CLIENT UPDATE

SEC PROPOSED CROSS-BORDER RULES AND GUIDANCE ON SECURITY-BASED SWAP ACTIVITIES

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On May 23, 2011, the Securities and Exchange Commission (the "SEC") published in the Federal Register its proposed rules and interpretive guidance (the "Proposed Rules") addressing the cross-border application of the security-based swap regulatory framework established under the Securities Exchange Act of 1934 (the "Exchange Act"), as amended by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

The Proposed Rules address issues relating to cross-border activities with respect to: security-based swap dealers ("SBSDs"), major security-based swap participants ("MSBSPs"), security-based swap clearing agencies ("SCAs"), security-based swap data repositories ("SDRs") and security-based swap execution facilities ("SEFs").

The Proposed Rules also address the application of certain transaction-related requirements in connection with reporting, clearing and trade execution to cross-border security-based swap activities and provide a framework under which the SEC may permit substituted compliance for security-based swap activities subject to certain foreign regulatory regimes.

The comment period for the Proposed Rules will end on August 21, 2013.[1]

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[1] The text of the Proposed Rules and the accompanying release can be found at: https://www.federalregister.gov/articles/2013/05/23/2013-10835/cross-border-security-based-swap-activities-re-proposal-of-regulation-sbsr-and-certain-rules-and

DEFINITION OF "U.S. PERSON"

The definition of "U.S. person" is the linchpin of the cross-border application of the Dodd-Frank Act regulatory regime for swaps and security-based swaps. In contrast to the definition of "U.S. person" proposed by the Commodity Futures Trading Commission (the "CFTC") with respect to swaps and the alternative definition temporarily implemented by the CFTC in a final exemptive order, the SEC defines "U.S. person" to mean:

- any natural person[2] resident in the United States;
- any partnership, corporation, trust or other legal person organized or incorporated under U.S. law or having its principal place of business in the United States; and
- any account (whether discretionary or non-discretionary) of a U.S. person.

Legal Persons. Under the Proposed Rules, a legal person's status as a U.S. person is determined at the legal entity-level and thus applies to the entire legal entity, including its branch, agency or office. The SEC notes that the risks posed by security-based swaps are borne by the entire corporate entity even if the transaction is entered into by a specific trading desk, office or branch of that entity.

However, the SEC proposes that the status of an entity as a U.S. person has no bearing on whether separately incorporated or organized legal entities in its affiliated corporate group are U.S. persons. Thus, a foreign subsidiary of a U.S. person will not be a U.S. person by virtue of its relationship with its U.S. parent, and a foreign entity with a U.S. subsidiary will not be a U.S. person simply by virtue of its relationship with its U.S. subsidiary.

Accounts. The Proposed Rules include as a U.S. person any account (whether discretionary or not) of a U.S. person, regardless of whether the entity at which the account is held or maintained is itself a U.S. person, including a joint account in which any owner is a U.S. person (in addition to individual accounts owned by a U.S. person). However, an account of a non-U.S. person will not be a U.S. person solely because it is held by a U.S. financial institution or other entity that is itself a U.S. person.

Regulatory Exclusions. The Proposed Rules exclude the following international organizations from the U.S. person definition: the International Monetary Fund, the International Bank for Reconstruction and Development, the Inter-American Development

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[2] Under the Proposed Rules, any natural person resident in the United States would be a U.S. person, regardless of such individual's citizenship status while individuals residing abroad would not be treated as U.S. persons even if they are U.S. citizens.

Bank, the Asian Development Bank, the African Development Bank, the United Nations, and their agencies and pension plans, and any similar international organizations, their agencies and pension plans.

Differences from CFTC Definition. The SEC notes that its proposed U.S. person definition is generally similar to the definition provided by the CFTC in its no-action letter No. 12-22, dated October 12, 2012, which has already expired, and in the time-limited final exemptive order (the "CFTC Temporary Exemptive Order"), which expires on July 12, 2013.[3] With respect to each of the differences from the CFTC definitions, the SEC solicits comments on whether it should adopt the broader definition of U.S. person as proposed by the CFTC.

Like the CFTC Temporary Exemptive Order, the Proposed Rules include within the scope of the term U.S. person: (1) a legal entity formed under laws outside the United States with a principal place of business in the United States and (2) a joint account owned, at least in part, by a U.S. person (in addition to individual accounts where the beneficial owner is a U.S. person).

However, in contrast to the definitions of "U.S. person" in both the CFTC no-action letter and the CFTC Temporary Exemptive Order, the SEC's definition does not specifically list pension plans, estates or trusts of any kind.

Additionally, the proposed interpretive guidance[4] issued by the CFTC in July 2012 (the "CFTC Cross-Border Proposal") defines "U.S. person" to include any commodity pool, pooled account or collective investment vehicle that is (1) majority-owned (directly or indirectly) by a U.S. person or (2) operated by a person required to register as a commodity pool operator under the Commodity Exchange Act. The additional proposed guidance issued by the CFTC in January 2013 (the "Further Cross-Border Guidance") replaces the first of these collective investment vehicle prongs with an alternative prong. Subject to an exception for collective investment vehicles that are publicly-traded but not offered to U.S. persons, this alternative prong includes any collective investment vehicle that is directly or indirectly majority-owned[5] by one or more of the following persons or

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3 *See* our client memorandum, "Further Guidance and Order with Respect to Cross-Border Application of CFTC Swap Regulation," http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=00a2b8f5-fb53-40da-a078-2803de8e39d1, noting certain differences between the "U.S. person" definitions in the CFTC Temporary Exemptive Order and the CFTC no-action letter.

4 See our client memorandum, "CFTC Issues Proposed Guidance on the Cross-Border Application of the Commodity Exchange Act to Swap Transactions," http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=fd521022-999e-414b-a384-bc17a2190a63

5 For purposes of this alternative prong, the CFTC has proposed that "majority-owned" be defined as "beneficial ownership of 50 percent or more of the equity or voting interests in the collective investment vehicle."

entities ("Specified U.S. Persons"): (1) natural persons resident in the United States or (2) legal entities that are either organized or incorporated under U.S. law or, for all entities other than funds or collective investment vehicles, having their principal place of business in the United States. The SEC definition of "U.S. person" does not include an equivalent provision covering such collective investment vehicles.

Finally, the CFTC Cross-Border Proposal defines "U.S. person" to include a legal entity in which the direct or indirect owners thereof are responsible for the liabilities of the entity and one or more of such owners is a U.S. person. In its Further Cross-Border Guidance, the CFTC has proposed to limit the scope of this prong to any legal entity that is directly or indirectly majority-owned by one or more Specified U.S. Persons (as opposed to U.S. persons generally) and in which such Specified U.S. Person(s) bears unlimited responsibility for the obligations and liabilities of the legal entity, subject to an exception for limited liability companies and limited liability partnerships in which partners have limited liability. The SEC definition does not have an equivalent provision to include such an entity.

SECURITY-BASED SWAP DEALERS

Definition of "Security-Based Swap Dealer"

Section 3(a)(71) of the Exchange Act[6] defines "security-based swap dealer" as a person that (1) holds itself out as a dealer in security-based swaps, (2) makes a market in security-based swaps, (3) regularly enters into security-based swaps with counterparties as an ordinary course of business for its own account or (4) engages in any activity causing it to be commonly known in the trade as a dealer or market maker in security-based swaps.

In April 2012, the SEC, jointly with the CFTC, issued final rules and interpretive guidance further defining certain terms, including the term "security-based swap dealer" (the "Entity Definition Rules"),[7] setting forth a *de minimis* threshold of security-based swap dealing that takes into account the notional amount of security-based swap positions connected with a person's dealing activity over the prior 12 months. A person must register with the SEC as an SBSD only if its security-based swap dealing activities exceed that *de minimis* threshold.

