The Manifold Compliance Challenges of Foreign Security Futures

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Aristotle cites the "tragelaph" (the mythical "goat-stag") as an example of how a concept can have meaning without existing. A "security future" is the US financial system's "goat-stag": a concept packed with meaning but non-existent on the securities and futures exchanges of the nation. By contrast, *foreign* security futures congregate in thick herds in the listings of non-US exchanges (where, it should be said, they are categorized simply as listed derivatives rather than as the part-security/part-futures hybrid that is unique to US regulation).

By now, more than 14 years after the fact, the industry is familiar with many of the manifold compliance challenges the SEC's 2009 exemptive order on foreign security futures presents to broker-dealer/FCMs that facilitate transactions in those products (as well as to their customers looking to trade them). It was the growing awareness of those challenges that moved FIA Tech to develop the FSF Databank tool that provides a month-end snapshot of each security and security index underlying the broad-based security index futures and foreign security futures contracts listed on non-US exchanges globally and analyzes its status as broad or narrow-based (for the indices) and whether it passes the primary trading market test under the 2009 Order (for all single-name and narrow-based security index futures). Katten has partnered with FIA Tech to enrich that offering with commentary about regulatory developments affecting the quantitative analysis presented by the FSF Databank.

The FSF Databank is a critical tool for broker-dealer/FCMs looking to implement procedures and processes reasonably designed to achieve compliance with the 2009 Order. But by itself, it is not sufficient; the 2009 Order presents other challenges, as well. Below is a catalog of those challenges intended to assist broker-dealer/FCM in-house lawyers and compliance officers tasked with creating and monitoring compliance with such procedures and processes.

But first, a quick synopsis of the main points of the 2009 Order. The 2009 Order defines two sets of compliance conditions governing transactions in foreign security futures involving a registered broker-dealer. (For its part, the CFTC simply requires that customers for which FCMs facilitate transactions in foreign security futures be eligible contract participants.)

Customer Conditions. The 2009 Order permits the following customers to transact in foreign security futures that satisfy the product conditions: 1) qualified institutional buyers as defined in Rule 144A of the Securities Act; (2) non-US persons as defined under Reg S under the Securities Act; (3) registered broker/dealers effecting transactions on behalf of QIBs or Reg S non-US persons; and (4) banks effecting transactions on behalf of QIBs or Reg S non-US persons.

Product Conditions. The 2009 Order permits eligible customers to transact in foreign security futures that satisfy the following criteria:

- For futures on single securities, the security is issued by a foreign private issuer and has its Primary Trading Market outside the US, or the security is a debt security issued by a foreign government that is eligible to be registered under Schedule B of the Securities Act.

- For futures on narrow-based security indices, at least 90 percent of the securities in the index, by number and by weight, are foreign private issuers and satisfy the Primary Trading Market test or debt securities issued by a foreign government that is eligible to register under Schedule B (and any issuers in the index that do not meet these criteria are subject to reporting under Section 13 or 15(d) of the Exchange Act).
- The futures contract is listed on an exchange not required to register under Section 5 of the Exchange Act and must clear and settle on a clearinghouse outside the US (and the contract must not be closed or liquidated by transactions effected on a US exchange registered under Section 6 or 15A of the Exchange Act).

A security is deemed to have its Primary Trading Market outside the US if:

- at least 55 percent of the worldwide trading volume in the security took place in, on, or through the facilities of a securities market or markets located either (i) in a single foreign jurisdiction or (ii) in no more than two foreign jurisdictions during the issuer's most recently completed fiscal year.
- the trading in the foreign private issuer's security is in two foreign jurisdictions, the trading for the issuer's security in at least one of the two foreign jurisdictions must be greater than the trading in the US for the same class of the issuer's securities in order for such security's primary trading market to be considered outside the US.

Critically, under the Primary Trading Market test, ADRs count.

Turning to the catalog of compliance challenges that the FSF Databank is not currently designed to solve:

Contracts in Transition. The FSF Databank will tell you when a security index is "on the bubble" between broad-based and narrow-based but does not count trading days for contracts in transition between the two classifications to track the 45-trading-day test set forth under CFTC Rule 41.14. Currently, only exchanges track that day-by-day data. Market participants need to monitor communication from exchanges to track developments regarding contracts in transition.

