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SEC Adopts First Installment of Rules for Cross-Border Security-Based Swap Activity

On June 25, 2014, the Securities and Exchange Commission (SEC) re-started its rulemaking for security-based swaps (SBS) under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) by adopting a first installment of rules (the “Rules”) that are applicable to SBS involving persons and entities located outside the United States.¹ The SEC took into consideration many of the comments made on the proposed cross-border rules it issued in 2012 (the “Proposed Rules”), so the Rules are different in numerous ways from the Proposed Rules. The Rules are broadly consistent with the positions taken by the Commodity Futures Trading Commission (CFTC) in its “Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations” (the “Final Guidance”), but they are formal rules rather than mere guidance.² Although the Rules will become effective on September 7, 2014, market participants will not have to comply with them until the SEC adopts the rest of the substantive rules necessary to complete the regulatory regime for security-based swaps created by the Dodd-Frank Act. In the meanwhile, the most active market participants can use the Rules to estimate more accurately the possibility of needing to register with the SEC because of their SBS activity.

I. Executive Summary

The Rules, which were adopted under the Securities Exchange Act of 1934 (the “Exchange Act”), cover the following swap topics:

1. Rule 3a71-3 contains definitions and rules to be used in analyzing cross-border security-based swap dealing activity and determining when registration with the SEC is required. The key definitions provided are ones for “U.S. person” and “conduit affiliate.”
2. Rule 3a67-10 contains rules for the application of major security-based swap participant tests in the cross-border context.
3. Rule 0.13 provides SEC procedures for filing applications to request substituted compliance orders for SBS under the Exchange Act.

The SEC also adopted a rule defining its cross-border antifraud authority that is applicable to all securities (not just security-based swaps). (Rule 250.1.)

¹ The Rules were published in 79 Federal Register 39068 (July 9, 2014).

² The Final Guidance was published in 78 Federal Register 45292 (July 26, 2013). The Final Guidance is currently the subject of a court challenge from industry groups alleging that it is, in effect, a formal rule that was adopted without required rulemaking formality.

For more information, please contact any of the following members of Katten's **Financial Services practice.**

Guy C. Dempsey Jr.
+1.212.940.8593
guy.dempsey@kattenlaw.com

Gary DeWaal
+1.212.940.6558
gary.dewaal@kattenlaw.com

Carolyn H. Jackson
+44.0.20.7776.7625
carolyn.jackson@kattenlaw.co.uk

Ross Pazzol
+1.312.902.5554
ross.pazzol@kattenlaw.com

II. Key Points

A. Definitional Points

1. U.S. Person Definition

Unlike the CFTC, the SEC has adopted a formal definition for the term “U.S. person.” (Rule 3a71-3(a)(4)(i).) The table below shows the differences between the SEC’s defined term and the CFTC’s interpretation of “U.S. person” in the Final Guidance:

CFTC Interpretation (by prong in Final Guidance)	SEC Definition (by subsection in Rule 3a71-3(a)(4))
(i) any natural person who is a resident of the United States	(A) A natural person resident in the United States
(ii) any estate of a decedent who was a resident of the United States at the time of death	(D) An estate of a decedent who was a resident of the United States at the time of death
(iii) 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 an entity described in prongs (iv) or (v), below) (a “legal entity”), in each case that is 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	(B) 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
(iv) any pension plan for the employees, officers or principals of a legal entity	Not covered separately from subsection (B)
(v) 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	Not covered separately from subsection (B)
(vi) any commodity pool, pooled account, investment fund, or other collective investment vehicle that is not described in prong (iii) and that is majority-owned by one or more persons described in prong (i), (ii), (iii), (iv), or (v), 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	Not covered separately from subsection (B) (so no U.S. ownership test for commodity pools and investment vehicles)
(vii) 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 prong (i), (ii), (iii), (iv), or (v) and in which such person(s) bears unlimited responsibility for the obligations and liabilities of the legal entity	Not covered separately from subsection (B) (so no liability test)
(viii) 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 person described in prong (i), (ii), (iii), (iv), (v), (vi), or (vii)	(C) An account (whether discretionary or non-discretionary) of a U.S. person

The absence of elements in the SEC definition corresponding to the special tests for commodity pools and entities with recourse to U.S. persons in the Final Guidance could cause difficulties for such entities, but the SEC states in its Fact Sheet concerning the Rules that it believes, “[a]s a practical matter, the [Rules] generally produce similar outcomes [to the Final Guidance] in terms of whether an entity is a ‘U.S. person’.” The SEC has not provided an explicit definition for the term “non-U.S. person” but uses it consistently in the new rules to refer to a person who is not a U.S. person.

