

# SEC Proposes Cross-Border Security-Based Swap Rules

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On May 1, 2013, the Securities and Exchange Commission took long-awaited action to propose rules governing cross-border activities in security-based swaps.<sup>1</sup> The SEC’s proposal, developed over the course of more than two years, reflects a holistic approach that differs in key respects from that taken by the Commodity Futures Trading Commission with respect to transnational swap activities (the “**CFTC Proposal**”).<sup>2</sup> In light of the far-ranging significance of its cross-border proposal, the SEC has reopened comment periods for many of its previously proposed security-based swap regulations and its policy statement on the sequencing of compliance with these rules.<sup>3</sup>

The comment period for the proposed cross-border rules ends 90 days after publication in the *Federal Register*. The comment period for the previously proposed rules and policy statement ends 60 days after publication in the *Federal Register*.

This memorandum provides an overview of key provisions of the SEC’s proposal, highlighting the most important differences from the CFTC Proposal. We focus on those provisions of the SEC’s proposal that address the regulation of security-based swap dealers and security-based swap end users, but we note that the SEC’s proposal also addresses the cross-border regulation of clearing agencies, security-based swap data repositories and security-based swap execution facilities.

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<sup>1</sup> 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, RIN 3235-AL25 (initial release date May 1, 2013) available at <http://www.sec.gov/rules/proposed/2013/34-69490.pdf>.

<sup>2</sup> Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, 77 Fed. Reg. 41,214 (proposed July 12, 2012); Further Proposed Guidance Regarding Compliance With Certain Swap Regulations, 78 Fed. Reg. 909 (Jan. 7, 2013); Final Exemptive Order Regarding Compliance With Certain Swap Regulations, 78 Fed. Reg. 858 (Jan. 7, 2013).

<sup>3</sup> 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, RIN 3235-AK74, 3235-AK77, 3235-AK80, 3235-AK79, 3236-AK88, 3235-AK91, 3235-AK93, 3235-AL13, 3235-AL10, 3235-AL05, 3235-AL12 (initial release date May 1, 2013) available at <http://www.sec.gov/rules/proposed/2013/34-69491.pdf>.

### Definition of U.S. Person

- Any natural person resident in the United States
- 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
- Any account (whether discretionary or non-discretionary) of a U.S. person

The “U.S. person” definition includes a foreign branch, agency or office of a U.S. person but excludes foreign central banks, or international multilateral organizations such as members of the World Bank Group, the IMF, the United Nations and similar organizations or their agencies and pension plans.

### Definition of Foreign Branch

A branch of a U.S. bank if the branch:

- is located outside the United States;
- operates for valid business reasons; and
- is engaged in the business of banking and is subject to substantive banking regulation in the jurisdiction where located.

A **transaction conducted through a foreign branch** means a security-based swap transaction to which the foreign branch is a counterparty that is not solicited, negotiated or executed by a person within the United States on behalf of the foreign branch or its counterparty.

## Territorial Approach to U.S. Jurisdiction

The SEC proposes that its security-based swap regulatory regime generally would apply to security-based swap activities:

- involving a **“U.S. person,”** or
- involving a **“transaction conducted within the United States.”**

This “territorial approach” differs from the CFTC Proposal, which primarily focuses on the U.S. person status of the counterparties to the transaction.

### U.S. Person Definition

Like the CFTC Proposal, the SEC’s proposal includes a definition of “U.S. person” that is important in identifying the application of security-based swap requirements to cross-border transactions. The SEC’s proposed definition is provided in the sidebar. The SEC considered, but explicitly declined to adopt, the definition used in Regulation S under the Securities Act of 1933, the SEC’s rule exempting from registration securities offerings that are conducted outside the United States. A comparison of the U.S. person definitions contained in the proposal, Regulation S and the CFTC Proposal is available at

<http://davispolk.com/files/uploads/USpersondefinition.pdf>.

### Transactions Conducted Within the United States

The term **“transaction conducted within the United States”** includes any security-based swap that is solicited, negotiated, executed, or booked within the United States by or on behalf of either counterparty to the transaction. The SEC clarified that it would not view clearing, reporting or engaging in collateral management for a security-based swap within the United States as causing that transaction to be considered to be conducted within the United States. A security-based swap transaction conducted through a foreign branch of a U.S. bank (a **“foreign branch”**) would not be a transaction conducted within the United States, as long as the branch and the transaction meet the requirements in the accompanying sidebar. As discussed in the following sections, this exclusion has important implications for whether transactions with a foreign branch would be subject to U.S. security-based swap regulatory requirements.

