PROPOSED RULES FOR CROSS-BORDER SECURITY-BASED SWAP ACTIVITIES

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On May 1, the U.S. Securities and Exchange Commission (the “SEC”) released proposed rules and interpretive guidance regarding cross-border security-based swap activities that fall within its jurisdiction (the “Proposed Rules”). The Proposed Rules seek to balance the financial protections intended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) with the need to maintain incentives for participation in the security-based swap market.

The Proposed Rules address the applicability of Subtitle B of Title VII of the Dodd-Frank Act and the rules thereunder (collectively, the “Security-Based Swap Market Regulations”) to cross-border activities. The determination of when and how the Security-Based Swap Market Regulations will apply to cross-border activities is a matter that impacts the efficiency, competitiveness, transparency, liquidity and systemic risk of the global financial markets. In addition to addressing the question as to when these regulations apply, the proposal addresses the question of how non-U.S. market participants may comply with the regulations. The proposal introduces the concept of substituted compliance, which in certain circumstances permits market-participants subject to the Security-Based Swap Market Regulations to satisfy certain compliance obligations by complying with comparable non-U.S. regulations.

Background and Regulatory Framework

The Dodd-Frank Act established a framework for regulating the derivatives market. The SEC has jurisdiction over “security-based swaps” while the U.S. Commodity Futures Trading Association (the “CFTC”) has jurisdiction over other swaps. The proposed rules discussed herein relate solely to security-based swaps. The CFTC has separately proposed rules addressing cross-border swap activities that differ, in several material respects, from those proposed by the SEC for security-based swaps.

A security-based swap is a swap based on:

(i) a single equity security or loan; or
(ii) a narrow-based security index; or
(iii) the occurrence of an event relating to either of the above, which impacts the financial condition of the issuer (e.g., a single name credit default swap).

The framework for the regulation of security-based swaps is at both the user level (e.g., requirements applicable only to certain users of security-based swaps) and transactional level (e.g., requirements applicable to specific participants or all participants in security-based swap transactions).

Counterparties to security-based swaps fall into three categories:

- Security-Based Swap Dealer (“SBSD”)
  - A SBSD is an entity that holds itself out as a security-based swap dealer, makes a market in security-based swaps or regularly enter into security-based swaps as part of its ordinary business and for its own account.
  - A SBSD is required to register with the SEC and is subject to SEC regulation.
• Major Security-Based Swap Participant ("MSBSP")
  o A MSBSP is an entity (other than a SBSD) that maintains a substantial position in security-based swaps that are not held for hedging or mitigating risk.
  o A MSBSP is required to register with the SEC and is subject to SEC regulation.
• Other participants
  o All other security-based swap users.
  o No SEC registration is required.
  o Must comply with certain transaction level regulations, including regulatory and public reporting, clearing and trade execution, as discussed herein.

The security-based swap marketplace is global. It is the norm for multiple jurisdictions to be implicated, to one degree or another, by a single transaction. This creates the disconcerting possibility that a market participant could be subject to conflicting regulatory regimes. As a result, both market participants and non-U.S. regulators have been concerned as to what extraterritorial reach the SEC will assert when implementing the Security-Based Swap Markets Regulations.

Scope of Applicability of Security-Based Swap Markets Regulations to Cross-Border Activities

In determining the scope and the applicability of the Security-Based Swap Markets Regulations to cross-border activities, the Proposed Rules focus on two key premises:

• the definition of U.S. Person; and
• the interpretation of “transaction conducted within the U.S.”

The SEC created a new definition of “U.S. Person” solely for security-based swap purposes rather than utilize the definition of such term set forth in Regulation S of the U.S. Securities Act of 1933, as amended. The U.S. Person definition set forth in the proposed rules focuses on the location of the person bearing the direct risk of the transaction.

Proposed definition of “U.S. Person”:

• A natural person resident in the U.S. (The determination is based on residency, not citizenship.)
• An entity organized or incorporated in the U.S. or having principal place of business in the U.S.
  o A foreign branch of a U.S. bank (a “Foreign Branch”) is a U.S. Persons because it is not separate legal entity from the U.S. bank.
  o A U.S. branch of a foreign bank is not U.S. Person for same reason.
• A discretionary or nondiscretionary account of a U.S. Person. (The determination is made on the basis of the account owner, not the person making the investment decision).
• Certain international organizations such as the International Monetary Fund and the International Bank for Reconstruction and Development are excepted from the proposed definition of U.S. Person.

The fact that a person or entity does not fall within this definition of U.S. Person does not mean that the Security-Based Swap Markets Regulations do not apply to it. A person who is not a US. Person still needs to be concerned with the applicability of both the user level and transactional level Security-Based Swap Markets Regulations with respect to any:

• transaction entered into with a U.S. Person;
• transaction where a U.S. Person guarantees either its performance or the performance of the
counterparty; and
• “transaction conducted within the United States.”

