CLIENT UPDATE

SEC FINAL RULES ON CROSS-BORDER APPLICATION OF SECURITY-BASED SWAP ENTITY DEFINITIONS AND OTHER RELATED MATTERS

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On June 25, 2014, the Securities and Exchange Commission (the "SEC") adopted the first of a series of final rules and interpretive guidance (the "Final 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 ("Title VII") of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

The Final Rules primarily focus on the application of the "security-based swap dealer" ("SBSD") *de minimis* exception and the "major security-based swap participant" ("MSBSP") registration thresholds to cross-border security-based swap transactions by addressing which cross-border transactions must be counted towards such thresholds to register as an SBSD or an MSBSP and by providing a definition of "U.S. person" for these purposes.

The Final Rules also include a procedural rule regarding the submission (by foreign regulators or market participants) of "substituted compliance" requests to the SEC to allow market participants to satisfy certain Title VII obligations by complying with comparable foreign regulatory requirements.

In addition, the Final Rules include an anti-fraud rule addressing the scope of the SEC's cross-border anti-fraud enforcement authority, clarifying that the authority applies where the fraud occurs or is felt within the United States.

In developing the Final Rules, the SEC consulted and coordinated with the Commodity Futures Trading Commission (the "CFTC"), the relevant prudential regulators[1] and foreign regulatory authorities. The SEC also gathered information about foreign regulatory reform efforts and the possibility of conflicts, gaps, inconsistencies and overlaps between U.S. and foreign regulatory regimes, and has taken this information into consideration in adopting the Final Rules.

The text of the Final Rules and the accompanying release can be found at https://www.sec.gov/rules/final/2014/34-72472.pdf.

EFFECTIVE DATE AND IMPLEMENTATION

The SEC has not yet promulgated final rules implementing the substantive requirements imposed by Title VII on SBSDs and MSBSPs. Therefore, while these Final Rules will become effective 60 days after their publication in the Federal Register, their application to cross-border security-based swap activities of SBSD and MSBSP will impose actual requirements on market participants only after the SEC's adoption of the applicable substantive rules.[2]

SEC'S PROPOSED RULES AND ISSUES TO BE ADDRESSED IN SUBSEQUENT RULEMAKINGS

The Final Rules are based on the SEC's May 23, 2013 proposed rules (the "Proposed Rules") which addressed the application of Title VII in the cross-border context. The Proposed Rules addressed a range of cross-border issues that are not addressed in the Final Rules, including: (1) the substantive (entity-level and transaction-level) requirements applicable to SBSDs and MSBSPs (*e.g.*, margin, capital and business conduct requirements); (2) the registration of security-based swap clearing agencies and requirements relating to mandatory clearing; (3) the registration of security-based swap execution facilities and mandatory trade execution requirements; and (4) the registration of security-based swap data repositories and reporting and public dissemination requirements. These issues will be addressed in subsequent SEC rulemakings in order to allow the SEC to consider the

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1 The "prudential regulator" of an SBSD or MSBSP may be any of the following federal agencies, depending on which agency is responsible for directly supervising the SBSD or MSBSP: 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.

2 The SEC notes that it does not expect to receive any requests for substituted compliance until relevant substantive rulemakings have been completed, since those rulemakings are necessary to determine when substituted compliance may be available and to assess the comparability of a foreign requirement for purposes of making a substituted compliance determination.

cross-border application of the substantive Title VII requirements in conjunction with the final substantive rules implementing such requirements.[3]

CFTC CROSS-BORDER GUIDANCE

Following the notice of proposed rulemaking for the SEC's Proposed Rules, the CFTC issued its final guidance (the "CFTC Guidance") regarding Title VII's application to cross-border swap activity. The CFTC Guidance differed from the SEC's Proposed Rules in certain respects, including with regard to the meaning of "U.S. person," the cross-border application of the *de minimis* exception to the dealer definition, the cross-border application of the major participant definition and the process for submitting substituted compliance requests.[4]