## Security-Based Swap Dealer Obligations

The proposal classifies those security-based swap regulatory requirements that the SEC views as applying specifically to security-based swap dealers into “entity-level” and “transaction-level” requirements and defines how these requirements would apply to U.S. and foreign dealers. These requirements, and their classification as entity- or transaction-level, are listed in the sidebar on the following page.

The proposal’s classifications differ from the CFTC’s in several ways. First, the classifications in the proposal only apply to requirements specific to security-based swap dealers; they do not apply to reporting, clearing and trade execution requirements, which potentially apply to all market

### Security-Based Swap Dealer-Specific Requirements

#### Entity-Level Requirements:

- Capital
- Margin
- Risk management, including trade acknowledgment and verification, and trade documentation requirements
- Recordkeeping and reports to regulators
- Internal systems and controls
- Diligent supervision
- Conflicts of interest
- Chief compliance officer
- Inspection and examination
- Licensing requirements and statutory disqualification

#### Transaction-Level Requirements:

- External business conduct standards (other than diligent supervision)
- Segregation of assets

### Definition of U.S. Business

**For a U.S. security-based swap dealer**, any transaction by or on behalf of the U.S. security-based 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.

#### For a foreign security-based swap dealer:

- any transaction entered into, or offered to be entered into, by or on behalf of the foreign security-based swap dealer with a U.S. person (other than with a foreign branch); or
- any transaction conducted within the United States.

**Foreign Business** is any security-based swap transactions of a U.S. security-based swap dealer or a foreign security-based swap dealer, other than U.S. Business.

participants. These are addressed separately in the proposal and are subject to different “transaction-level” and substituted compliance rules. Second, several requirements classified as “transaction-level” by the CFTC are classified as “entity-level” by the SEC, including margin, trading documentation, confirmation and portfolio reconciliation rules. The classification of these requirements as entity- and transaction-level requirements affects how they are treated for purposes of compliance by security-based swap dealers and for purposes of substituted compliance.

### U.S. Security-Based Swap Dealers

As a basic rule, a security-based swap dealer that is a U.S. person (“**U.S. security-based swap dealer**”) would be subject to all security-based swap dealer specific entity- and transaction-level requirements, regardless of whether its counterparties are U.S. or non-U.S. persons and whether or not the U.S. security-based swap dealer is acting out of a foreign branch. However, a U.S. security-based swap dealer that is a U.S. bank would not be subject to business conduct standards with respect to activities that are not part of its “**U.S. Business**,” as defined in the accompanying sidebar. Specifically, a foreign branch would not be subject to the external business conduct standards when transacting with a non-U.S. person or another foreign branch.

### Foreign Security-Based Swap Dealers

A security-based swap dealer that is a non-U.S. person (a “**foreign security-based swap dealer**”) would be required to comply with all entity-level requirements for all security-based swap transactions, whether with U.S. or non-U.S. person counterparties. However, as discussed below, substituted compliance potentially would be available for entity-level requirements.

A foreign security-based swap dealer would need to comply with external business conduct requirements with respect to its U.S. Business (subject to the potential availability of substituted compliance), but not for its “**Foreign Business**,” as defined in the accompanying sidebar.

The proposed application of segregation requirements to foreign security-based swap dealers is more complex and depends on whether a particular security-based swap transaction is cleared, whether the foreign security-based swap dealer is also an SEC-registered broker-dealer and whether the security-based swap dealer is a foreign bank with a U.S. agency or branch. The proposed application of the segregation requirement to foreign security-based swap dealers is summarized in the sidebar on the following page.

A foreign security-based swap dealer would need to provide any U.S. person counterparty with written disclosure relating to the applicability of the segregation requirements to that counterparty’s assets, which would need to contain a discussion of the potential treatment of the assets under the particular laws that would govern the insolvency or resolution of the dealer.