Which Securities Act Exemption? The 2009 Order frames transactions in foreign security futures as transactions in securities not involving a public offering. This means that the transactions must be made in reliance on an exemption from registration. So, which one? Although there's some language in the 2009 Order suggesting that market participants should consider Reg S as the best available exemption, the Order is nonetheless clear that broker-dealers must determine for themselves which exemption to rely on.

At least one non-US clearinghouse has considered this issue and elected to rely on Reg D rather than Reg S — evidently, out of concern that the SEC might view it to be involved in directed selling efforts in the US. (Note that where clearing members facilitating transactions in foreign security futures for customers within the jurisdiction of the US in reliance on Reg D must assure themselves that any such transaction with for a customer that is an accredited investor within the meaning of Reg D.)

Where does this leave broker-dealer/FCMs who need to determine which Securities Act exemption to rely on? The best answer appears to be: It depends on the circumstances. Reg D for exchanges involved in directed selling efforts into the US; Reg S for exchanges that are not. In practical terms, this means diligence confirming that customers trading and clearing FSF are (i) QIB/non-US Persons and/or (ii) accredited investors (as well as ECPs). It means documentation confirming the customer's agreement that foreign security futures transactions are offered and sold in private transactions not registered under the Securities Act; may not be publicly distributed, re-offered, resold, or otherwise transferred in the US; and are entered into on an unsolicited basis (i.e., by the broker-dealer/FCM).

Foreign Private Issuers. Issuers of securities that are the underlying of foreign single-name security futures and (90 percent of the components of) narrow-based indexes that are the underlying of foreign narrow-based security index futures must be foreign private issuers. There are two tests to determine whether a foreign company

qualifies as a foreign private issuer: the first relates to the relative degree of its US share ownership, and the second relates to the level of its US business contacts. A foreign company will qualify as a foreign private issuer if 50 percent or less of its outstanding voting securities are held by US residents; or if more than 50 percent of its outstanding voting securities are held by US residents and none of the following three circumstances applies: the majority of its executive officers or directors are US citizens or residents; more than 50 percent of the issuer's assets are located in the United States; or the issuer's business is administered principally in the United States.

Most broker-dealer/FCMs will have access to databases that can be mined to extract this information about any non-US issuer, but, as should be evident from the complexity of the test, it is not a straightforward exercise.

Schedule B Issuer Status. Futures on securities issued by foreign governments or political subdivisions thereof (other than the 21 governments listed in Security Exchange Act Rule 3a12-8) are eligible under the product conditions set forth in the 2009 Order only if the foreign government issuer is eligible to be registered as a Schedule B issuer. Again, most broker-dealer/FCMs will have the means to determine whether a foreign government is an eligible Schedule B issuer (but may not be readily accessible to personnel covering the trading desks that handle foreign security futures).

Issuers in Narrow-Based Indices that Do Not Satisfy the Primary Trading Market Test. A narrow-based security index that passes the primary trading market test may include a handful (no more than 10 percent, by volume and weight in the index) of names that do not satisfy that test. For such an index to remain eligible under the Product Conditions in the 2009 Order, those names must be subject to reporting under Section 13 or 15(d) of the Exchange Act. In essence, this requirement says that if an issuer does not pass the primary trading market test (that is, its securities are "primarily" traded on US registered markets), then it should be subject to Exchange Act reporting (annual, quarterly and other current reports, including 8-K and 13F filings). Once again — this is information broker-dealers will have, but trading desk coverage will need to track it down.

Exchange and Clearinghouse Eligibility. Eligible foreign security futures must be listed on a non-US not required to register under Section 5 of the Exchange Act and must clear and settle on a clearinghouse outside the US (and the contract must not able to be closed or liquidated by transactions effected on a US exchange registered under Section 6 or 15A of the Exchange Act).

The diligence around these compliance conditions involves a combination of confirming that an exchange is, in fact, not a national securities exchange registered with the SEC; that the broker-dealer/FCM is not offering "direct access" to transactions in foreign security futures listed on the non-US exchange in question (which could trigger the requirement to register and would likely breach the exchange's terms of access); the clearinghouse is not located in the US; and that transactions in the relevant contract cannot be executed through the facilities of a registered exchange (even if the mode of execution under consideration does not leverage such facilities).

The SEC's 2009 Order is available here. More information about the FSF Databank is available here. More information about Katten's partnership with FIA Tech is available here. Additional information about the foreign private issuer test is available here. Security Exchange Act Rule 3a12-8 is available here.

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