SEC Adopts Security-Based Swap Cross-Border Definitional Rule

July 3, 2014

Contents

On June 25, the SEC adopted the first in a series of rules governing the cross-border reach of its security-based swap regulatory regime.[1] The rules define the term "U.S. person" and provide the test for counting cross-border security-based swap transactions to determine whether a firm must register as a security-based swap dealer or a major security-based swap participant. The final rules also provide a process by which market participants or non-U.S. regulators can request that the SEC make a determination that a foreign regime's security-based swap rules are comparable to the SEC's, thereby permitting market participants in that jurisdiction to meet SEC rules through compliance with local law. Finally, the rules provide clarification of the SEC's view of the cross-border application of its anti-fraud authority for all securities.

The SEC has aligned its registration threshold rules more closely to the CFTC's cross-border guidance.[2] Specifically, unlike the SEC's *proposed* rule, but similar to the CFTC's guidance, the newly adopted rules require a non-U.S. potential dealer to count security-based swaps with non-U.S. counterparties towards its swap dealer *de minimis* threshold where the potential dealer is a "conduit affiliate" or the potential dealer's transaction is guaranteed by its U.S. affiliate. The newly adopted rules do not require a non-U.S. potential dealer to consider whether its transactions are "conducted within the United States" in counting towards registration thresholds. However, the SEC plans to request comment on whether such a conduct test would be appropriate and how to implement it.

These rules do not start the clock ticking on a registration requirement – they are purely definitional. With these definitions in place, however, market participants can now begin analyzing their future registration obligations and can consider what information they will need to gather from their counterparties to determine U.S. person status both for registration purposes and, ultimately, the application of the SEC's substantive rules.

---

[1] Application of "Security-Based Swap Dealer" and "Major Security-Based Swap Participant" Definitions to Cross-Border Security-Based Swap Activities, Release No. 34-72472 (June 25, 2014), *available at* http://www.sec.gov/rules/final/2014/34-72472.pdf.

[2] Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations, 78 Fed. Reg. 45292 (July 26, 2013), *available at* http://www.cftc.gov/ http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-17958a.pdf.

U.S. Person Definition

The rules include a definition of "U.S. person" that is important in identifying the application of security-based swap requirements to cross-border transactions. The final definition includes:

- 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; and
- any estate of a decedent who was a resident of the United States at the time of death.

Non-U.S. branches of U.S. banks are considered part of the U.S. bank and therefore U.S. persons, while U.S. branches of non-U.S. banks are considered part of the non-U.S. bank and therefore not U.S. persons. The definition of U.S. person excludes foreign central banks as well as members of the World Bank Group, the IMF, the United Nations and certain similar organizations and their agencies and pension plans.

The final rules include guidance on the concept of "principal place of business" of a corporation or other entity. Generally, "principal place of business" means "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 rules provide specific guidance on the interpretation of "principal place of business" for externally managed investment vehicles, providing that such a vehicle's principal place of business "is the office from which the manager of the vehicle primarily directs, controls, and coordinates the investment activities of the vehicle." In general, the SEC expects that an investment vehicle with a U.S. manager will be a U.S. entity. For investment vehicles, the SEC's U.S. person definition does not include an ownership test – an important departure from the CFTC definition. However, the SEC definition does not include an exception similar to that in the CFTC guidance for foreign publicly-offered funds.

The rules explicitly allow market participants to rely on U.S. person representations from counterparties, unless the recipient of the representation knows or has reason to know that the representation is not accurate – a "constructive knowledge" standard. The SEC does not explicitly permit market participants to rely on CFTC-related representations because of the use of facts and circumstances in the CFTC analysis, but states that such representations might be useful in certain circumstances.

A comparison of the U.S. person definitions contained in the SEC's rules and the CFTC's guidance is available in Appendix A.

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 exceed $8 billion in notional of credit default security-based swaps, $400 million in notional of other types of security-based swaps or $25 million in notional of any type of security-based swap with counterparties that are special entities. A market participant must generally aggregate all security-based swap dealing activities of its affiliates with its own for purposes of the notional threshold calculations, other than those of registered security-based swap dealer affiliates. The rules clarify which security-based swap dealing transactions of U.S. and non-U.S. persons and their affiliates must be counted towards the security-based swap dealer *de minimis* thresholds.

The rules separately address cross-border security-based swap transactions that must be counted towards the major security-based swap participant registration threshold. The SEC notes that it expects approximately 12 institutions to be required to perform these calculations, and fewer than 5 institutions to be required to register as major security-based swap participants. As noted above, the rules do not start the clock ticking on the counting period for registration, but rather are purely definitional in nature.

Requirements for U.S. Persons

A U.S. person must count all of its security-based swap dealing transactions (aggregated with those of its affiliates, as provided below) with U.S. and non-U.S. counterparties towards the security-based swap dealer *de minimis* thresholds, including transactions conducted through a foreign branch.