### Segregation Requirements

#### Dually Registered Foreign Security-Based Swap Dealer and SEC-Registered Broker-Dealer:

- *Cleared and uncleared transactions.*
  - Subject to the segregation requirements with respect to all counterparties (both U.S. and non-U.S. persons)

#### Foreign Security-Based Swap Dealer that is not an SEC-Registered Broker-Dealer:

- *Uncleared transactions.*
  - Subject to the segregation requirements only with respect to U.S. person counterparties
- *Cleared transactions:*
  - Foreign bank with a branch or agency in the United States: subject to the segregation requirements only with respect to U.S. person counterparties
  - Entity other than a foreign bank with a branch or agency in the United States: subject to the segregation requirements with respect to U.S. and non-U.S. person counterparties, but only if it receives such assets from at least one U.S. counterparty

## Security-Based Swap Reporting, Clearing and Trade Execution Requirements

The SEC’s proposal applies the same general territorial approach to the jurisdictional reach of the security-based swap reporting, clearing and trade execution requirements.

### Regulatory Reporting and Public Dissemination

The Dodd-Frank Act generally requires that all security-based swaps be reported to a registered security-based swap data repository and that anonymized transaction, volume and pricing data for security-based swaps be publicly disseminated, with a delay for block trades. The proposal would require regulatory reporting to a security-based swap data repository of any security-based swap transaction where:

- the transaction is conducted within the United States;
- one or both of the direct counterparties is a U.S. person;
- one or both of the direct counterparties has a U.S. person guarantor for its obligations under the security-based swap (which is referred to as an “**indirect counterparty**”);
- one or both of the direct or indirect counterparties is a security-based swap dealer or major security-based swap participant (whether U.S. or foreign); or
- the transaction is cleared through a clearing agency having its principal place of business in the United States.

Specified data about a security-based swap would be subject to public dissemination in real time, with a delay for dissemination of block trade information, if:

- the transaction is conducted within the United States;
- both sides of the transaction have a U.S. person that is either a direct or an indirect counterparty;
- at least one direct counterparty to the transaction is a U.S. person other than a foreign branch;
- one side of the transaction includes a U.S. person as a direct or indirect counterparty and the other side includes a direct or indirect counterparty that is a foreign security-based swap dealer; or
- the transaction is cleared through a clearing agency having its principal place of business in the United States.

### Reporting Hierarchy

The direct and indirect counterparties on the “**reporting side**” of a security-based swap would have joint responsibility for the reporting obligation. The reporting side (*i.e.*, the direct counterparty and any guarantor) for a security-based swap transaction would generally be determined as described in the sidebar on the following page.

**“Reporting Side” (Direct or Indirect Counterparties) for Security-Based Swaps (Abridged)**

- Security-based swap dealer on both sides: by agreement
- Security-based swap dealer on only one side: the side that includes the security-based swap dealer
- No security-based swap dealer or major security-based swap participant and both sides include a U.S. person or neither side includes a U.S. person: by agreement
- No security-based swap dealer or major security-based swap participant on either side and only one side includes a U.S. person: the side that includes the U.S. person

**Counterparty Representations**

The SEC is proposing to allow a person to rely on a counterparty representation to verify that a transaction is conducted in the United States or is conducted through a foreign branch, unless the party has actual knowledge that a representation is not accurate.

**Foreign Privacy Laws**

The SEC release requests additional information from security-based swap market participants on whether, and precisely how, requiring a counterparty to report a security-based swap transaction, including the requirement to report the participant ID of its counterparty, might cause the reporting party to violate foreign privacy laws.

**Mandatory Clearing and Trade Execution**

The Dodd-Frank Act requires security-based swap market participants to submit for central clearing any security-based swap designated as being subject to mandatory clearing by the SEC, subject to a commercial end-user exception. Any such security-based swap must be traded on a securities exchange or security-based swap execution facility, unless no such market makes the security-based swap “available to trade.” The proposal generally would apply the security-based swap mandatory clearing and trade execution requirements to any security-based swap transaction if:

- the transaction is conducted within the United States, unless both counterparties to the transaction are non-U.S. persons, neither counterparty is a foreign security-based swap dealer and neither counterparty is guaranteed by a U.S. person; or
- the transaction is not conducted within the United States, but at least one counterparty to the transaction is a U.S. person or is a non-U.S. person whose performance under the security-based swap is guaranteed by a U.S. person, unless:
  - one counterparty to the transaction is a foreign branch or a non-U.S. person whose performance under the security-based swap is guaranteed by a U.S. person; and
  - the other counterparty to the transaction is a non-U.S. person whose performance is not guaranteed by a U.S. person and who is not a foreign security-based swap dealer.

**Inter-affiliate Transactions**

The proposal contains no exemptions from the reporting, clearing or trade execution requirements for inter-affiliate security-based swap transactions, but the SEC invites comments on whether it should consider adopting such exemptions.