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6 Unless otherwise specified, all section references are to sections of the Exchange Act.

7 See our client memorandum, "CFTC and SEC Release Joint Final Rule on Key Entity Definitions in Title VII of the Dodd-Frank Act," http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=4ed74ee3-8bb2-4efc-9236-b6affd903e98

In the Proposed Rules, the SEC provides guidance on how security-based swap activities involving non-U.S. persons should be accounted for in applying the *de minimis* threshold.

Registration Requirement and Cross-Border Activities

Proposed Approach for Non-U.S. Persons' Dealing Activities

The Proposed Rules provide that a non-U.S. person must register as an SBSD if the notional amount of security-based swap positions connected with its dealing activity with U.S. persons (excluding activities with "foreign branches" of U.S. banks) or otherwise conducted within the United States exceeds the relevant *de minimis* threshold (taking into account certain affiliate transactions, as discussed below).

The Proposed Rules do not require a non-U.S. person engaged in security-based swap dealing activity to count a transaction with a non-U.S. person conducted outside the United States towards its *de minimis* threshold, even if its performance (or that of its counterparty) is guaranteed by a U.S. person. In contrast to the SEC proposal, the CFTC Cross-Border Proposal requires a non-U.S. person to consider the aggregate notional value of its swap dealing transactions (or any swap dealing transactions of its affiliates under common control) where such non-U.S. person's obligations are guaranteed by a U.S. person.

Proposed Approach for U.S. Persons' Dealing Activities

The Proposed Rules provide that a U.S. person must count all of its security-based swap transactions connected with its dealing activity (including those conducted through a foreign branch and certain affiliate transactions, as discussed below) toward the *de minimis* threshold to determine whether it is required to register, regardless of where those transactions are solicited, negotiated, executed or booked. The SEC declined to propose an approach suggested by some commenters that would permit U.S. persons to exclude positions connected with dealing activity conducted through its foreign branches from this calculation.

Transaction Conducted Within the United States

In contrast to the CFTC's proposal, the SEC proposes that, for purposes of the *de minimis* threshold, a non-U.S. person must include in its calculation security-based swap dealing activities facing another non-U.S. person if such activities are deemed to have been "conducted within the United States."

For purposes of this requirement, a security-based swap transaction is "conducted within the United States" if it 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. However, transactions conducted through a foreign branch of a U.S. bank will not be considered to be "conducted within the United States."

In the absence of other relevant factors for the determination, the Proposed Rules do not treat the following as activities that will cause a transaction to be deemed to be "conducted within the United States": submitting a transaction for clearing in the United States, reporting a transaction to an SDR in the United States, or activities related to collateral management (*e.g.*, margin payments) occurring in the United States or involving U.S. banks or custodians.

Further, the SEC notes that non-U.S. persons engaged in cross-border dealing activities will be required to include in their *de minimis* calculations the notional amount of any security-based swap position connected with such entity's dealing activity with another non-U.S. person, if a U.S. branch or office of either counterparty, or an associated person of either counterparty (including an affiliate and an associated person of an affiliate, or a third party agent, located in the United States) is directly involved in the transaction. In other words, a non-U.S. person engaged in security-based swap dealing activity will be required to count toward its *de minimis* threshold any dealing transaction entered into with a non-U.S. person counterparty that was conducted in the United States, whether the transaction falls within the "conducted within the United States" definition through such non-U.S. person's own activity (or that of an agent within the United States), or that of its non-U.S. person counterparty (or such counterparty's agent).

In practice, for purposes of determining whether a transaction is "conducted within the United States," the Proposed Rules allow parties to rely on a representation received from a counterparty indicating that a given transaction "is not solicited, negotiated, executed, or booked within the United States by or on behalf of such counterparty." A party may rely on such a representation by its counterparty unless the party knows that the representation is not accurate.

Proposed Treatment of Transactions with Foreign Branches of U.S. Banks

As noted above, the SEC permits a non-U.S. person to exclude from its *de minimis* calculation any security-based swap transaction with a foreign branch of a U.S. bank (the "Foreign Branch Exception"). The Proposed Rules define "foreign branch" as any branch of a U.S. bank if the branch (1) is located outside the United States, (2) operates for valid

business reasons and (3) is engaged in the business of banking and is subject to substantive banking regulation in the jurisdiction where located.

Under the Proposed Rules, in order for a transaction to be excluded from a non-U.S. person's *de minimis* calculation as being conducted through a foreign branch, the foreign branch must be the named counterparty to the transaction and the transaction must not be solicited, negotiated or executed by a person within the United States on behalf of the foreign branch or its counterparty. To the extent that the transaction is conducted within the United States (whether on behalf of the U.S. bank to which the branch belongs or of the foreign counterparty), the non-U.S. person will be required to count such transaction toward its *de minimis* threshold for purposes of determining whether it is required to register as an SBSD.

For purposes of the Foreign Branch Exception, the Proposed Rules permit parties to rely on a representation received from a counterparty indicating that "no person within the United States is directly involved in soliciting, negotiating, executing, or booking" a given transaction on behalf of the counterparty. A person may rely on such a representation by its counterparty unless the party knows that the representation is not accurate.

Proposed Rule Regarding Aggregation of Affiliate Positions

In the Entity Definitions Rule, the SEC and the CFTC jointly stated that the notional thresholds in the *de minimis* exception encompass swap and security-based swap dealing positions entered into by an affiliate controlling,[8] controlled by or under common control with the person at issue.

The Proposed Rules generally require aggregation of the security-based swap dealing transactions of all affiliates (without regard to their status as U.S. persons or non-U.S. persons) of a person for purposes of its *de minimis* determination, except that a person is not required to include the security-based swap transactions of a U.S. person affiliate or a non-U.S. person affiliate where such affiliate is itself a registered SBSD as long as that the dealing activity of such person is operationally independent of the dealing activity of the registered SBSD.

Specifically, the Proposed Rules provide that, in determining whether a person's dealing activities exceed the *de minimis* threshold, such person must aggregate:

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[8] "Control" means, for these purposes, the possession (direct or indirect) of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract or otherwise.

- all of the security-based swap dealing positions entered into by any U.S. person controlling, controlled by or under common control with such person (a "U.S. person affiliate"), including transactions conducted through a foreign branch but excluding positions of a U.S. person affiliate that is a registered SBSD; and
- all of the security-based swap dealing positions entered into by any non-U.S. person controlling, controlled by or under common control with such person (a "non-U.S. person affiliate") that are entered into with U.S. persons (other than a foreign branch) or that are transactions conducted within the United States,[9] excluding positions of a non-U.S. person affiliate that is a registered SBSD.

However, the SEC notes that the exclusion of the dealing activities of the registered SBSD affiliates will be limited to circumstances where a person's security-based swap activities are operationally independent from those of its registered SBSD affiliates and that the security-based swap activities of two affiliates are considered operationally independent if the two affiliates maintain separate sales and trading functions, operations (including separate back offices) and risk management with respect to any such activity conducted by either affiliate that is required to be counted towards their *de minimis* thresholds.

The Proposed Rules also provide that a person is not required to aggregate transactions of affiliates that are themselves non-U.S. persons with other non-U.S. persons (or foreign branches) outside the United States.

The SEC clarifies that, under its proposal, if the aggregate security-based swap dealing activity of an affiliated group, calculated as described above, exceeds the *de minimis* threshold, each affiliate within such group that engages in security-based swap dealing activity included in such calculation will be required to register as an SBSD, subject to an exclusion of the dealing positions of a registered SBSD affiliate.