Since many market participants engage in both swap and security-based swap activities and will therefore be subject to regulations under Title VII by both the SEC (with respect to security-based swaps) and the CFTC (with respect to swaps), the SEC took into account the related elements of the CFTC Guidance in developing these Final Rules. As a result, the SEC's Final Rules generally would produce outcomes similar to those produced by the CFTC Guidance in terms of whether an entity is a "U.S. person" and whether a particular transaction is counted toward the relevant dealer or major participant thresholds.[5]

Unlike the CFTC Guidance, which is a statement of the CFTC's general policy regarding cross-border swap activities (allowing for flexibility in its application), the SEC's Proposed Rules specified when particular requirements apply to particular situations. While the SEC has not yet adopted final rules applying specific Title VII substantive requirements to cross-border security-based swaps activities, the release accompanying the Final Rules (the

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[3] Market participants are not required to comply with certain of those Title VII requirements pending the publication of final rules or other SEC action, and are temporarily exempt from certain other requirements added by or arising under Title VII. *See* Exchange Act Release No. 64678 (Jun. 15, 2011), 76 FR 36287 (Jun. 22, 2011) (clarifying the compliance date for certain Title VII requirements, and in some cases providing temporary exemptive relief from those requirements), available at http://www.gpo.gov/fdsys/pkg/FR-2011-06-22/pdf/2011-15432.pdf. *See also* Exchange Act Release No. 71485 (Feb. 5, 2014), 79 FR 7731 (Feb. 10, 2014) (extending exemptive relief from certain Exchange Act provisions in connection with Title VII's revision of the Exchange Act definition of "security" to encompass security-based swaps), available at http://www.sec.gov/rules/exorders/2014/34-71485.pdf.

[4] As discussed below, the Final Rules track the CFTC Guidance in a number of respects, including the treatment of conduit affiliates, the treatment of transactions with foreign branches and the exclusion for cleared, anonymous transactions from non-U.S. persons' *de minimis* calculations. See our client memorandum entitled "CFTC Cross-Border Guidance, Temporary Exemptive Order and No-Action Letters" (June 24, 2013), available at http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=e39c6856-07fa-4600-867d-ed23701a1ef0.

[5] In the Adopting Release, the SEC notes that many of the steps that market participants have taken to comply with the CFTC Guidance may be transferable to compliance with the SEC's Final Rules, thus mitigating the costs of compliance.

"Adopting Release") indicates that the SEC will follow the rule-by-rule approach outlined in its Proposed Rules, rather than the CFTC's more general approach.

"U.S. PERSON" DEFINITION

Generally

The Final Rules define "U.S. person" to mean:[6]

- Any natural person resident in the United States;
- Any partnership, corporation, trust, investment vehicle[7] or other legal person organized, incorporated or established under U.S. laws or having its principal place of business in the United States;
- Any account (whether discretionary or not) beneficially owned by a U.S. person;[8] or
- Any estate of a decedent who was a U.S. resident at the time of death.

Also, consistent with the SEC's Proposed Rules, the final definition excludes certain enumerated international organizations from the "U.S. person" definition.[9]

This definition is in most respects unchanged from the definition in the Proposed Rules and is generally consistent with the CFTC definition. However, the final SEC definition does include some changes from the SEC's proposed definition aimed at clarifying its scope while aligning it in certain respects with the CFTC's definition (in response to

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6 Despite requests from certain commenters to adopt a "U.S. person" definition that is consistent with the definition in Regulation S, the SEC declined to do so, reasoning that Title VII addresses different concerns from those addressed by that regulation and therefore requires a new definition specifically tailored to its regulatory objectives.

7 The Proposed Rules did not include an explicit reference to "investment vehicles," as such vehicles are commonly established as partnerships, trusts or limited liability entities and, therefore, would fall within the definition in the Proposed Rules despite the absence of such an explicit reference. However, the SEC added an explicit reference to investment vehicles in its final definition to avoid ambiguity.

8 In the Adopting Release, the SEC clarifies that an account owned solely by one or more U.S. persons is a U.S. person, even if it is held or maintained at a foreign financial institution or other person that is itself not a U.S. person. The SEC also clarifies that account ownership is evaluated only with respect to beneficial owners and that the status of any nominee, fiduciary or any person managing an account is irrelevant in determining whether the account is a U.S. person.