**Substituted Compliance**

The SEC’s proposal would allow security-based swap market participants to satisfy some U.S. security-based swap regulations by complying with foreign regulatory requirements if the SEC has made a determination that substituted compliance is available. The proposal includes rules that would set standards and would govern the SEC’s process for making such comparability determinations.

### Comparison to CFTC's Proposed Substituted Compliance

The SEC's proposed approach to substituted compliance differs from the CFTC's proposed approach in a number of ways, including by:

- extending substituted compliance to end users, rather than just registered entities;
- allowing the use of substituted compliance, in certain cases, for transactions with U.S. person counterparties; and
- not allowing major security-based swap participants to use substituted compliance.

## Standards and Process for Substituted Compliance Determinations

When considering a substituted compliance request, the SEC would evaluate whether the foreign security-based swap regime achieves regulatory outcomes in a particular area comparable to the relevant U.S. requirements. The SEC would take into account factors such as the scope and objectives of the relevant foreign regulatory requirements, the effectiveness of the foreign supervisory compliance scheme and the enforcement authority exercised by the foreign regulatory authority. In most cases, the SEC would need to enter into a supervisory and enforcement memorandum of understanding with the relevant foreign jurisdiction before issuing a substituted compliance determination.

The SEC emphasized that foreign regulatory requirements would not need to be identical to U.S. requirements for it to make a comparability determination and that it would not anticipate engaging in a rule-by-rule analysis in coming to such a determination. Instead, the SEC would focus on regulatory outcomes and not necessarily the means by which those outcomes are achieved. The proposal contemplates that the SEC may provide substituted compliance for specific requirements in a particular jurisdiction, even if substituted compliance is not deemed appropriate on a regime-wide basis.

## Substituted Compliance for Foreign Security-Based Swap Dealer-Specific Requirements

A foreign security-based swap dealer, or dealers, may request that the SEC make a substituted compliance determination that could apply to entity- and transaction-level requirements if the security-based swap dealer or group of dealers:

- is directly supervised by the relevant foreign financial regulatory authority or authorities; and
- provides an opinion of counsel confirming that the SEC can have prompt access to its books and records and conduct on-site inspections and examinations.

Though major security-based swap participants are generally subject to the same requirements, substituted compliance is not available.

## Substituted Compliance for Regulatory Reporting and Public Dissemination

The SEC's proposal states that substituted compliance with security-based swap regulatory reporting is potentially available to any market participants when engaging in cross-border security-based swap transactions in which:

- at least one direct counterparty to the security-based swap is a non-U.S. person or a foreign branch; and
- the security-based swap is not solicited, negotiated or executed by a person within the United States on behalf of the non-U.S. person or foreign branch counterparty.

To make a substituted compliance determination, the SEC must find that:

- the foreign regulatory regime has comparable requirements concerning the data elements that must be reported and the timing and manner of reporting and public dissemination;
- it has direct electronic access to the security-based swap data held by the trade repository or foreign regulatory authority to which the data is reported; and
- the trade repository or foreign regulatory authority is subject to comparable requirements concerning data collection and maintenance, systems capacity, resiliency, security and recordkeeping.

### **Substituted Compliance for Mandatory Clearing**

The proposal would permit a security-based swap transaction that is subject to mandatory clearing to be cleared through a clearinghouse that is not registered with the SEC or is exempt from registration as a clearing agency, upon a substituted compliance determination for the clearinghouse. This is the case even where the underlying counterparties to a transaction are U.S. persons clearing through non-U.S. person clearing members.

The SEC proposes that it could make a substituted compliance determination for a clearinghouse, upon a request from the clearinghouse, if:

- the clearinghouse has no U.S. person members or activities in the United States (and thus would not be required to register or seek an exemption from registration as a clearing agency); and
- the SEC finds the clearinghouse to be subject to comparable foreign regulation.

### **Substituted Compliance for Mandatory Trade Execution**

The proposal would allow a counterparty to a security-based swap transaction that is subject to the mandatory trade execution requirement to satisfy that requirement by executing the security-based swap transaction on a security-based swap market that is not registered or is exempt from registration with the SEC, upon a substituted compliance determination for the security-based swap market.

The SEC proposes that it could make a substituted compliance determination for transactions where:

- at least one counterparty to the security-based swap is a non-U.S. person or a foreign branch; and
- the security-based swap is not solicited, negotiated or executed by a person within the United States on behalf of the non-U.S. person or foreign branch counterparty.

