Cross-Border Security-Based Swap Transactions

SEC Publishes Proposed Rules Regarding Cross-Border Security-Based Swap Transactions

SUMMARY

Yesterday the Securities and Exchange Commission (“SEC”) proposed rules and interpretive guidance regarding the application of the U.S. regulatory regime to cross-border security-based swap (“SBS”) transactions. The proposals also address the impact of cross-border SBS transactions on the registration obligations of security-based swap dealers (“SBSDs”), major security-based swap participants (“MSBSPs”), SBS clearing agencies, SBS execution facilities and SBS swap data repositories (“SDRs”).

The proposed rules also would establish a framework of “substituted compliance” under which certain participants in the SBS market may comply with non-U.S. regulatory regimes that the SEC determines to be comparable with U.S. requirements, in lieu of the rules that would otherwise apply to these participants. The proposed rules will be open for comment for 90 days after the date of their publication in the Federal Register.

The SEC separately voted to reopen, for 60 days, the comment period for all rules relating to Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) that are not yet final. This 60-day comment period also applies to the related SEC policy statement describing the expected order for these rules to take effect.

The proposing release is more than 600 pages long and requests public comment on numerous topics. This memorandum provides a preliminary outline of a few key aspects of the proposals. We will publish a more detailed memorandum on the proposed rules and interpretive guidance shortly.
BACKGROUND

Title VII of Dodd-Frank (“Title VII”) gives the SEC authority over SBSs, as well as certain intermediaries and major players in the SBS market. Because the SBS market is global and interconnected, and because various non-U.S. regulatory agencies are presently implementing their own regimes for SBSs and other forms of swaps, the SEC recognizes that market participants could be subject to “multiple and overlapping regulatory regimes, potentially resulting in regulatory conflicts and duplications.”

The proposed rules and interpretive guidance would inform parties which U.S. regulatory requirements are applicable in the case of an SBS transaction that occurs in part within and in part outside the United States, and would outline the circumstances under which non-U.S. market participants would be able to satisfy their obligations under U.S. law by complying with non-U.S. regulatory regimes.

KEY ASPECTS OF THE PROPOSAL

A. TERRITORIAL APPLICATION OF THE TITLE VII FRAMEWORK TO SBS TRANSACTIONS

The proposals reflect a “territorial approach” to the application of the Title VII regulatory framework to cross-border SBS transactions. Generally, the requirements of Title VII would apply to SBS transactions that involve a “U.S. person” or that are “transactions conducted within the United States.”

1. “U.S. Person”

The proposed rules define a “U.S. person” as:

- 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; or
- any account (whether discretionary or non-discretionary) of a U.S. person.

A non-U.S. subsidiary of a U.S. parent could be a non-U.S. person, even if the subsidiary’s obligations are guaranteed by the U.S. parent.

The “U.S. person” definition includes foreign branches of U.S. banks (“U.S. Foreign Branches”). Under the proposed rules, however, certain activities of U.S. Foreign Branches, and the activities of other market participants relating to them, may be treated like activities of or relating to non-U.S. persons. In this regard, certain portions of the proposed rules differ from the pending Commodity Futures Trading Commission (“CFTC”) guidance relating to cross-border swaps.

Certain multinational financial organizations, including the World Bank, the IMF and other similar organizations, as well as their agencies and pension plans, would also be excluded from the definition of “U.S. person.”
2. “Transaction Conducted Within the United States”

The proposed rules would consider an SBS to be a “transaction conducted within the United States” if the SBS transaction 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.” Thus, any person located within the United States and engaged in counterparty-facing activity would be subject to the Title VII regime, regardless of whether the transaction is booked through a non-U.S.-based booking entity.

For a non-U.S. person, however, transactions with U.S. Foreign Branches would be excluded for purposes of determining whether the non-U.S. person is required to register as an SBSD. In addition, non-U.S. persons that are required to register as SBSDs would be subject to less regulation with respect to their non-U.S. business (including SBS transactions with U.S. Foreign Branches) than apply to their U.S. business or to U.S. registered SBSDs.

The proposed rules would permit a person to rely on a representation as to whether the SBS transaction was solicited, negotiated or executed within the United States, absent actual knowledge to the contrary.

B. SUBSTITUTED COMPLIANCE

The proposed rules also provide that, if the Title VII regime applies to a particular SBS transaction, the parties to that transaction may be able to satisfy their obligations under U.S. law with respect to that transaction by complying with the applicable regulatory regime(s) of non-U.S. countries.

A person relying on substituted compliance would still be subject to the comparable U.S. requirement, but could comply with that requirement in an alternative fashion. Failure of the person to comply with the applicable non-U.S. regulatory requirement would result in violation of the U.S. requirement.

