similar to the Proposed Rules, the Final Rules define “U.S. person” to mean: (1) a natural person resident in the United States; (2) a partnership, corporation, trust, investment vehicle, [3] 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; (3) an account (whether discretionary or non-discretionary) of a U.S. person; or (4) an estate of a decedent who was a resident of the United States at the time of death. [4] The Final Rules explicitly provide that a person may rely on a counterparty’s representation regarding its status as a U.S. person, unless the person knows, or has reason to know, that the representation is inaccurate. [5]

Principal Place of Business

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.” [6] With respect to an externally managed investment vehicle, this location “is the office from which the manager [7] of the vehicle primarily directs, controls, and coordinates the investment activities of the vehicle.” [8] While the SEC acknowledged the challenges of applying a principal place of business test to externally managed investment vehicles, and the objections of ICI and other commenters to doing so, [9] it did not provide any exclusions from this definition.

The SEC explains that “[t]his definition directs market participants to consider where the activities of an externally managed investment vehicle generally are directed, controlled, and coordinated, even if this conduct is performed by one or more legally separate persons.” [10] The SEC believes that the primary manager is the person responsible for directing, controlling, and coordinating the overall activity of the investment vehicle, such that the business of the vehicle, for example its investment and financing activity, is principally carried out at the location of the primary manager. The SEC therefore concludes that an investment vehicle’s principal place of business under the Final Rules would be the location from which the manager carries out those responsibilities.

Fund Ownership

Consistent with ICI’s recommendation in the ICI 2013 Comment Letter, [11] the SEC declined to include in the U.S. person definition investment vehicles that are majority-

owned by U.S. persons. The SEC reasoned that the risks created through ownership interests in collective investment vehicles are not the types of risks that Title VII of the Dodd-Frank Act is intended to address with respect to SB swaps.

Application of De Minimis Exception from SBSD Registration

The Final Rules specify the types of SB swap transactions a person must count in determining whether the person may rely on the de minimis exception from dealer registration under Exchange Act Rule 3a71-2(a)(1). [12] Which SB swap transactions must be included depends on whether the person conducting the dealing activity is a U.S. person, a "conduit affiliate," or a non-U.S. person, other than a conduit affiliate.

A U.S. person is required to include all SB swap transactions in which the person engages, including transactions conducted through a foreign branch.

A "conduit affiliate" generally is a non-U.S. person that enters into SB swap transactions on behalf of its U.S. affiliates. The Proposed Rules would have treated these entities like other non-U.S. persons, and required them to count toward the de minimis thresholds only dealing transactions with U.S. persons other than foreign branches, and dealing transactions conducted in the United States. In a change from the Proposed Rules, the Final Rules reflect an approach similar to that of the CFTC in its Final Cross-Border Guidance, and require conduit affiliates to consider all of their dealing transactions for purposes of determining their eligibility to rely on the de minimis exception.

Under the Final Rules, non-U.S. persons must count toward the de minimis thresholds SB swap transactions that are entered into with a U.S. person, although the Final Rules provide exceptions for transactions conducted through a foreign branch of a U.S. person that is a registered SBSD or is in the process of registering. In another change from the Proposed Rules, non-U.S. persons must count SB swap transactions for which the counterparty to the transaction has a right of recourse against a U.S. person that is controlling, controlled by, or under common control with the non-U.S. person. [13]

In addition, under the Final Rules, U.S. persons, conduit affiliates, and non-U.S. persons are also required to count, for purposes of the de minimis exception, transactions by certain persons controlling, controlled by, or under common control with them. The Final Rules contain an exception from these aggregation requirements, however, for affiliates that are registered as SBSDs or deemed not to be SBSDs. [14] The Final Rules also provide that a non-U.S. person, other than a conduit affiliate, shall not count, for purposes of the de minimis exception, SB swap transactions of itself or an affiliate (other than a conduit affiliate) that are entered into anonymously on an execution facility or national securities exchange and are cleared through a clearing agency. [15]

Application of De Minimis Exception from MSBSP Registration

The Final Rule for MSBSPs generally follows the same principles as the Final Rules for SBSDs with respect to which positions must be included in applying the MSBSP de minimis tests in the cross-border context. [16] It also provides that a U.S. person must include any SB swap position of a non-U.S. person for which the non-U.S. person's counterparty to the SB swap has a right of recourse against the U.S. person. A non-U.S. person must include any SB swap of a U.S. person for which that U.S. person's counterparty has a right of recourse against the non-U.S. person, as well as certain other SB swaps with rights of recourse. The Final Rule for MSBSPs contains exceptions for SB swap positions if the person whose performance is guaranteed is subject to capital regulation by the SEC or CFTC; regulated as a bank in the United States; subject to capital standards that are consistent "in

all respects" with the Capital Accord of the Basel Committee on Banking Supervision; or deemed not to be an MSBSP.