Requirements for Non-U.S. Persons That Are Not Conduit Affiliates

A non-U.S. person (other than a conduit affiliate, as described below) must count towards the *de minimis* threshold its security-based swap dealing transactions (aggregated with those of its affiliates, as provided below):

- with U.S. persons (other than foreign branches, as described below); and
- with non-U.S. persons to the extent that the counterparty has a right of recourse against a U.S. affiliate of the counting entity.

The SEC notes that a right of recourse exists "if the counterparty has a conditional or unconditional legally enforceable right, in whole or in part, to receive payments from, or otherwise collect from, the U.S. affiliate in connection with the non-U.S. person's obligations under the security-based swap." Unlike the counting requirements imposed by the CFTC, only those specific transactions that are guaranteed are counted towards the *de minimis* threshold; as a result, there is no concept of a market participant being a "guaranteed affiliate" as in the CFTC's guidance.

Comparison of CFTC and SEC Approaches to Transactions with Guaranteed Affiliates

The CFTC guidance requires that a non-U.S. person count towards its swap dealer *de minimis* threshold all swap dealing transactions with a "guaranteed affiliate," unless the guaranteed affiliate in question:

- is registered as a swap dealer;
- is not a registered swap dealer but engages in *de minimis* swap dealing activity and is affiliated with a swap dealer; or
- is guaranteed by a non-financial entity.

As a result, if a non-U.S. person that is not guaranteed by a U.S. affiliate enters into both swap and security-based swap dealing transactions with a non-U.S. counterparty that is not a swap dealer or affiliated with a swap dealer but is guaranteed by a U.S. financial affiliate, the non-U.S. person would be required to count the swap dealing positions towards its swap dealer *de minimis* threshold, but would not have to count the security-based swap dealing positions towards its security-based swap dealer *de minimis* threshold.

The SEC does not require a market participant to count a swap dealing transaction with a non-U.S. counterparty towards its own *de minimis* threshold solely by virtue of its counterparty's obligations being guaranteed by a U.S. person. This differs from the CFTC's swap dealer *de minimis* threshold rules, which require that a non-U.S. person count towards its swap dealer *de minimis* threshold all swaps for which its non-U.S. counterparty is a "guaranteed affiliate," subject to a number of exceptions, as described in greater detail in the accompanying sidebar.

A non-U.S. person that is not a conduit affiliate is not required to count towards its security-based swap dealer *de minimis* threshold a transaction with a "foreign branch" of a registered security-based swap dealer (or one that has exceeded the *de minimis* threshold and is in the process of registering), unless the non-U.S. person is guaranteed by a U.S. affiliate. For this purpose, a foreign branch is any branch of a U.S. bank that 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. To qualify for this exception, the foreign branch must be the named counterparty to the transaction, and no person within the United States may be directly involved in "soliciting, negotiating, executing, or booking" the transaction on behalf of the foreign branch. A party may rely on its counterparty's representation that no person within the United States is directly involved in the transaction, unless the person knows or has reason to know that the representation is not accurate.

Finally, a non-U.S. entity that is not a conduit affiliate is not required to count a position towards its security-based swap dealer *de minimis* threshold where the counting entity is not guaranteed by a U.S. affiliate if the transaction is anonymous and cleared.

Importantly, unlike the proposed rule, the final rules do not generally require a non-U.S. person to count towards the *de minimis* threshold security-based swap dealing transactions with non-U.S. person counterparties solely by virtue of those transactions being "conducted within the United States." Instead, the SEC intends to request comment on whether and how such a conduct test should be adopted.

Requirements for Non-U.S. Persons That Are Conduit Affiliates

The SEC's final rules incorporate the concept of a "conduit affiliate," which was not present in the proposed rule but exists in the CFTC's cross-border guidance. The definition of conduit affiliate is provided in the sidebar on the following page, and is generally meant to capture non-U.S. entities that are majority-owned by U.S. persons and that, in the regular course of business, enter into security-based swaps offshore and transfer the risks of those swaps into the United States. The SEC does not believe that there are currently any entities that would qualify as conduit affiliates in the security-based swap market – as a result, the addition of a conduit affiliate status is meant as a prophylactic anti-evasion measure.

Definition of Conduit Affiliate

A "conduit affiliate" is defined as a non-U.S. person:

- that is directly or indirectly majority-owned by one or more U.S. persons; and
- that:
  - in the regular course of business,
  - enters into security-based swaps with one or more other non-U.S. persons, or with foreign branches of U.S. banks that are registered as security-based swap dealers,
  - for the purpose of hedging or mitigating risks faced by, or otherwise taking positions on behalf of, one or more U.S. persons (other than U.S. persons that are registered as security-based swap dealers or major security-based swap participants) who are controlling, controlled by, or under common control with the person, and
  - enters into offsetting security-based swaps or other arrangements with such U.S. persons to transfer risks and benefits of those security-based swaps.

Conduit affiliates are required to count all of their security-based swap dealing transactions (aggregated with those of their affiliates, as provided below) towards their security-based swap dealer *de minimis* thresholds. All positions must be counted, whether or not the risks of those particular positions are transferred to a U.S. affiliate.