The CFTC Cross-Border Proposal permits a non-U.S. person engaged in dealing activity with U.S. persons to exclude from its *de minimis* calculation the swap dealing positions of any U.S. person affiliate (though such positions will still need to be aggregated separately from the swap dealing positions of any non-U.S. affiliates and counted towards such affiliated U.S. person's *de minimis* threshold). Additionally, the CFTC Temporary Exemptive Order permits a non-U.S. person to exclude from its *de minimis* calculation the swap dealing positions of an affiliated non-U.S. person registered as a swap dealer ("SD") and not guaranteed by a U.S. person with respect to its swap obligations. The SEC solicits

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[9] The SEC notes that, under the Proposed Rules, such affiliates would be required to count such transactions toward their own respective *de minimis* thresholds in accordance with the proposed approach described above.

comment as to whether it should adopt a similar approach with respect to SBSD registration.

Proposed Treatment of Inter-Affiliate and Guaranteed Transactions

Consistent with the approach taken in the Entity Definitions Rules, the Proposed Rules do not require that cross-border security-based swap transactions between majority-owned affiliates be considered when determining whether a person is an SBSD (*i.e.*, a person cannot be considered to be a dealer to its affiliates).[10]

Moreover, the Proposed Rules do not require a non-U.S. person that receives a U.S. person's guarantee of its performance on security-based swaps with non-U.S. persons outside the United States to count its dealing transactions with such non-U.S. persons toward the *de minimis* threshold; however, the U.S. person guarantor will be required to do so.[11]

The Proposed Rules also do not require a non-U.S. dealer to count security-based swap transactions with non-U.S. persons that receive guarantees from U.S. persons towards the *de minimis* threshold.

The CFTC Cross-Border Proposal subjects an entity that operates a "central booking system" where swaps are booked into a single legal entity to any applicable SD registration requirement as if it had entered into such swaps directly, regardless of whether such entity is a U.S. person or whether the booking entity is a counterparty to the swap or enters into the swap indirectly through a back-to-back swap or other arrangement with its affiliate. The SEC solicits comments as to whether it should adopt a similar approach.

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[10] Thus, under the Proposed Rules, a non-U.S. person engaged in dealing activity outside the United States can disregard its security-based swaps with its majority-owned U.S. affiliate, including back-to-back transactions in which the non-U.S. subsidiary acts as a "conduit" for the U.S. person. Similarly, a U.S. person will not be required to register as an SBSD as a result of back-to-back transactions with a non-U.S. subsidiary acting as a conduit for such U.S. person. This approach differs from the treatment of conduits in the CFTC Cross-Border Proposal, under which a U.S. entity may be required to register as an SD as a result of its swaps with an affiliated foreign dealer if such foreign dealer acts as a conduit by transferring swaps to the U.S. entity through back-to-back transactions.

[11] This approach differs from the treatment of guaranteed entities in the CFTC Cross-Border Proposal, under which a non-U.S. person that receives a guarantee from a U.S. person is required to count all of its swap dealing transactions against the *de minimis* threshold.

REGULATION OF SECURITY-BASED SWAP DEALERS

Generally

The Proposed Rules provide that the external business conduct standards and segregation requirements in the Dodd-Frank Act do not apply to the "foreign business" of a registered foreign SBSD or of a registered U.S. SBSD, subject to a limitation relating to diligent supervision, discussed below.

The Proposed Rules define "foreign business" as the security-based swap transactions entered into, or offered to be entered into, by or on behalf of a foreign SBSD or a U.S. SBSD, other than the U.S. business of such entities.

"U.S. business" is defined as:

- with respect to a foreign SBSD, (a) any transaction entered into, or offered to be entered into, by or on behalf of such foreign SBSD, with a U.S. person (other than a foreign branch), or (b) any transaction conducted within the United States; and
- with respect to a U.S. SBSD, any transaction by or on behalf of such U.S. SBSD, wherever entered into or offered to be entered into, other than a transaction conducted through a foreign branch with a non-U.S. person or another foreign branch.

Under the Proposed Rules, whether the activity occurred within the United States or with a U.S. person for purposes of identifying whether security-based swap transactions are part of a U.S. business or foreign business will turn on the same factors used to determine whether a foreign SBSD is engaging in dealing activity within the United States or with U.S. persons, as described above. The Proposed Rules provide that a U.S. SBSD will be considered to have conducted a security-based swap transaction through a foreign branch if (1) the foreign branch is the counterparty to such transaction and (2) no person within the United States is directly involved in soliciting, negotiating or executing the transaction on behalf of the foreign branch or its counterparty.

While certain Dodd-Frank Act requirements applicable to SBSDs apply at the transaction level (*e.g.*, the external business conduct standards, segregation of assets), other requirements apply at the entity level (*e.g.*, capital, risk management, recordkeeping and reporting, supervision and designation of a chief compliance officer). Some requirements, such as the margin requirement in section 15F(e), may be considered both entity-level and transaction-level requirements.

Transaction-Level Requirements

External Business Conduct Standards

The SEC has proposed Rules 15Fh-1 through 15Fh-6 under the Exchange Act to implement external business conduct requirements and certain other requirements.[12]

The Proposed Rules exempt a registered foreign SBSD and a foreign branch of a registered U.S. SBSD, with respect to their foreign business, from the external business conduct requirements, with the exception that the foreign SBSDs must remain in compliance with such business conduct standards relating to diligent supervision as the SEC may prescribe. However, as discussed below, the Proposed Rules permit substituted compliance with this diligent supervision requirement by foreign SBSDs.

Additionally, the Proposed Rules exempt foreign SBSDs from complying with the rules and regulations prescribed by the SEC pursuant to sections 15F(h)(1)(A) or (C), which, respectively, require SBSDs to (1) conform with such business conduct standards relating to fraud, manipulation and other abusive practices involving security-based swaps and (2) adhere to applicable position limits.[13]

Under the Proposed Rules, all other external business conduct standards requirements will apply to both U.S. and foreign SBSDs registered with the SEC, although the SEC has proposed to establish a framework under which it will consider permitting substituted compliance for foreign SBSDs (but not for U.S. SBSDs conducting dealing activity through foreign branches) under certain circumstances as discussed below.

Further, the SEC proposes that it will not subject U.S. SBSDs to most of the external business conduct standards in section 15F(h) with respect to security-based swap transactions conducted through their foreign branches outside the United States with non-U.S. counterparties.

Segregation of Assets

The SEC is mandated to prescribe segregation requirements for SBSDs that receive assets from, for or on behalf of a counterparty ("customer collateral") to margin, guarantee or

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[12] These additional rules would impose certain "know your counterparty" and suitability obligations on SBSDs, as well as restrict SBSDs from engaging in certain "pay to play" activities.

[13] The SEC notes that it has not engaged in rulemaking pursuant to these provisions but that if it does so in the future, it will consider, at that time, whether to subject foreign SBSDs to such requirements with respect to their foreign business.

secure a security-based swap transaction.[14] The SEC has proposed Rule 18a-4(a)-(d) under the Exchange Act to establish segregation requirements for SBSDs with respect to both cleared and non-cleared security-based swap transactions.[15]

The Proposed Rules provide an exemption for foreign SBSDs from compliance with the segregation requirements set forth in section 3E and proposed Rule 18a-4(a)-(d) (collectively, the "SBSD segregation requirements"), with respect to security-based swap transactions with non-U.S. person counterparties in certain circumstances. Specifically, the Proposed Rules provide the following:[16]

- With respect to non-cleared security-based swap transactions:
  - a registered foreign SBSD that is a registered broker-dealer is subject to the SBSD segregation requirements with respect to all customer collateral; and
  - a registered foreign SBSD that is not a registered broker-dealer is subject to the SBSD segregation requirements only with respect to customer collateral received from, for or on behalf of a U.S. person counterparty.
- With respect to cleared security-based swap transactions:
  - a registered foreign SBSD that is not a foreign bank with a branch or agency in the United States and is a registered broker-dealer is subject to the SBSD segregation requirements with respect to all customer collateral;
  - a registered foreign SBSD that is not a foreign bank with a branch or agency in the United States and that is not a registered broker dealer is subject to the SBSD

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14 Section 3E(c) authorizes the SEC to prescribe how any margin received by an SBSD with respect to cleared security-based swaps may be maintained, accounted for, treated and dealt with by the SBSD. Additionally, section 3E(g) extended the customer protections of the U.S. Bankruptcy Code to counterparties of an SBSD with respect to cleared security-based swaps, and with respect to non-cleared security-based swaps, under certain circumstances.