The Proposed Rules define “transaction conducted within the United States” as any transaction that is
solicited, negotiated, executed or booked in the U.S., excluding a transaction conducted through a
Foreign Branch. The status of the individual counterparties is irrelevant in determining whether a
transaction is conducted within the U.S. Thus, a transaction between a foreign bank and a non-U.S.
Person that is solicited, negotiated and/or executed in New York City would be a transaction conducted
within the U.S. A person may rely on a representation from its counterparty that the transaction was not
conducted in the U.S. (absent knowledge the contrary).

Substituted Compliance

The Proposed Rules permit foreign security-based swap participants that are subject to the Security-
Based Swap Markets Regulations as well as security-based swap regulations of a foreign jurisdiction to
comply with certain of the Security-Based Swap Markets Regulations through substituted compliance.
Under substituted compliance, a market participant may satisfy a SEC requirement by satisfying a
comparable requirement of a foreign jurisdiction. The party remains subject to the SEC requirement. As
a result, a party that choses substituted compliance but fails to comply with the applicable foreign
regulations would be in violation of the relevant SEC regulations.

As discussed further below, substituted compliance is only available as a means of satisfying certain of
the Security-Based Swap Markets Regulations. Further, substituted compliance would only be available
where the SEC has determined that the foreign requirements are comparable to the SEC requirements.
The comparability determination would be made with respect to each of the four applicable categories of
requirements – registered SBSD requirements, regulatory and public reporting requirements, clearing
requirements and trade execution requirements. In making its determination, the SEC would not look at
whether the foreign requirements were similar to the SEC requirements in each aspect. Instead, the
focus would be on whether the regulatory outcomes achieved under the foreign requirements are
comparable to those achieved under the SEC requirements. Because determinations will be made with
respect to each category of requirements rather than the Security-Based Swap Market Regulations as a
whole, it is possible that the SEC would determine that a particular country’s security-based swap
regulations were comparable to the SEC’s with respect to one category of requirements, but not another.

As proposed, the SEC would only make a substituted compliance determination upon receipt of a written
request including all supporting documentation. Such a request could not be anonymous or hypothetical.

Cross-Border Application of Registration and Other Requirements at the User Level

Application to the De Minimis Exemption to the Definition of Security-Based Swap Dealer

As one might expect, there is a de minimis exemption to the SBSD definition. An entity that engages in a
de minimis amount of security-based swap dealing activity is not a SBSD. In calculating the amount of
security-based swap positions for this purpose, a U.S. Person must include all security-based swap
transactions connected with its dealing activity (including those conducted through a Foreign Branch).
An entity that is not a U.S. Person, however, need only count security-based swap transactions connected with its dealing activity where either (i) the counterparty is a U.S. Person other than a Foreign Branch, or (ii) the transaction is conducted in the U.S.

Application to the Calculation of “Substantial Position in Security-Based Swaps”

An entity’s status as a MSBSP turns on whether the aggregate amount of its security-based swap positions (other than those held for hedging or risk mitigation) is “substantial” as prescribed in the Security-Based Swap Market Regulations. In making this determination, a U.S. Person must include all of its security-based swap transactions. A non-U.S. Person, on the other hand, need only count its security-based swap transactions with counterparties that are U.S. Persons.

Applicability of Security-Based Swap Market Regulations to Foreign SBSDs and Foreign MSBSPs

Any non-U.S. Person that must register with the SEC as a SBSD (a “Foreign SBSD) or as a MSBSP (a “Foreign MSBSP”) is subject to regulations concerning matters such as net capital, margin, segregation and business conduct standards, including requirements as to external business conduct (e.g., disclosing material information regarding the transaction, including material risks, to the investors, providing daily marks and verifying that the counterparty is an eligible contract participant).

- Net Capital and Margin Requirements – All Foreign SBSDs and Foreign MSBSPs are required to fully adhere to the capital and margin requirements in the same manner as U.S. SBSDs and MSBSPs.
- Segregation Requirements –
  - Foreign SBSDs – While generally applicable, there are certain circumstances where they are not, which depend on a number of factors, including whether or not the transaction is a cleared security-based swap, whether or not the Foreign SBSD is a registered broker-dealer or a foreign bank, and whether or not assets are received from, for or on behalf of a counterparty that is a U.S. Person.
  - Foreign MSBSPs – Applicable except where (i) the Foreign MSBSP is not a registered broker-dealer, (ii) the transaction is a non-cleared security-based swap, and (iii) the assets are received from, for or on behalf of a counterparty that is not a U.S. Person.
- External Business Conduct Requirements –
  - Foreign SBSDs – Applicable except where (i) the counterparty is not a U.S. Person (other than a Foreign Branch), and (ii) the transaction is conducted in the U.S; however, rules relating to diligent supervision always apply.
  - Foreign MSBSPs – Generally applicable except where the counterparty is not a U.S. Person, but rules relating to diligent supervision always apply.
- Substituted Compliance
  - Foreign SBSDs – Available for net capital, margin and external business conduct rules. Not available for segregation rules.
  - Foreign MSBSPs – Never available.