2. Principal Place of Business Rule

For purposes of its “U.S. person” definition, the SEC has defined the principal place of business of any legal person as “the location from which the officers, partners or managers of the legal person primarily direct, control, and coordinate the activities of the legal person.” (Rule 3a71-3(a)(4)(ii).) This definition also includes a special rule for investment vehicles: “With respect to an externally managed investment vehicle, this location is the office from which the manager of the vehicle primarily directs, controls, and coordinates the investment activities of the vehicle.” This definition will capture as a U.S. person any hedge fund that is organized outside the United States but which is managed by a management company based in the United States. Despite this definition, the SEC expresses the view in the preamble to the Rules that “mere retention of an asset manager that is a U.S. person, without more, would not necessarily bring an offshore investment vehicle or other person within the scope of the ‘U.S. person’ definition.” (79 Federal Register 39101 (July 9, 2014).)

3. Multinational Entities

The SEC definition of “U.S. person” explicitly excludes multinational entities based in the U.S. such as the International Monetary Fund, the United Nations and other similar organizations (along with their agencies and pension plans). (Rule 3a71-3(a)(4)(iii).)

4. Conduit Affiliates

SEC Rule 3a71-3(a)(1)(i) provides a definition for the term “conduit affiliate” first used by the CFTC in its Final Guidance:

“‘Conduit affiliate’ means a person, other than a U.S. person, that:

(A) is directly or indirectly majority-owned by one or more U.S. persons; and

(B) 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.”

The definition also specifies that the test of majority-ownership relates to control of any class of voting securities or, in the case of a partnership, the right to receive the majority of the partnership’s capital upon dissolution.

5. Foreign Branches of U.S. Persons

The SEC has adopted a definition and rules relating to foreign branches of U.S. banks that treat such entities in a manner very similar to the manner in which the CFTC treats them under the Final Guidance. (Rule 3a71-3(a)(2).) To qualify as a transaction with a foreign branch of a U.S. person, the relevant SBS must be “arranged, negotiated and executed on behalf of the foreign branch solely by persons located outside the United States.” (Rule 3a71-3(a)(3).)

6. Reliance on Representations

The SEC has specifically provided that a party can rely on a representation from its counterparty in determining whether the counterparty is a U.S. person or a foreign branch unless such person “has reason to know that the representation is not accurate.” (Rule 3a71-3(a)(2)(ii) and Rule 3a71-3(a)(4)(iv).)

B. Counting Security-Based Swaps for Determination of Security-Based Swap Dealer (SSD) Status

The Rules have similar substance to the Final Guidance, but involve a slightly different technical framework. As used in the Rules, the term “affiliate” means, with respect to any legal person, another person that controls, is controlled by or is under common control with, the such legal person. (Rule 3a71-4.)

1. For U.S. Persons

Under Rule 3a71-3(b)(1)(i) and Rule 3a71-3(b)(2), a U.S. person must aggregate all of the following SBS for purposes of calculating the size of its security-based swap positions connected with dealing activity:

- A. All of the SBS connected with dealing activity (“Dealing SBS”) executed by such U.S. person as principal, including those conducted through a foreign branch of such U.S. person.
- B. All of the Dealing SBS executed by U.S. person affiliates of such U.S. person, including those conducted through a foreign branch of such a U.S. affiliate, except for SBS executed by a U.S. affiliate that has passed the *de minimis* threshold for registration as an SSD.
- C. All of the Dealing SBS executed by conduit affiliates of such U.S. person except for SBS executed by a conduit affiliate that has passed the *de minimis* threshold for registration as an SSD.
- D. All of the Dealing SBS executed by non-U.S. person affiliates of such U.S. person to the extent that such SBS would be counted towards the SSD status of such non-U.S. person, except for SBS executed by such a non-U.S. person affiliate that has passed the *de minimis* threshold for registration as an SSD.