For the purpose of making comparability determinations, the proposed rules divide the Title VII requirements into the following four categories:

- requirements applicable to registered non-U.S. SBSDs;
- requirements relating to regulatory reporting and public dissemination of SBS data;
- requirements relating to mandatory clearing for SBSs; and
- requirements relating to mandatory trade execution for SBSs.

In determining whether a particular non-U.S. regulatory regime is comparable to Title VII, the SEC would make determinations on a category-by-category basis and may permit substituted compliance in one or more categories, without allowing it in others. The SEC would apply a holistic approach focusing on comparability of regulatory outcomes, rather than a rule-by-rule comparison. Among other factors, the SEC would consider the effectiveness of the supervisory compliance program administered and the enforcement authority exercised by the relevant non-U.S. regulatory authority.
Comparability determinations may be initiated at the request of a market participant or group of market participants. The proposed rules provide that the SEC would not permit substituted compliance with respect to the registration, regulatory reporting and public dissemination, and trade execution requirements unless the SEC has entered into a supervisory and enforcement memorandum of understanding or other arrangement with the relevant non-U.S. financial regulatory authorities. The SEC expects the process of making a determination would include consultation with relevant non-U.S. regulatory authorities and the potential for solicitation of public comment. Once made, a comparability determination generally would be available to all SBS market participants in the relevant non-U.S. jurisdiction, and the SEC would have the authority to periodically review its determinations.

C. REGISTRATION OF NON-U.S. PERSONS AS SBSDS AND APPLICABLE REQUIREMENTS

1. Calculation of De Minimis Amount

Under the current definition of “security-based swap dealer,” generally an SBSD whose aggregate effective notional amount of dealing activity over the preceding 12 months does not exceed a “de minimis amount” of $3 billion (in the case of credit default swaps) or $150 million (in the case of other SBSs) is not required to register with the SEC.\(^1\)

   a. Limitation to U.S. Business

Under the proposed rules, in determining whether its SBS dealing activity exceeds the de minimis amount, a non-U.S. SBSD would only be required to consider its SBS dealing activity to the extent such activity is conducted with U.S. persons or is conducted within the United States. For the purpose of this calculation, SBS transactions conducted through U.S. Foreign Branches would not be considered to be “transactions conducted within the United States.”

   b. Aggregation of Transactions by Affiliates

A person would be able to exclude from the calculation of its de minimis threshold the dealing transactions of any affiliate that is registered with the SEC as an SBSD, as long as the person’s SBS activities are “operationally independent” from those of the registered SBSD affiliate. The SBS activities of two affiliated persons would be considered “operationally independent” if they “maintained separate sales and trading functions, operations (including separate back offices), and risk management with respect to any security-based swap dealing activity conducted by either affiliate that is required to be counted against their respective de minimis thresholds.”

---

\(^1\) For more information regarding classification of entities as SBSDs see our Memorandum to Clients dated June 8, 2012, entitled “CFTC and SEC Issue Final Rules and Guidance to Further Define the Terms ‘Swap Dealer,’ ‘Security-Based Swap Dealer,’ ‘Major Swap Participant,’ ‘Major Security-Based Swap Participant’ and ‘Eligible Contract Participant’” (the “Swap Dealer Definition Memo”).

Cross-Border Security-Based Swap Transactions
May 2, 2013
The proposed rules would not affect the current rule that SBS transactions between majority-owned affiliates are not considered when determining whether a person is an SBSD. This rule would apply even where an inter-affiliate transaction is a back-to-back transaction in which a non-U.S. subsidiary acts as a conduit for its U.S. affiliate.

A non-U.S. person whose performance on an SBS is guaranteed by a U.S. person would not be required to count its dealing transactions with non-U.S. persons outside the United States toward its de minimis threshold. In addition, a non-U.S. person would not be required to count toward its de minimis threshold SBS transactions with non-U.S. counterparties that benefit from guarantees by U.S. persons.

The SEC’s proposed treatment of conduit entities and guaranteed entities differs from the approach taken by the CFTC in its pending proposal on cross-border swaps.

2. Requirements Applicable to Non-U.S. SBSDs

The proposed rules divide the Title VII requirements applicable to SBSDs into two categories:

- entity-level requirements, which apply to the SBSD as a whole (e.g., capital, margin, and risk management requirements); and
- transaction-level requirements, which apply to individual SBS transactions (e.g., requirements relating to counterparty disclosure, adherence to business conduct standards, and segregation of customer funds, securities, and other assets).