Substituted Compliance Procedural Rule

In the Proposed Rules, the SEC set out 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. [17] The SEC expects to address substantive issues regarding the availability of substituted compliance as part of future rulemakings, in connection with considering the cross-border application of the relevant substantive rules. The Final Rules only address the procedure for submitting substituted compliance requests.

The SEC adopted the Final Rule regarding substituted compliance largely as proposed. [18] In response to comments, including those of ICI, the rule was modified from the Proposed Rules to provide that an application for a substituted compliance order may be made by a foreign financial regulatory authority or authorities, or by a party that potentially would be required to comply with SEC requirements. The application must be in writing, and must include supporting documentation regarding the methods that foreign financial regulatory authorities use to enforce compliance with the applicable rules. The Final Rule provides for a 25-day public notice and comment period with respect to applications for substituted compliance orders that are submitted to the SEC for review. Determinations on applications will be made by vote of the SEC, following a recommendation by the SEC staff.

Cross-Border Antifraud Authority

The SEC also adopted a Final Rule to confirm the scope of its antifraud authority in the cross-border context, consistent with Section 929P(b) of the Dodd-Frank Act. The Final Rule confirms that the antifraud provisions of the federal securities laws apply to: (1) conduct within the United States that constitutes significant steps in furtherance of the violation; or (2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States. The Final Rule provides that the antifraud provisions apply to such conduct even if the violation relates to a securities transaction or transactions occurring outside the United States that involves only foreign investors, or is committed by a foreign adviser and involves only foreign investors. The Final Rule also confirms that violations under the rule may be pursued in judicial proceedings brought by the SEC or the United States.

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endnotes

[1] Application of "Security-Based Swap Dealer" and "Major Security-Based Swap

Participant" Definitions to Cross-Border Security-Based Swap Activities, 79 Fed.Reg. 39068 (July 9, 2014) ("Adopting Release").

[2] For ICI's memorandum summarizing the proposed rules ("Proposed Rules"), see ICI Memorandum No. 27238 (May 13, 2013), available at http://www.ici.org/iciglobal/pubs/memos/memo27238. ICI's comment letter on the Proposed Rules is available at http://www.ici.org/pdf/27482.pdf ("ICI 2013 Comment Letter").

[3] The specific reference to "investment vehicle" was added as part of the Final Rules, as was the provision for estates, below.

[4] Rule 3a71-3 under the Securities Exchange Act of 1934 ("Exchange Act"). The Final Rules 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) their agencies and pension plans; and (8) any other similar international organizations, their agencies and pension plans.

[5] Rule 3a71-3(a)(4)(iv) under the Exchange Act.

[6] Rule 3a71-3(a)(4)(ii) under the Exchange Act.

[7] The SEC states that "identifying the manager for purposes of this definition will depend on the structure and organizing documents of the investment vehicle under consideration." Adopting Release, supra note 1, at n.273.

[8] Rule 3a71-3(a)(4)(ii) under the Exchange Act.

[9] ICI had asserted that, consistent with the U.S. person test used by the Commodity Futures Trading Commission ("CFTC") in its final interpretive guidance regarding the cross-border application of the swaps provisions of the Commodity Exchange Act, the SEC should exclude from the definition of U.S. person non-U.S. regulated funds that are offered publicly to only non-U.S. persons, non-U.S. regulated funds that are publicly offered to only non-U.S. persons but offered privately to U.S. persons under Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940 as permitted by the SEC, as well as certain non-U.S. regulated funds authorized to make a public offering but that elect only to offer privately to non-U.S. institutional investors. See ICI 2013 Comment Letter, supra note 2; Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed.Reg. 45292 (July 26, 2013) ("Final Cross-Border Guidance").

[10] Adopting Release, supra note 1, at 39100.

[11]ICI 2013 Comment Letter, supra note 2.

[12] See Rule 3a71-3 under the Exchange Act.

[13] This approach is also similar to that of the CFTC in its Final Cross-Border Guidance. See Final Cross-Border Guidance, supra note 9.

[14] See Rule 3a71-4 under the Exchange Act.

[15] See Rule 3a71-5 under the Exchange Act.

[16] See Rule 3a67-10 under the Exchange Act.

[17] See ICI Memorandum No. 27238, supra note 2.

[18] See Rule 0-13 under the Exchange Act.