15 Specifically, proposed Rule 18a-4(b) requires an SBSD to promptly obtain and maintain physical possession or control of all excess securities collateral carried for the accounts of security-based swap customers. Proposed Rule 18a-4(c) requires an SBSD to maintain a special account for the exclusive benefit of security-based swap customers and have on deposit in that account at all times an amount of cash or qualified securities determined by computing the net amount of credits owed to customers. The Proposed Rules provide that the special account maintained by a registered foreign SBSD that is not a registered broker-dealer or by a registered foreign SBSD that is a foreign bank with a branch in the United States must be designated for the exclusive benefit of U.S. person security-based swap customers. Finally, with respect to non-cleared security-based swaps, proposed Rule 18a-4(d) requires an SBSD to provide the notice required under section 3E(f)(1)(A) to a counterparty in writing prior to the execution of the first non-cleared security-based swap transaction with such counterparty. If a counterparty to a non-cleared security-based swap elects to segregate funds or other property with a third-party custodian pursuant to section 3E(f) or elects not to require the omnibus segregation of funds or other property pursuant to proposed Rule 18a-4(c), the SBSD must obtain an agreement from such counterparty to subordinate all claims against the SBSD to the claims of security-based swap customers of such SBSD.

16 The Proposed Rules provide that "assets received . . . to margin" a security-based swap include, in all cases, money, securities or property accruing to the relevant counterparty as a result of the relevant security-based swap.

segregation requirements with respect to all customer collateral if such registered foreign SBSD accepts customer collateral from, for or on behalf of a U.S. person counterparty; and

- a registered foreign SBSD that is a foreign bank with a branch or agency in the United States is subject to the SBSD segregation requirements only with respect to customer collateral received from, for or on behalf of a U.S. person counterparty.[17]

Entity-Level Requirements

Background on Entity-Level Requirements

Pursuant to its authority under Section 15F, the SEC has proposed the following "internal business conduct" rules: (1) capital and margin requirements[18] for non-cleared security-based swaps and risk management requirements for SBSDs for which there is not a prudential regulator[19] ("nonbank SBSDs"); (2) a requirement that an SBSD establish policies and procedures for obtaining certain information; (3) a "diligent supervision" requirement; (4) a requirement that an SBSD establish a system for avoiding conflicts of interest; (5) a requirement that an SBSD designate a chief compliance officer; (6) a requirement that "nonresident" SBSDs required to register with the SEC appoint an agent in the United States for service of process and provide the SEC with a legal opinion regarding access to its books and records and its ability to submit to onsite inspection and examination; and (7) a requirement that SBSDs (and MSBSPs) certify that no person effecting security-based swaps on their behalf is subject to statutory disqualification, as defined in section 3(a)(39).

Also, while the SEC has not yet proposed rules in this regard, section 15F requires the SEC to prescribe rules or regulations requiring registered nonbank SBSDs and registered bank SBSDs to keep books and records of all activities related to their dealer activities.

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17 The Proposed Rules also require foreign SBSDs to disclose to each U.S. person counterparty, prior to accepting any customer collateral, the potential treatment of the assets segregated by such foreign SBSD pursuant to the requirements in section 3E, in insolvency proceedings relating to such foreign SBSD under U.S. bankruptcy law and applicable foreign insolvency laws. Specifically, the Proposed Rules require that a foreign SBSD disclose whether: (1) it is subject to such segregation requirement with respect to the assets collected from the U.S. counterparty; (2) it could be subject to the stockbroker liquidation provisions of the U.S. Bankruptcy Code, and (3) the segregated assets could be afforded customer property treatment under U.S. bankruptcy law and any other relevant considerations that may affect the treatment of the segregated assets in insolvency proceedings of a foreign SBSD.

18 The SEC acknowledges that its approach to margin differs from the approach proposed in the CFTC Cross-Border Proposal, which treat margin requirements for uncleared swaps as a transaction-level requirement only.

19 If an SBSD is directly supervised by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration or the Federal Housing Finance Agency, such agency is the SBSD's "prudential regulator."

Proposed Application of Entity-Level Requirements

The SEC proposes to treat the foregoing "internal business conduct" requirements as entity-level requirements since they primarily address concerns relating to an SBSD as a whole, with a particular focus on safety and soundness of the entity to reduce systemic risk in the U.S. financial system. The Proposed Rules therefore apply such requirements on a firm-wide basis.

The Proposed Rules do not provide specific relief for foreign SBSDs from these entity-level requirements. However, under an SEC substituted compliance determination, a foreign SBSD (or class thereof) may satisfy such "internal business conduct" requirements by complying with corresponding requirements established by a foreign financial regulatory authority.

Comparison to CFTC Approach

The CFTC Cross-Border Proposal effectively treats a non-U.S. person whose obligations are guaranteed by a U.S. person as a U.S. person for purposes of determining whether a swap between it and a non-U.S. SD or major swap participant ("MSP") will be subject to transaction-level requirements as interpreted by the CFTC to include, without limitation, margin, segregation, reporting, clearing and trade execution requirements.

Additionally, the CFTC Cross-Border Proposal provides that "conduit affiliates" are subject to transaction-level requirements as if they are U.S. persons, and defines "conduit affiliate" to include (1) a non-U.S. person that is majority-owned by a U.S. person where (2) the non-U.S. person regularly enters into swaps with one or more U.S. affiliates of the U.S. person and (3) the financial statements of the non-US. Person are included in the consolidated financial statements of the U.S. person.

Finally, the CFTC Cross-Border Proposal will subject foreign branches of U.S.-based SDs and MSPs to the CFTC's entity-level and transaction-level requirements (other than external business conduct standards for swaps with non-U.S. persons), subject to a limited exception for foreign branches in emerging markets where foreign regulations are not comparable.

The SEC solicits comments as to whether it should adopt a similar approach with respect to each of these three CFTC proposals.

No Proposed Rules on Intermediation

The SEC has not proposed any specific rules regarding security-based swap dealing activities undertaken through "intermediation," a term used generally to refer to origination activity (*e.g.*, solicitation and negotiation of transactions) in connection with security-based swaps. The SEC expects many foreign SBSDs will operate within the U.S. market by utilizing U.S. affiliates or other U.S. entities as agents in the United States, while booking transactions facilitated by such U.S. personnel in a central booking entity located abroad. The SEC notes that while a foreign SBSD could use a non-SBSD agent, the foreign SBSD would still be responsible for ensuring compliance with all Dodd-Frank Act and other securities law requirements applicable to SBSDs, regardless of whether the regulated activities were carried out by the foreign SBSD or its non-SBSD agent.

Registration Application Re-Proposal

The SEC has previously proposed Form SBSE, Form SBSE-A and Form SBSE-BD relating to the registration of SBSDs and MSBSPs. Forms SBSE-A and SBSE-BD are shorter forms that have been modified to provide a more streamlined application process for entities that are already registered or registering with the CFTC or with the SEC as a broker-dealer.