Unless substituted compliance is permitted, non-U.S. persons registered as SBSDs would be required to comply with the entity-level requirements in all their activities. Title VII’s external business conduct requirements would only apply to the “U.S. business” of registered non-U.S. SBSDs, and Title VII’s segregation requirements generally would only apply to their transactions with counterparties who are U.S. persons.

The scope of the “U.S. business” definition in the proposed rules depends on whether the SBSD is a U.S. person:

- If an SBSD is a U.S. person, “U.S. business” would include any transaction by or on behalf of the SBSD, wherever it occurs, except for a transaction conducted by a U.S. Foreign Branch with a non-U.S. person or another U.S. Foreign Branch.
- If an SBSD is not a U.S. person, “U.S. business” would be limited to any transaction conducted within the United States, or entered into or offered to be entered into by or on behalf of the SBSD with a U.S. person (other than a U.S. Foreign Branch).

Generally, SBSDs that are U.S. persons would be required to comply with all Title VII requirements. However, U.S. banks that conduct SBS activity out of a U.S. Foreign Branch would not be required to comply with external business conduct requirements with respect to any business that is not “U.S. business.”
D. REGISTRATION OF NON-U.S. PERSONS AS MSBSPS AND APPLICABLE REQUIREMENTS

1. Calculation of SBS Positions

Under Title VII, generally an entity is required to register with the SEC as an MSBSP if its SBS positions exceed certain thresholds. The proposals would clarify that, in determining whether its SBS positions exceed these thresholds, a non-U.S. person would only be required to consider transactions it has entered into with U.S. persons (including U.S. Foreign Branches).

The SEC’s proposed interpretive guidance covers the treatment of SBS positions that are subject to guarantees. Specifically:

- a non-U.S. person that guarantees performance of the SBS obligations of a U.S. person would attribute to itself all of the U.S. person’s SBS positions that it guarantees;
- a non-U.S. person that guarantees performance on the SBS transactions of another non-U.S. person would attribute to itself only the guaranteed SBS positions arising from transactions with counterparties that are U.S. persons; and
- a U.S. person that guarantees performance of the SBS obligations of a non-U.S. person would attribute to itself all of that non-U.S. person’s SBS positions that it guarantees, whether the non-U.S. person’s counterparty is a U.S. person or a non-U.S. person.

However, no guarantor of an SBS position will be required to attribute to itself any guaranteed SBS position entered into by a non-U.S. person that is subject to Basel capital standards.

2. Requirements Applicable to non-U.S. MSBSPs

Generally, Title VII subjects registered MSBSPs to the entity-level and transaction-level requirements described above. Under the proposed rules, non-U.S. MSBSPs would be required to comply with the entity-level requirements, but would not be required to comply with transaction-level requirements that are specific to MSBSPs in their transactions with non-U.S. counterparties.

E. REPORTING AND EXECUTION REQUIREMENTS

1. Regulatory Reporting and Public Dissemination Requirements

Under the proposed rules, an SBS transaction would be subject to regulatory reporting to an SDR if:

- it is a transaction conducted within the United States;
- there is a U.S. counterparty on either side of the transaction, either directly or indirectly as a guarantor;
- there is an SBSD or an MSBSP on either side of the transaction, either directly or indirectly as a guarantor; or
- the transaction is cleared through a clearing agency with its principal place of business in the United States.

---

2 For more information regarding classification of entities as MSBSPs see the Swap Dealer Definition Memo.
The public dissemination requirements for SBS transactions would be somewhat narrower than the regulatory reporting requirements under the proposed rules. Public dissemination would be required if:

- the SBS is a transaction conducted within the United States;
- a U.S. person is a direct or indirect counterparty on each side of the SBS transaction;
- at least one direct counterparty to the SBS transaction is a U.S. person (other than a U.S. Foreign Branch);
- one side of the SBS transaction includes a U.S. person and the other side includes a non-U.S. SBSD; or
- the transaction is cleared through a clearing agency with its principal place of business in the United States.

2. Clearing and Trade Execution Requirements

Under the proposed rules, the Securities Exchange Act’s mandatory clearing and trade execution requirements would apply to any SBS transaction in which either counterparty is a U.S. person or a non-U.S. person whose performance under the SBS is guaranteed by a U.S. person, or which is a “transaction conducted within the United States,” as described above. The proposed rules include two exceptions to the mandatory clearing and trade execution requirements:

- if the SBS is not a “transaction conducted within the United States,” the mandatory clearing and trade execution requirements would not apply if one counterparty to the SBS transaction is a U.S. Foreign Branch or a non-U.S. person whose performance under the SBS is guaranteed by a U.S. person, and the other counterparty is a non-U.S. person (i) whose performance under the SBS is not guaranteed by a U.S. person and (ii) who is not a non-U.S. SBSD; and
- even if the SBS is a “transaction conducted within the United States,” the mandatory clearing and trade execution requirements would not apply if (i) neither counterparty to the transaction is a U.S. person, (ii) neither counterparty’s performance under the SBS is guaranteed by a U.S. person, and (iii) neither counterparty to the SBS is a non-U.S. SBSD.