Cross-Border Application to Transaction Level Requirements

In addition to the specific requirements described above, which are applicable to SBSDs and MSBSPs, all market participants are required to comply with applicable transactional requirements pertaining to individual security-based swaps. As mentioned above, the main transaction level requirements are:
clearing, trade execution, regulatory reporting and public reporting. Every security-based swap user must comply with at least one of these requirements (regulatory reporting) with respect to every transaction that in some way touches upon the U.S. Under the Proposed Rules, substituted compliance is permitted with respect to most of the applicable transaction level requirements. This is true even with respect to transactions that are conducted within the U.S.

In the most general terms, the cross-border applicability and substituted compliance regime for these requirements is as follows:

- **Unregistered market participants who are not U.S. Persons and whose obligations are not guaranteed by any U.S. Person:**
  - **Clearing** –
    - Required where:
      - Counterparty is a U.S. Person; or
      - Obligations of the counterparty are guaranteed by a U.S. Person and the transaction is conducted within the U.S.
    - Exception – Clearing not required where counterparty is a Foreign Branch and the transaction is not conducted within the U.S.
    - Substituted compliance: Permitted whenever clearing is required.
  - **Trade Execution** –
    - Required wherever clearing is required.
    - Substituted compliance: Permitted except where the transaction is conducted within the U.S. with a counterparty that is a U.S. Person other than a Foreign Branch.
  - **Regulatory Reporting** –
    - Required unless all of the following conditions are met:
      - Neither counterparty nor its guarantor (if any) is a U.S. Person;
      - Neither counterparty nor its guarantor (if any) is a Foreign SBSD or a Foreign MSBSP;
      - Transaction is not conducted within the U.S.; and
      - Transaction is not cleared through a clearing agency having its principal place of business in the U.S.
    - Substituted compliance: Permitted except where:
      - Counterparty is a U.S. Person other than a Foreign Branch; or
      - Counterparty is a non-U.S. Person and the transaction is solicited, negotiated or executed, on behalf of both counterparties, within the U.S.
  - **Public Reporting** –
    - Required unless all of the following conditions are met:
      - Counterparty is either a non-U.S. Person or a Foreign Branch;
      - Transaction is conducted outside the U.S.; and
      - Transaction is not cleared through a clearing agency having its principal place of business in the U.S.
    - Substituted compliance: Permitted wherever substituted compliance is permitted for regulatory reporting.
• Foreign SBSDs and Foreign MSBSPs whose obligations are not guaranteed by any U.S. Person:
  o Clearing –
    ▪ Required unless:
      • Neither counterparty nor its guarantor (if any) is a U.S. Person; and
      • Transaction is not conducted within the U.S.
    ▪ Substituted compliance: Permitted whenever clearing is required.
  o Trade Execution –
    ▪ Required wherever clearing is required.
    ▪ Substituted compliance: Permitted except where:
      • Counterparty is a U.S. Person other than a Foreign Branch; or
      • Counterparty is a non-U.S. Person and the transaction is solicited, negotiated or executed, on behalf of both counterparties, within the U.S.
  o Regulatory Reporting –
    ▪ Required for all transactions.
    ▪ Substituted compliance: Permitted except where:
      • Counterparty is a U.S. Person other than a Foreign Branch; or
      • Counterparty is a non-U.S. Person and the transaction is solicited, negotiated or executed, on behalf of both counterparties, within the U.S.
  o Public Reporting –
    ▪ Required unless all of the following conditions are met:
      • Counterparty is:
        o with respect to Foreign SBSDs, a non-U.S. Person whose obligations are not guaranteed by a U.S. Person, and
        o with respect to Foreign MSBSPs, either a non-U.S. Person or a Foreign Branch;
      • Transaction is conducted outside the U.S.; and
      • Transaction is not cleared through a clearing agency having its principal place of business in the U.S.
    ▪ Substituted compliance: Permitted wherever substituted compliance is permitted for regulatory reporting.

The regulatory reporting and public reporting requirements discussed above address the question of whether or not a transaction must be reported. Separate from this inquiry is the question of who is required to report the transaction. Under the Proposed Rules, a non-U.S. Person who is not a Foreign SBSD or a Foreign MSBSP would not have an obligation to report swap data relating to any transaction that is not conducted within the U.S. (although the counterparty might have a duty to report such data in the circumstances set forth above). The SEC has not yet addressed potential conflicts between the obligation to report counterparty identity and foreign privacy laws, and has requested comments on this matter.

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At this time, there is still no certainty as to how the Dodd-Frank Act will ultimately be applied to either security-based swap activities generally or to cross-border security-based swap activities. In addition to soliciting comments on over 630 points concerning the Proposed Rules described above, the SEC has reopened the comment period for all other proposed rules concerning security-based swaps.
This summary is intended to provide general information only on the matters presented. It is not a comprehensive analysis of these matters and should not be relied upon as legal advice.

For further information about the proposed rules regarding cross-border security-based swap activities or about any other aspect of security-based swaps, please contact Janet R. Murtha, Partner at Wuersch & Gering LLP, at 212-509-6314 or by email at janet.murtha@wg-law.com.