2. For Conduit Affiliates

Under Rule 3a71-3(b)(1)(ii) and Rule 3a71-3(b)(2), a conduit affiliate must aggregate all of the following SBS for purposes of calculating the size of its Dealing SBS positions:

- A. All of the Dealing SBS executed by such conduit affiliate as principal.
- B. All of the Dealing SBS executed by U.S. person affiliates of such conduit affiliate, including those conducted through a foreign branch of such a U.S. affiliate, except for SBS executed by an affiliate that has passed the *de minimis* threshold for registration as an SSD.
- C. All of the Dealing SBS executed by conduit affiliates of such conduit affiliate except for SBS executed by a conduit affiliate that has passed the *de minimis* threshold for registration as an SSD.
- D. All of the Dealing SBS executed by non-U.S. person affiliates of such conduit affiliate to the extent that such SBS would be counted towards the SSD status of such non-U.S. person, except for SBS executed by such a non-U.S. person affiliate that has passed the *de minimis* threshold for registration as an SSD.

3. For Non-U.S. Persons That Are Not Conduit Affiliates

Under Rule 3a71-3(b)(1)(iii) and Rule 3a71-3(b)(2), a non-U.S. person that is not a conduit affiliate must aggregate all of the following SBS for purposes of calculating the size of its Dealing SBS positions:

- A. All of the Dealing SBS executed by such non-U.S. person as principal in which its counterparty is a U.S. person (other than a foreign branch of a U.S. person that has passed the *de minimis* threshold for registration as an SSD).
- B. Any of its own Dealing SBS in which its counterparty is a non-U.S. person if the non-U.S. counterparty has legally enforceable recourse against a U.S. person affiliate of such non-U.S. person for some or all of the payments due from such non-U.S. person. (Note that this approach of counting only specific SBS that have been guaranteed

avoids the scope issues that have arisen with respect to the interpretation of the CFTC's use of the term "guaranteed affiliate" in the Final Guidance.)

- C. All of the Dealing SBS executed by U.S. person affiliates of such non-U.S. person, including those conducted through a foreign branch of such a U.S. affiliate, except for SBS executed by an affiliate that has passed the *de minimis* threshold for registration as an SSD.
- D. All of the Dealing SBS executed by conduit affiliates of such non-U.S. person except for SBS executed by a conduit affiliate that has passed the *de minimis* threshold for registration as an SSD.
- E. All of the Dealing SBS executed by non-U.S. person affiliates of such non-U.S. person to the extent that such SBS would be counted towards the SSD status of such non-U.S. person, except for SBS executed by such a non-U.S. person affiliate that has passed the *de minimis* threshold for registration as an SSD.

A non-U.S. person that is not a conduit affiliate may ignore Dealing SBS executed anonymously on an execution facility or exchange by it or an affiliated non-U.S. person that is not a conduit affiliate provided such swap is cleared through a clearing agency. (Rule 3a71-5.) This rule implies that such anonymous cleared Dealing SBS do count for determining the SSD status of U.S. persons.

C. Counting Security-Based Swaps for Determination of Major Security-Based Swap Participant (MSSP) Status

The rules for calculating volumes of SBS activity for potential MSSPs involve selective aggregation of positions depending on whether a potential MSSP has liability for the swap obligations of another person. However, no aggregation applies for a person who has guaranteed the performance of another person in SBS if the person whose performance is guaranteed is: (i) subject to capital regulation by the SEC or the CFTC (as a swap dealer or otherwise); (ii) regulated as a bank in the U.S.; (iii) subject to capital standards that are consistent in all respects with the Capital Accord of the Basel Committee on Banking Supervision; or (iv) has passed the threshold to become a MSSP but has not yet used all the time allowed to complete the registration process for an MSSP. (Rule 3a67-10(c)(2).)

1. For U.S. Persons

Under Rule 3a67-10(b)(1) and Rule 3a67-10(c), a U.S. person must aggregate all of the following SBS for purposes of calculating the size of its security-based swap positions for MSSP purposes:

- A. All of the SBS executed by such U.S. person as principal, including those conducted through a foreign branch of such U.S. person.
- B. Any SBS executed by a non-U.S. person to the extent that the counterparty to such an SBS has legally enforceable recourse against such U.S. person for some or all of the payments due from the non-U.S. person.