The mandatory clearing and trade execution requirements would also be subject to certain relevant statutory exceptions, including the end-user exemption.³

F. REQUIREMENTS APPLICABLE TO CLEARING AGENCIES, EXECUTION FACILITIES AND DATA REPOSITORIES

The proposals also reflect a territorial approach to the registration requirements applicable to non-U.S. clearing agencies, swap execution facilities and SDRs. Generally, these entities would be required to register with the SEC if they perform SBS-related functions in the United States.

- A non-U.S. clearing agency acting as a central clearing party to a member that is a U.S. person would be subject to registration. The proposals indicate, however, that the SEC may consider a registration exemption in circumstances where the non-U.S. clearing agency is subject to comparable, comprehensive home-country regulation.

³ For more information regarding the end-user exemption see our Memorandum to Clients dated July 11, 2012, entitled “SEC and CFTC Adopt Product Definitions Under Title VII of Dodd-Frank.”

Cross-Border Security-Based Swap Transactions
May 2, 2013
A non-U.S. swap execution facility that provides U.S. persons or non-U.S. persons located in the United States with the direct ability to trade or execute SBSs would be subject to registration. The proposals indicate, however, that the SEC may consider a registration exemption that depends on the nature or scope of the non-U.S. swap execution facility’s activities in, and contacts with, the United States, and that is conditioned on the existence of comparable, comprehensive home-country regulation.

A non-U.S. SDR that enters into contracts with U.S. persons to enable U.S. persons to report SBS data to such non-U.S. SDR, or that has operations in the United States (such as maintaining SBS data on servers physically located in the United States), would be subject to registration. The proposals would provide a registration exemption, however, if the SEC has entered into an arrangement with each relevant regulator regarding the confidentiality of, and the SEC’s access to, data collected by the non-U.S. SDR, and other matters determined by the SEC.

Under Title VII, certain government authorities (including non-U.S. government authorities) may obtain information from SBS data repositories, provided such authority provides the repository with an indemnification agreement. Under the proposals, an SBS data repository would be able to waive this indemnification requirement if the following three requirements are satisfied:

- the authority’s request for SBS information is for the purpose of fulfilling its regulatory mandate or legal responsibility;
- the authority’s request pertains to a person or financial product subject to that authority’s jurisdiction, supervision, or oversight; and
- the authority has entered into a supervisory and enforcement memorandum of understanding or other arrangement with the SEC that addresses the confidentiality of the SBS information provided and any other matters as determined by the SEC.

PUBLIC COMMENT

The SEC will accept public comment on the proposed rules for a 90-day period beginning on the date the proposals are published in the Federal Register. The proposed rules are expected to generate significant public comment.

* * *

Copyright © Sullivan & Cromwell LLP 2013
ABOUT SULLIVAN & CROMWELL LLP
Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 800 lawyers on four continents, with four offices in the United States, including its headquarters in New York, three offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP
This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed below, or to any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future related publications from John Castro (+1-212-558-4417; castrojoh@sullcrom.com) in our New York office.

CONTACTS

New York
- Robert E. Buckholz, Jr. +1-212-558-3876 buckholzr@sullcrom.com
- Jay Clayton +1-212-558-3445 claytonwj@sullcrom.com
- Robert W. Downes +1-212-558-4312 downesr@sullcrom.com
- David J. Gilberg +1-212-558-4680 gilbergd@sullcrom.com
- David B. Harms +1-212-558-3882 harmsd@sullcrom.com
- Kenneth M. Raisler +1-212-558-4675 raislerk@sullcrom.com
- Robert W. Reeder III +1-212-558-3755 reederr@sullcrom.com
- Rebecca J. Simmons +1-212-558-3175 simmonsr@sullcrom.com
- Frederick Wertheim +1-212-558-4974 wertheimf@sullcrom.com

Washington, D.C.
- Eric J. Kadel, Jr. +1-202-956-7640 kadelej@sullcrom.com
- Robert S. Risoleo +1-202-956-7510 risoleor@sullcrom.com
- Dennis C. Sullivan +1-202-956-7554 sullivand@sullcrom.com

Los Angeles
- Patrick S. Brown +1-310-712-6603 brownp@sullcrom.com
- Alison S. Ressler +1-310-712-6630 resslera@sullcrom.com