In order to address its proposed rule regarding substituted compliance, the SEC has added certain questions to Forms SBSE, SBSE-A and SBSE-BD and has thus re-proposed these forms. The re-proposed forms require an applicant to seek to avail itself of an existing substituted compliance determination at the time it files its SBSD registration application by providing certain information including information on its local primary regulator and a proposed method to implement substituted compliance. Additional information must be provided if an applicant is a U.S. branch of a non-resident entity.

MAJOR SECURITY-BASED SWAP PARTICIPANTS

Background

Section 3(a)(67) defines "major security-based swap participant" as a person that is not an SD and (1) that maintains a substantial position in security-based swaps for any of the major security-based swap categories, subject to certain exclusions for positions that hedge or mitigate risk; (2) whose outstanding security-based swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or (3) that is a highly leveraged financial entity that is not subject to capital requirements established by a federal banking agency and maintains a substantial position in outstanding security-based swaps in any

major category. The SEC and the CFTC have provided further guidance defining this term in the Entity Definition Rules.[20]

Registration Requirement

Generally

The Proposed Rules require that, when determining whether a person falls within the MSBSP definition, a U.S. person[21] must calculate its security-based swap positions under the three prongs of the MSBSP definition taking into account all of its security-based swap transactions, while a non-U.S. person must make such calculations based solely on transactions entered into with U.S. persons, including foreign branches of U.S. banks. Any security-based swap transactions between two non-U.S. persons, regardless of whether they are conducted within the United States or whether the counterparties are guaranteed by a U.S. person, will be excluded from the MSBSP analysis.[22]

Guarantees

The SEC and the CFTC noted in the adopting release accompanying the Entity Definitions Rules (the "Entity Definitions Release") that, as a general principle, an entity's security-based swap positions are attributed to a parent, other affiliate or guarantor for purposes of the MSBSP analysis to the extent that counterparties have recourse to the parent, other affiliate or guarantor in connection with the position.

The SEC proposes that all security-based swaps entered into by a non-U.S. person and guaranteed by a U.S. person must be attributed to such U.S. person guarantor for purposes of determining such guarantor's MSBSP status, regardless of whether the underlying transaction was entered into with a U.S. person or non-U.S. person counterparty.

Subject to certain limited exceptions discussed in the Entity Definitions Release, a non-U.S. person providing a guarantee on performance of the security-based swap obligations of a U.S. person must attribute to itself all of the U.S. person's security-based swap positions

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20 See our client memorandum, "CFTC and SEC Release Joint Final Rule on Key Entity Definitions in Title VII of the Dodd-Frank Act, http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=4ed74ee3-8bb2-4efc-9236-b6affd903e98

21 The Proposed Rules would use the same definition of U.S. person described above in the context of SBSDs.

22 The SEC notes that its approach to the MSBSP definition differs from its approach to the SBSD definition because the statutory definition of MSBSP focuses specifically on risk, while the SBSD focuses not only on risk but also on the nature of the activities undertaken by an entity, its interactions with counterparties and its role within the security-based swap market.

that are so guaranteed for purposes of determining its MSBSP status. By contrast, subject to certain limited exceptions described below, where a non-U.S. person guarantees performance on the security-based swap transactions of other non-U.S. persons, the non-U.S. guarantor need only attribute to itself such guaranteed transactions entered into with U.S. person counterparties for purposes of determining its MSBSP status.

The Entity Definitions Release provides interpretive guidance that even in the presence of a guarantee, it is not necessary to attribute a person's swap or security-based swap positions to a parent or other guarantor if the person already is subject to capital regulation by the CFTC or the SEC (*i.e.*, SDs, SBSDs, MSPs, MSBSPs, futures commission merchants and broker-dealers) or if the person is a U.S. entity regulated as a bank in the United States. In expanding this interpretation, the SEC proposes to interpret that it is not necessary to attribute a non-U.S. person's security-based swap positions to a parent or other guarantor if such non-U.S. person is already subject to capital regulation by the CFTC or the SEC.

Further, the Proposed Rules do not require attribution of a non-U.S. person's security-based swap positions to its guarantor if such non-U.S. person is subject to capital standards adopted by its home country supervisor that are consistent in all respects with the capital standards such non-U.S. person would be subject to if it were a bank subject to the prudential regulators' capital regulation (even when such non-U.S. person is not subject to capital regulation by the CFTC or the SEC). Specifically, to avoid attribution, the home country's capital standards must be consistent in all respects with the Capital Accord of the Basel Committee on Banking Supervision (the "Basel Accord").

Finally, the SEC states that the principle set forth in the Entity Definitions Release regarding delegation of operational compliance should continue to apply even when the guarantor and the guaranteed person are located in different jurisdictions (*i.e.*, an entity that becomes an MSBSP by virtue of security-based swaps entered into by others may delegate operational compliance with transaction-focused requirements, but not entity-level requirements, to entities that directly are party to the transaction).

Regulation of MSBSP

The Proposed Rules exempt non-U.S. MSBSPs from certain transaction-level requirements with respect to their security-based swap transactions with non-U.S. persons. Specifically, registered foreign MSBSPs are not subject to the requirements relating to business conduct standards described in section 15F(h) with respect to their transactions with non-U.S. persons (other than the rules relating to diligent supervision).

Additionally, registered foreign MSBSPs that are not registered broker-dealers need not comply with collateral segregation requirements with respect to customer collateral of non-U.S. person counterparties. On the other hand, the SEC determines that a registered foreign MSBSP should be required to adhere to the entity-level requirements.

Finally, the SEC notes that, in light of the limited information available, it has not proposed to establish a framework for substituted compliance by a foreign MSBSP. However, the SEC states that it will continue to consider the appropriateness of permitting substituted compliance for MSBSPs in light of comments received and further market developments.

SECURITY-BASED SWAP CLEARING AGENCIES, SWAP DATA REPOSITORIES AND SWAP EXECUTION FACILITIES

Security-Based Swap Clearing Agencies

Clearing agencies that use interstate commerce to perform the functions of a clearing agency with respect to security-based swaps must register with the SEC as an SCA. The SEC has proposed interpretive guidance providing that an SCA must register with the SEC if it performs the functions of a central clearing counterparty ("CCP")[23] within the United States, and that an SCA performs such functions within the United States if it provides such services to a member that is a U.S. person.

The SEC anticipates that some U.S. persons may choose to clear transactions at a foreign SCA on an indirect basis through a correspondent clearing arrangement with a non-U.S. member of the clearing agency and that such an arrangement will not cause the foreign SCA to be required to register with the SEC since its business will be conducted outside the United States.

Additionally, the SEC states that it may consider an exemption from registration where the clearing agency is subject to comparable, comprehensive supervision and regulation by appropriate government authorities in its home country, and the nature of the clearing agency's activities and performance of functions within the United States suggest that

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[23] The SEC states that, although technology and risk management practices frequently change and vary from CCP to CCP, the following are some of the functions performed by the subset of clearing agencies that are CCPs: (1) the extinguishing of a security-based swap contract between two counterparties and the associated novation of it with two new contracts between the CCP and each of the original counterparties; (2) the assumption of counterparty credit risk of CCP members through the novated contracts; (3) the calculation and collection of initial and variation margin during the life of the contract; (4) the determination of settlement obligations and defaults under the contract; (5) the collection from members of contributions to a clearing fund; (6) the implementation of a loss-sharing arrangement among members to respond to member insolvency or default; and (7) the multilateral netting of trades.

registration is not necessary to achieve the SEC's regulatory objectives. However, the SEC has not specified how such determinations might be made.[24]

Security-Based Swap Data Repositories

Background and Proposed Approach

Any person that directly or indirectly uses interstate commerce to perform the functions of an SDR[25] must register with the SEC as an SDR.[26] Although the SEC has previously proposed Rule 13n-1 governing the registration process for SDRs, which includes requirements for "non-resident" SDRs,[27] the SEC has not explained under what circumstances in the cross-border context a person performing the functions of an SDR will be required to register with the SEC and comply with the other requirements under section 13(n) (the "SDR Requirements").