2. For Conduit Affiliates

Under Rule 3a67-10(b)(2) and Rule 3a67-10(c), a conduit affiliate must aggregate all of the following SBS for purposes of calculating the size of its SBS positions for MSSP purposes:

- A. All of the SBS executed by such conduit affiliate as principal.
- B. Any SBS executed by a U.S. person to the extent that the counterparty to such an SBS has legally enforceable recourse against such conduit affiliate for some or all of the payments due from the U.S. person.
- C. Any SBS executed by another non-U.S. person with a U.S. person counterparty to the extent that the U.S. counterparty has legally enforceable recourse against such conduit affiliate for some or all of the payments due from the other non-U.S. person. The aggregation requirement in this paragraph does not apply if the U.S. person counterparty is a foreign branch of the U.S. person that has passed the *de minimis* threshold for registration as an SSD. (Rule 3a67-10(c)(1)(ii)(B).)

3. For Non-U.S. Persons That Are Not Conduit Affiliates

Under Rule 3a67-10(b)(3) and Rule 3a67-10(c), a non-U.S. person that is not a conduit affiliate must aggregate all of the following SBS for purposes of calculating the size of its SBS positions for MSSP purposes:

- A. All of the SBS executed by such non-U.S. person as principal in which its counterparty is a U.S. person other than SBS executed by such non-U.S. person with a foreign branch of a U.S. person that has passed the *de minimis* threshold for registration as an SSD.
- B. Any SBS executed by such non-U.S. person as principal to the extent that the counterparty to such SBS has legally enforceable rights of recourse against a U.S. person for some or all of the payments due from such non-U.S. person.
- C. Any SBS executed by a U.S. person to the extent that the counterparty of the U.S. person has legally enforceable recourse against the non-U.S. person calculating its MSSP status for some or all of the payments due from the U.S. person.
- D. Any SBS executed by another non-U.S. person with a U.S. person counterparty to the extent that the counterparty has legally enforceable recourse against the non-U.S. person calculating its MSSP status for some or all of the payments due from the other non-U.S. person.

D. Substituted Compliance

Although none of the Rules are ones that could be the subject of substituted compliance, the SEC nevertheless adopted a rule covering the procedure for applying for substituted compliance when that issue becomes relevant in light of future rulemakings. (Rule 0.13.) Under the procedure, an application to comply with a rule in another jurisdiction instead one of the SEC's rules for SBS can be made by an interested party or a foreign regulator and will be decided by a vote of the SEC upon no less than 25 days prior notice of the vote being published in the Federal Register. The rule does not, however, provide any information about the substantive criteria that will be applied by the SEC in making such determinations.

E. Cross-Border Antifraud Authority

The SEC also chose the same meeting to adopt a new rule (Rule 250.1) concerning the cross-border application of its antifraud authority. The new rule is not specific to SBS, but the SEC decided to adopt it in order to articulate the SEC's own interpretation of the international scope of its antifraud authority in light of Section 929P(b) of the Dodd-Frank Act:

Rule 250.1(a) Notwithstanding any other commission rule or regulation, the antifraud provisions of the 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.
- (b) The antifraud provisions of the securities laws apply to conduct described in paragraph (a)(1) of this section even if:
- (1) the violation relates to a securities transaction or securities transactions occurring outside the United States that involves only foreign investors; or
 - (2) the violation is committed by a foreign adviser and involves only foreign investors.

III. Next Steps

The SEC's roadmap for completing its SBS rulemakings was issued in 2012 and is still operative.³ Under the roadmap, the next swap action taken by the SEC is likely to be more rules relating to cross-border SBS activity. One of these will undoubtedly be a rule dealing with "transactions conducted with the United States" as that term was defined in the Proposed Rules. The Rules do not discuss that term or the related issues concerning activities conducted by U.S. branches of foreign banks arising from footnote 513 in the CFTC's Final Guidance, but the preamble to the Rules contains the statement that the SEC anticipates soliciting public comment on the application of swap definitions to "activity between two non-U.S. persons where one or both are conducting dealing activity that occurs within the United States." (79 Federal Register 39092 (July 9, 2014).)

It remains to be seen when the SEC produces the rest of its cross-border rules whether further action will be necessary by the SEC or the CFTC in order for those regulators to meet the statutory requirement in Section 712(a)(7) of the Dodd-Frank Act that they must "treat functionally and economically similar products or entities . . . in a similar manner."

³ "Statement of General Policy on the Sequencing of Compliance Dates for Final Rules Applicable to Security-Based Swaps . . .", 77 Federal Register 35625 (June 14, 2012).

Katten

Katten Muchin Rosenman LLP www.kattenlaw.com

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