### Major Security-Based Swap Participant Registration

In determining whether a person must register as a major security-based swap participant:

- **a U.S. person:**
  - must count all outstanding security-based swaps, regardless of the counterparty; and
  - must include any security-based swaps it guarantees;
- **a non-U.S. person:**
  - must count outstanding security-based swaps with U.S. person counterparties, including foreign branches;
  - must include any security-based swaps for which it guarantees a U.S. person's performance; and
  - must include security-based swaps for which it guarantees a non-U.S. person's performance if the guaranteed entity's counterparty is a U.S. person.
- In all cases, a guarantor is not required to include positions it guarantees if the entity it guarantees is subject to capital regulation by the SEC or the CFTC or is subject to Basel capital standards.

## De Minimis Threshold Calculations for Security-Based Swap Dealer Registration

An entity is required to register as a security-based swap dealer if its security-based swap dealing activities over the preceding 12 months (beginning on October 12, 2012) exceed \$8 billion in notional of credit default security-based swaps, \$400 million of other types of security-based swaps or \$25 million in any type of security-based swap with counterparties that are special entities. An entity must generally aggregate all security-based swap dealing activities of its affiliates with its own for purposes of the notional threshold calculations, subject to exceptions. The proposal clarifies which security-based swap dealing transactions of U.S. and non-U.S. persons, and their affiliates, would be counted toward the security-based swap dealer *de minimis* thresholds.

The proposal separately addresses cross-border security-based swap transactions that must be counted for major security-based swap participant registration. These proposed rules are summarized in the accompanying sidebar.

### Requirements for U.S. Persons

A U.S. person would need to count all of its security-based swap dealing transactions with U.S. and non-U.S. counterparties toward the security-based swap dealer *de minimis* thresholds. This includes transactions conducted through a foreign branch. However, security-based swap transactions between majority-owned affiliates would not need to be counted as security-based swap dealing activity.

A U.S. person would need to aggregate with its own security-based swap dealing transactions all those security-based swap dealing transactions engaged in by any of its affiliates, regardless of whether that affiliate is a U.S. person, a non-U.S. person, or a U.S. person conducting the transaction through a foreign branch, to the extent the affiliate would need to count the transaction toward its own *de minimis* threshold if it were transacted by the entity. However, the U.S. person would not need to aggregate the security-based swap dealing activities of an affiliate that is an SEC-registered security-based swap dealer, so long as the security-based swap dealing activities of the person and the registered security-based swap dealer are “**operationally independent**,” as defined in the sidebar on the following page.

### Requirements for Non-U.S. Persons

A non-U.S. person would need to count toward the *de minimis* threshold security-based swap dealing transactions:

- with U.S. persons (other than foreign branches, as described below), regardless of where the transaction is conducted; and
- with non-U.S. persons and foreign branches, to the extent the transaction is conducted within the United States.

A non-U.S. person would not need to count security-based swap transactions with a foreign branch as long as the foreign branch is the



### Operationally Independent

The security-based swap activities of an entity would be considered operationally independent from that of an affiliated registered security-based swap dealer if the affiliates maintain separate:

- sales and trading functions;
- operations (including separate back offices); and
- risk management

with respect to any security-based swap activity of either affiliate that is counted toward either affiliate's *de minimis* thresholds.

If any of the above functions were jointly managed — including being managed at a central booking location within the affiliate group — with respect to security-based swap activity of either affiliate, the exclusion from the *de minimis* thresholds for security-based swaps entered into by the affiliated registered security-based swap dealer would not be available.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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named counterparty to the transaction and no person within the United States is directly involved in “soliciting, negotiating, executing, or booking” the transaction on behalf of the foreign branch. Absent actual knowledge to the contrary, a party may rely on its counterparty’s representation that no person within the United States is directly involved in the transaction. As with U.S. persons, a non-U.S. person would not need to count security-based swap transactions between majority-owned affiliates.

A non-U.S. person would need to aggregate all security-based swap dealing transactions engaged in by any of its affiliates, whether that affiliate is a U.S. or non-U.S. person, to the extent the affiliate would need to count the transaction toward its own *de minimis* threshold if it were transacted by the entity.

As for U.S. persons, a non-U.S. person would not need to aggregate the security-based swap dealing activities of an affiliate that is an SEC-registered security-based swap dealer that is operationally independent, as described in the accompanying sidebar.

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