The SEC proposes that a U.S. person performing SDR functions must register with the SEC and, unless an exemption applies, a non-U.S. person performing such functions within the United States must also register. The SEC offers the following non-exclusive list of activities of a non-U.S. person constituting performance of SDR functions within the United States:

- entering into contracts, such as user or technical agreements, with a U.S. person to enable the U.S. person to report security-based swap data to such non-U.S. person, or
- having operations in the United States, such as maintaining such data on servers physically located in the United States, even if its principal place of business is elsewhere.

However, a non-U.S. person performing the functions of an SDR within the United States can be exempt from registration and from the SDR Requirements if each regulator with supervisory authority over such non-U.S. person has entered into a supervisory and

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24 As an alternative to such an exemption in certain circumstances, the SEC may consider proposing rules specific to foreign-based CCPs that are registered with the SEC.

25 An SDR is defined as "any person that collects and maintains information or records with respect to transactions or positions in, or the terms and conditions of, security-based swaps entered into by third parties for the purpose of providing a centralized recordkeeping facility for security-based swaps."

26 The SEC clarifies that the Dodd-Frank Act reporting requirements and the re-proposed Regulation SBSR may be satisfied only by reporting to a registered SDR (*i.e.*, reporting to an unregistered entity is insufficient).

27 Section 13n-1(a)(2) under the Exchange Act defines non-resident SDR as (1) an individual that resides in or has his principal place of business outside of the United States; (2) a corporation incorporated or having its principal place of business outside of the United States; or (3) a partnership or other unincorporated organization or association having its principal place of business outside of the United States.

enforcement memorandum of understanding ("MOU") or other arrangement with the SEC that addresses the confidentiality of data collected and maintained by such non-U.S. person, access by the SEC to such data and any other matters determined by the SEC.[28]

Authorities' Access to Information and the Indemnification Requirement

Upon its request to and after notifying the SEC (the "Notification Requirement"),[29] an SDR may make available all data obtained by the SDR to each appropriate prudential regulator, the Financial Stability Oversight Council, the CFTC, the Department of Justice, the Federal Deposit Insurance Corporation (the "Domestic Authorities") and any other person the SEC designates, including foreign financial supervisors, foreign central banks and foreign ministries (together with the Domestic Authorities, the "Relevant Authorities"). However, before sharing information with a Relevant Authority, the SDR must obtain a written agreement from the Relevant Authority stating that it will abide by the confidentiality requirements in section 24, and the Relevant Authority must agree to indemnify the SDR and the SEC for expenses arising from litigation relating to such information (the "Indemnification Requirement").

The SEC currently contemplates that a Relevant Authority will be able to request an SEC determination that such Relevant Authority is appropriate for requesting such data from an SDR and that the SEC will grant or deny such a request, in its sole discretion, by issuing an order (which it could revoke at any time). This determination would be conditioned on a supervisory and enforcement MOU or other arrangement between the SEC and the Relevant Authority.[30]

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[28] The SEC anticipates that in determining whether to enter into an MOU or other arrangement with a relevant authority, it will consider (among other factors) whether: (1) the relevant authority would keep data collected and maintained by the non-U.S. person confidential, (2) the SEC would have access to such data, (3) the relevant authority agrees to provide the SEC with reciprocal assistance in securities matters within the SEC's jurisdiction and (4) such an MOU or other arrangement would be in the public interest.

[29] The Proposed Rules permit an SDR to fulfill the Notification Requirement by notifying the SEC, upon the initial request for security-based swap data by a Relevant Authority, of such request, and keeping records of all requests.

[30] The SEC anticipates that in determining whether to enter into such an arrangement with a Relevant Authority, it will consider (among other factors) whether: (1) the Relevant Authority has a legitimate need for the information to fulfill its regulatory mandate or legal obligations, (2) the Relevant Authority agrees to protect the confidentiality of such information, (3) the Relevant Authority agrees to provide the SEC with reciprocal assistance in securities matters within the SEC's jurisdiction and (4) such an arrangement would be in the public interest.

The SEC declined to prescribe by rule a specific process such as the one proposed by the CFTC[31] that sets forth criteria for Relevant Authorities and the SDR to use in order to facilitate Relevant Authorities' access to security-based swap data maintained by the SDR.

The SEC has proposed an exemption from the Indemnification Requirement permitting[32] the registered SDR to disclose security-based swap information without indemnifying the SEC or any SDR if:

- a Relevant Authority requests such information from the SDR to fulfill its regulatory mandate and/or legal responsibility;
- the request pertains to a person or financial product subject to the jurisdiction, supervision or oversight of the entity; and
- the Relevant Authority has entered into a supervisory and enforcement MOU or other arrangement with the SEC addressing the confidentiality of the information provided and any other matters as determined by the SEC.

Security-Based Swap Execution Facilities

Background and General Registration Requirement

A person is prohibited from operating a facility for the trading or processing of security-based swaps without being registered as an SEF[33] or a national securities exchange. The SEC notes that, when evaluating whether to require SEF registration by a foreign market, activities by such foreign market that provide U.S. persons, or non-U.S. persons located in the United States, the ability to directly execute or trade security-based swaps on the foreign market, or facilitate or induce such execution or trading by such persons on the foreign market, should be considered.

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31 Section 49.17(d) of the CFTC regulations requires any "Appropriate Domestic Regulator" ("ADR") or "Appropriate Foreign Regulator" ("AFR") requesting access to swap data maintained by a swap data repository to file a request for access. The repository then must promptly notify the CFTC of such request and provide the regulator access to the data. In order to qualify as an ADR or AFR, the regulator must (1) enter an MOU or similar arrangement with the CFTC or (2) be designated as such by the CFTC through an application process.

32 The SEC stresses that, where an SDR does not rely on this exemption, it should negotiate an indemnification agreement in good faith.

33 An "SEF" is defined as a trading platform in which multiple participants have the ability to execute or trade security-based swaps by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce, including any trading facility that (1) facilities the execution of security-based swaps between persons and (2) is not a national securities exchange.

The SEC proposes that such registration be required when a foreign market provides U.S. persons, or non-U.S. persons located in the United States, with the ability to directly trade or execute security-based swaps on the foreign market by accepting bids and offers made by participant(s) on the foreign market. The SEC has proposed the following non-exhaustive list of activities for which a foreign security-based swap market must register as an SEF: (1) providing U.S. persons, and non-U.S. persons located in the United States, with proprietary electronic screens, market terminals, monitors or other devices for trading on its market; (2) granting such persons direct electronic access to the foreign market's trade system or network; (3) allowing its members or participants to provide such persons with direct electronic access to trading on the foreign market; and (4) granting membership or participation to such persons.

The SEC notes that, where a U.S. person, or non-U.S. person located in the United States, chooses to transact on a foreign security-based swap market indirectly through a non-U.S. person located outside the United States that is a member or participant of the foreign market, such a transaction will not on its own require the foreign market to register as long as the U.S. person, or non-U.S. person located in the United States, initiates the contact and the foreign market does not attempt to solicit such business. However, to the extent the foreign market initiates contact to induce or facilitate such execution or trading on its market, it will be required to register.