Aggregation

In determining whether an entity has met its security-based swap dealer *de minimis* threshold, the entity is required to aggregate its positions with those of its affiliates that it controls, that control it or with which it is under common control, to the extent those affiliates are themselves required to count those transactions towards their own *de minimis* thresholds. The aggregation requirement does not require a non-registrant to aggregate its positions with those of any affiliate that is registered as a security-based swap dealer or that has breached the *de minimis* threshold and is preparing to register. In the proposal, this exception required that the registrant and non-registrant be "operationally independent," but that requirement has been removed in the final rule.

Process for Substituted Compliance Requests and Scope of Antifraud Authority

The SEC's *proposed* cross-border rule would have allowed non-U.S. persons the ability to comply with the SEC's security-based swap rules through "substituted compliance" with local law in certain circumstances where the SEC has deemed local law to be comparable to the SEC's security-based swap rules. A description of the SEC's proposed cross-border rule, which includes the proposed circumstances under which substituted compliance would be available, can be found in our May 16, 2013 memo, available here.

The SEC did not address in the new rule the provisions from the proposed rule defining when substituted compliance may be used, but provides a process through which market participants and foreign regulators will be able to petition the SEC for a substituted compliance order. Specifically, the rule provides that a market participant or a foreign regulator may submit an application, written in English, to the SEC with regards to an actual (but not hypothetical or anonymous) request. The application must describe the comparable requirement in the foreign jurisdiction and include supporting documentation regarding the methods by which foreign regulators will monitor and enforce compliance with the comparable rules. The SEC staff will review complete applications and publish a determination for a public comment period of at least 25 days. The SEC may also choose to hold a hearing on the substituted compliance request. The SEC plans to adopt provisions regarding the situations in which substituted compliance may be used for each substantive Title VII rule as part of each relevant substantive rule.

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.

Annette L. Nazareth
202 962 7075
annette.nazareth@davispolk.com

Lanny A. Schwartz
212 450 4174
lanny.schwartz@davispolk.com

Susan C. Ervin
202 962 7141
susan.ervin@davispolk.com

Hilary S. Seo
212 450 4178
hilary.seo@davispolk.com

Jai R. Massari
202 962 7062
jai.massari@davispolk.com

Gabriel D. Rosenberg
212 450 4537
gabriel.rosenberg@davispolk.com

Finally, in response to a recent federal district court case, the SEC adopted a rule concerning the cross-border substantive reach of its anti-fraud rules. Specifically, the new provision (which is applicable to all securities and not just security-based swaps) states that the SEC's anti-fraud rules apply to conduct within the United States that constitutes significant steps in furtherance of a violation and conduct occurring outside the United States that has a foreseeable substantial effect within the United States, even if the violation relates to a securities transaction or securities transactions occurring outside the United States that involves only foreign investors or the violation is committed by a foreign adviser and involves only foreign investors. The new rule further provides that violations of these anti-fraud rules may be pursued in proceedings brought by the SEC or the United States.

Comparison of CFTC and SEC U.S. Person Definitions

Type of Counterparty	CFTC Final Cross-Border Guidance "U.S. Person"	SEC Final Cross-Border Rule "U.S. Person"
Natural Person	Any natural person who is a resident of the United States	A natural person resident in the United States
Estate	Any estate of a decedent who was a resident of the United States at the time of death	Any estate of a decedent who was a resident of the United States at the time of death
Corporate Entity	Any corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund, or any form of enterprise similar to any of the foregoing (other than a legal entity described in the ***pension plan*** or ***trust*** rows below) (a "**legal entity**"), in each case that organized or incorporated under the laws of a state or other jurisdiction in the United States or having its principal place of business in the United States	A 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
Pension Plan	Any pension plan for the employees, officers or principals of a legal entity (as defined above), unless the pension plan is primarily for foreign employees of such entity	[No separate pension plan test]
Trust	Any trust governed by the laws of a state or other jurisdiction in the United States, if a court within the United States is able to exercise primary supervision over the administration of the trust	See ***corporate entity*** row above
Investment Vehicle: Majority Ownership	Any commodity pool, pooled account, investment fund, or other collective investment vehicle that is not described in the ***corporate entity*** row above and that is majority-owned by one or more persons described in the ***natural person, estate, corporate entity, pension plan*** or ***trust*** rows above, except any commodity pool, pooled account, investment fund, or other collective investment vehicle that is publicly offered only to non-U.S. persons and not offered to U.S. persons	[No separate ownership test]
Unlimited Liability Entities	Any legal entity (other than a limited liability company, limited liability partnership or similar entity where all of the owners of the entity have limited liability) that is directly or indirectly majority-owned by one or more persons described in the ***natural person, estate, corporate entity, pension plan*** or ***trust*** rows above and in which such person(s) bears unlimited responsibility for the obligations and liabilities of the legal entity	[No separate unlimited liability entity test]
Discretionary or Other Account	Any individual account or joint account (discretionary or not) where the beneficial owner (or one of the beneficial owners in the case of a joint account) is a U.S. person	An account (whether discretionary or non-discretionary) of a U.S. person