Registration Exemption

The SEC notes that although a number of foreign jurisdictions are in the process of developing standards for the regulation of security-based swaps and associated markets, few jurisdictions have enacted legislation or adopted standards for such markets. To promote harmonization with foreign jurisdictions for future regulation, the SEC indicates that it may provide an exemption from SEF registration to a foreign market that is subject to comparable, comprehensive supervision and regulation by appropriate governmental authorities in its home country. This comparability determination may include a review of the foreign jurisdiction's laws, rules, regulatory standards and practices governing the foreign market, including not only written laws and rules but also the jurisdiction's comprehensive supervision and regulation of its security-based swap markets (*e.g.*, oversight of markets, enforcement of laws and rules).[34]

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[34] The SEC states that this process will entail consultation and cooperation with the foreign market's home country governmental authorities and may, depending on the level of differences among jurisdictions, necessitate that the SEC review each exemption request on a jurisdiction-by-jurisdiction basis. While the proposed comparability standard for granting an exemption from SEF registration could be similar to the proposed comparability standard for granting

Additionally, the SEC notes that such a registration exemption could be subject to certain conditions, including (without limitation): (1) that the foreign market appoint an agent for service of process in the United States who is not an SEC employee or official; (2) that the SEC and the appropriate financial regulator(s) in the foreign market's home jurisdiction enter into an MOU addressing the oversight and supervision of that market; and (3) that the foreign market (a) certify that it would provide the SEC with prompt access to its books and records and (b) provide a legal opinion that, as a matter of law, it is able to provide such access.

MANDATORY CLEARING AND TRADE EXECUTION REQUIREMENTS TO CROSS-BORDER ACTIVITIES

Application to Cross-Border Activities

Generally, a person may not "engage in a security-based swap" that is required to be cleared unless that person submits it for clearing to a clearing agency registered, or exempt from registration, under the Exchange Act. Further, counterparties executing security-based swaps subject to mandatory clearing must do so on an exchange or an SEF that is registered or exempt from registration (the "mandatory trade execution requirement"), unless an exception applies.

Specifically, subject to certain exceptions discussed below, the Proposed Rules apply the mandatory clearing requirement and the mandatory trade execution requirement to any person that engages in a security-based swap transaction:

- in which at least one counterparty is a U.S. person or a non-U.S. person whose performance under the security-based swap is guaranteed by a U.S. person; or
- if the transaction is a "transaction conducted within the United States," as defined above in the context of SBSD registration.[35]

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substituted compliance with respect to the mandatory trade execution requirement (discussed below), the SEC states that it may consider certain factors relevant in one context but not the other.

[35] In other words, the Proposed Rules apply the statutory language "engage in a security-based swap" to include any transaction in which a person performs any of the activities that are key stages in a security-based swap transaction (*i.e.*, solicitation, negotiation, execution or booking) within the United States.

Exceptions

The Proposed Rules include exceptions from mandatory clearing and mandatory trade execution in the following two scenarios:

- If the security-based swap is not a "transaction conducted within the United States": when (1) one counterparty is (a) a foreign branch of a U.S. bank or (b) a non-U.S. person whose performance is guaranteed by a U.S. person, and (2) the other counterparty is a non-U.S. person (a) whose performance is not guaranteed by a U.S. person and (b) who is not an SBSD.
- If the security-based swap is a "transaction conducted within the United States": when (1) neither counterparty is a U.S. person, (2) neither counterparty's performance is guaranteed by a U.S. person and (3) neither counterparty is a foreign SBSD.

SUBSTITUTED COMPLIANCE

General Framework

The Proposed Rules establish a policy and procedural framework under which the SEC will consider permitting compliance with comparable regulatory requirements in a foreign jurisdiction to substitute for compliance with requirements under the Exchange Act. The SEC clarifies that when a person is relying on substituted compliance, its failure to comply with the relevant foreign requirement would actually constitute a violation of the Exchange Act. Under the Proposed Rules and guidance, any person relying on a substituted compliance determination must comply with any conditions set forth in such determination.

The Proposed Rules permit substituted compliance determinations with respect to the following four categories of requirements:

- requirements applicable to SBSDs in section 15F,
- regulatory reporting and public dissemination requirements,
- clearing requirements and
- trade execution requirements.

With respect to each of these categories, the Proposed Rules set forth a "comparability" standard as the basis for making a substituted compliance determination. Generally, the SEC states that it will endeavor to take a "holistic approach" in making its determinations, focusing on regulatory outcomes as a whole with respect to requirements within the same

category rather than a rule-by-rule comparison. The SEC's proposal authorizes the SEC to make a substituted compliance determination with respect to one category of requirements but not another.

The Proposed Rules also provide that, in making a comparability determination with respect to any of the four categories of requirements, the SEC will consider such factors as it determines appropriate, including (without limitation): the scope and objectives of the relevant foreign regulatory requirements, the effectiveness of the supervisory compliance program administered, and the enforcement authority exercised, by the foreign regulatory authority or authorities in such system to support its oversight of such foreign SBSD (or class thereof), of the relevant reporting and public dissemination system for security-based swaps, of the foreign clearing agency or of the foreign security-based swap market (or class thereof), as applicable.

Process for Making Substituted Compliance Requests

The Proposed Rules set forth general procedures for submission of requests for substituted compliance determination. All applications[36] must be in writing in the form of a letter, including any supporting documents necessary to make the application complete.

Before issuing a substituted compliance determination with respect to SBSD requirements, reporting and public dissemination or the trade execution requirement, the Proposed Rules provide that the SEC must enter into a supervisory and enforcement MOU or other arrangement with the appropriate financial regulatory authority or authorities in that jurisdiction addressing oversight and supervision of applicable SBSDs (in the case of SBSD requirements) or applicable security-based swap markets (in the case of reporting and public dissemination or the trade execution requirement) subject to such determination.

The Proposed Rules and interpretive guidance permit the SEC to periodically review substituted compliance determinations it has granted for any of the four categories of requirements and, after appropriate notice and opportunity for comment, to modify the terms of, or withdraw, such a determination.

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[36] The SEC will not consider hypothetical or anonymous requests for a substituted compliance order and each application must contain the name, address, telephone number and email address of (1) each applicant and (2) a contact person to whom questions should be directed. In addition, the Proposed Rules require each applicant to provide the SEC with supporting documentation necessary for the SEC to make the requested determination, including information regarding applicable requirements established by the foreign regulatory authority, and the methods used by such authority to monitor compliance with, and enforce, such requirements. Finally, the Proposed Rules state that applicants should cite and discuss applicable precedent and that any amendments to an application must be submitted as set forth above with respect to the original application and marked to show changes.

Security-Based Swap Dealer Requirements

The Proposed Rules provide that, upon finding that the requirements of a foreign financial regulatory system are comparable to certain specified section 15F requirements, the SEC may, conditionally or unconditionally, by order, make a determination that compliance with such foreign requirements by a registered foreign SBSD (or class thereof) may satisfy the corresponding section 15F requirements.

The SEC notes that, depending on its assessment of the comparability of the foreign regime, the SEC may limit the substituted compliance determination to a particular class or classes of registrants in the foreign jurisdiction.[37]

While the Proposed Rules permit the SEC to make a substituted compliance determination with respect to one Dodd-Frank Act requirement applicable to SBSDs and not another, the SEC stresses that it intends generally to take a category-by-category approach, particularly where certain requirements are interrelated.[38]

Additionally, the Proposed Rules permit a foreign SBSD (or group thereof)[39] to file an application, pursuant to the procedures described above, requesting that the SEC make a substituted compliance determination for a foreign jurisdiction with respect to specified section 15F requirements, so long as the foreign SBSDs: (1) are directly supervised by a foreign regulatory authority in that jurisdiction with respect to requirements similar to the applicable section 15F requirements and (2) provide a certification and a legal opinion stating that the SBSDs can, as a matter of law, provide the SEC with prompt access to their books and records and can submit to onsite inspection and examination by the SEC. An application must provide the reasons for the request and any supporting documentation requested by the SEC.

The Proposed Rules provide that the SEC will not make substituted compliance determinations with respect to the registration requirements of section 15F.

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[37] As an example, the SEC notes that if the foreign jurisdiction imposes different levels of supervisory oversight with respect to classes of entities conducting dealing activity, the SEC could limit a substituted compliance determination to the classes for which oversight is robust.

[38] As an example, the SEC notes that since the entity-level regulations are highly interconnected, the SEC expects to make substituted compliance determinations on "the entire package of entity-level regulations." However, the SEC also notes that because the SEC is not responsible for the capital and margin regulation of bank SBSDs, any SEC substituted compliance determination for capital and margin requirements would extend only to nonbank SBSDs, whereas any such determination for other entity-level requirements would apply to all SBSDs.

[39] Although the request for a substituted compliance determination would come from a particular foreign SBSD or group thereof, the Proposed Rules would require the SEC to make such a determination on a class or jurisdiction basis, depending on the regulator(s) and the foreign regulatory regime (rather than on a firm-by-firm basis).

Regulatory Reporting and Public Dissemination

The Proposed Rules include a re-proposal of Regulation SBSR, which sets forth certain reporting and public dissemination requirements for security-based swaps. Unlike the initially proposed Regulation SBSR that did not contemplate that the reporting and public dissemination requirements associated with cross-border security-based swaps could be satisfied through substituted compliance, the Proposed Rules provide that substituted compliance may be permitted for such requirements. Specifically, the Proposed Rules provide that the SEC may make a substituted compliance determination with respect to reporting and public dissemination in a foreign jurisdiction if such foreign jurisdiction imposes a comparable system for the reporting and public dissemination of all security-based swaps. Under the Proposed Rules, persons covered by such an order could substitute compliance with such foreign system for compliance with the Exchange Act requirements so long as the following conditions are met: [40]

- at least one of the direct counterparties to the security-based swap is either a non-U.S. person or a foreign branch (regardless of whether such counterparty is also an SBSD, MSBSP or is guaranteed by a U.S. person); and
- no person within the United States is directly involved in executing, soliciting or negotiating the terms of the security-based swap on behalf of such counterparty.

The Proposed Rules further provide that any person that executes a security-based swap that will, in the absence of a substituted compliance order, be required to be reported under Regulation SBSR may file an application, pursuant to the procedures described above, requesting that the SEC make a substituted compliance determination regarding reporting and public dissemination with respect to a foreign jurisdiction's corresponding rules.

The Proposed Rules provide that the SEC will not make a substituted compliance determination with respect to regulatory reporting and public dissemination unless it finds that:

- the data elements that are required to be reported pursuant to the foreign jurisdiction's rules are comparable to those required to be reported under Rule 242.901 of re-proposed Regulation SBSR;

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[40] This is different from the CFTC Cross-Border Proposal, which provides that the public dissemination requirements applicable to a swap between a U.S. person SD and a non-U.S. person guaranteed by a U.S. person cannot be satisfied through substituted compliance.

- the foreign jurisdiction's rules require the security-based swap to be reported and publicly disseminated in a manner and a timeframe comparable to those required by Rules 242.900-911 of re-proposed Regulation SBSR;[41]
- the SEC has direct electronic access to the security-based swap data held by a trade repository or foreign regulatory authority to which such data is reported pursuant to the foreign jurisdiction's rules; and
- any trade repository or foreign regulatory authority in the foreign jurisdiction that receives and maintains required transaction reports of security-based swaps under the foreign jurisdiction's laws is subject to requirements regarding data collection and maintenance; systems capacity, resiliency and security; and recordkeeping that are comparable to those imposed on SDRs under previously proposed Rules 13n-5, 13n-6 and 13n-7 under the Exchange Act.

Clearing Requirement

The SEC acknowledges that, in some circumstances, counterparties may seek, either due to their own preference or foreign regulatory requirements, to clear security-based swaps subject to mandatory clearing at a clearing agency that is neither registered with the SEC nor exempt from registration (*e.g.*, one that is not required to register under section 17A(g) since it has no U.S. members and does not clear transactions conducted within the United States). Absent a substituted compliance determination, this will not satisfy the mandatory clearing requirement.

The SEC proposes to exempt persons from the clearing mandate in section 3C if a relevant transaction is submitted to a foreign clearing agency that is the subject of an SEC substituted compliance determination and such foreign clearing agency has no U.S. person members or activities in the United States. The SEC clarifies that since such foreign clearing agencies will not be engaged in activities requiring registration, such substituted compliance determination will not be subject to the procedure outlined in section 17A(k) to obtain an exemption from clearing agency registration, but will instead be considered in the context of an exemption from the clearing mandate in section 3C.

Additionally, the SEC notes that a foreign clearing agency with no U.S. person members or activities in the United States may initiate the process by filing an application requesting that the SEC make a substituted compliance determination.

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[41] The SEC proposes to not permit substituted compliance with respect to regulatory reporting and public dissemination if (1) the foreign jurisdiction does not impose public dissemination requirements on a trade-by-trade basis or (2) non-block size security-based swaps are publicly disseminated other than in real time.

Trade Execution Requirement

The Proposed Rules provide that the SEC may, conditionally or unconditionally, by order, make a substituted compliance determination with respect to a foreign jurisdiction to permit a person subject to the mandatory trade execution requirement with respect to a security-based swap transaction to execute such transaction, or have such transaction executed on its behalf, on a security-based swap market (or class of markets)[42] that is neither registered under the Exchange Act nor exempt from registration if the SEC determines that such a market (or class thereof) is subject to comparable, comprehensive supervision and regulation by a foreign financial regulatory authority or authorities in such foreign jurisdiction.

However, a security-based swap transaction will be eligible for such substituted compliance only if both of the following conditions apply to at least one counterparty:

- the counterparty is either a non-U.S. person or a foreign branch of a U.S. bank; and
- the security-based swap transaction is not solicited, negotiated or executed by a person within the United States on behalf of such counterparty.

The SEC indicates that it will consider (among other things) the existence of a dedicated examination program; examiners with proper expertise; a risk monitoring framework and an examination plan; and a disciplinary program to enforce compliance with laws. The mere fact that the SEC grants a substituted compliance determination with respect to mandatory trade execution for a foreign security-based swap market (or class thereof) will not necessarily result in a determination to exempt that foreign market (or class) from SEF registration.

Finally, the Proposed Rules authorize one or more security-based swap markets to initiate the process by filing an application with the SEC requesting a substituted compliance order.

ANTIFRAUD AUTHORITY

The Proposed Rules and interpretive guidance relate solely to the applicability of the registration, reporting, clearing and trade execution requirements under the Dodd-Frank

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42 The SEC notes that if a foreign jurisdiction imposes different levels of supervisory oversight with respect to different classes of security-based swap markets, the SEC could apply a substituted compliance determination to an entire class of such markets in such jurisdiction.

Act and do not limit the cross-border reach of the antifraud or other provisions of the federal securities laws to these entities.[43]

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Please do not hesitate to contact us with any questions.

May 31, 2013

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[43] The SEC clarifies that its antifraud enforcement authority under the Securities Act and the antifraud provisions of the Exchange Act extends to "(1) conduct within the United States that constitutes significant steps in furtherance of [the antifraud violation], even if the securities transaction occurs outside the United States and involves only foreign investors," and "(2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States." Similarly, the SEC's enforcement authority under the Investment Advisers Act applies broadly to "(1) conduct within the United States that constitutes significant steps in furtherance of the violation, even if the violation is committed by a foreign adviser and involves only foreign investors," and "(2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States."