9 The "U.S. person" definition in the Final Rules excludes the following organizations: the International Monetary Fund, the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the United Nations and their agencies and pension plans, and any other similar international organizations, their agencies and pension plans. While the CFTC Guidance does not exclude these international financial institutions from its "U.S. person" definition, that Guidance clarifies that the CFTC will generally not consider the application of certain Title VII transaction-level requirements to be warranted with respect to swaps between a non-U.S. swap dealer or major swap participant and such an international financial institution (even where the international institution's principal place of business is in the United States).

commenters' concerns that divergences between the two agencies' definitions should be minimized).

Reasonable Reliance on Counterparty's Representations

In response to commenters' requests, the Final Rules have been revised from the proposal to provide that a person may rely on a counterparty's representation regarding its status as a U.S. person, unless such person knows, or has reason to know, that the representation is inaccurate. This change is consistent with the CFTC Guidance, which also permits a party to a swap to "reasonably rely" on its counterparty's written representations in determining whether the counterparty is a U.S. person.

However, unlike the CFTC Guidance, which provides that a party may rely on its counterparty's representation if reasonable due diligence is performed on the counterparty, the Final Rules provide that a person may rely on a counterparty's representation regarding its status as a U.S. person unless such person knows, or has reason to know, that the representation is inaccurate. A person would have reason to know the representation is not accurate if a reasonable person should know, under all of the facts of which the person is aware, that such representation is not accurate.

Principal Place of Business

The SEC has adopted a general definition of "principal place of business" and a specific application of the term to externally managed vehicles. Generally consistent with the CFTC Guidance, the Final Rules define "principal place of business" to mean the "location from which the officers, partners, or managers of the legal person primarily direct, control, and coordinate the activities of the legal person."[10]

The Final Rules further provide that, with respect to an externally managed investment vehicle, the principal place of business "is the office from which the manager of the vehicle primarily directs, controls, and coordinates the investment activities of the vehicle." While this definition is generally consistent with the "principal place of business" definition in the CFTC Guidance for collective investment vehicles, the two definitions are not identical. The Final Rules focus on the location from which the manager (or, where there are multiple managers, the "primary manager")[11] directs, controls and coordinates the

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[10] As the CFTC noted in its Guidance, the SEC notes in the Adopting Release that for most entities (other than externally managed entities), this location would generally correspond to the location of the headquarters or main office.

[11] In the Adopting Release, the SEC clarifies that where the investment activities of a collective investment vehicle are performed by multiple persons, the principal place of business is the location of the "primary manager."

"overall activity of the vehicle" (such as its investment and financing activity)[12] and specifically rejects one commenter's suggestion that it look to the location from which the vehicle's operational management activities (*i.e.*, establishing the vehicle, selecting a manager, broker and placement agent) are carried out. The CFTC Guidance, on the other hand, provides that the analysis should focus not only on the senior personnel responsible for the vehicle's trading and investment decisions, but also on the senior personnel who direct, control and coordinate the formation of the vehicle "and bring it to commercial life" (i.e., the promoters), particularly for vehicles with specialized structures or where the promoters continue to be integral to the ongoing success of the fund (including by retaining overall control).[13] Note, however, that the SEC specifies that the focus of the Final Rules is on where the activities of the vehicle as a whole is primarily directed, controlled and coordinated, as opposed to a focus merely on the security-based swap activities of that vehicle.

The SEC clarifies in the Adopting Release that the mere retention of an asset manager that is a U.S. person, without more, would not necessarily bring an offshore investment vehicle or other person within the scope of the "U.S. person" definition. However, where an asset manager, whether or not a U.S. person, is primarily responsible for directing, controlling and coordinating the activities of an externally managed vehicle and carries out this responsibility within the United States, the externally managed vehicle is a U.S. person.

U.S. Person Status Determined at Entity Level

Consistent with the CFTC Guidance and the SEC's Proposed Rules, the "U.S. person" definition in the Final Rules determines a legal person's status at the entity level and thus applies to the entire legal person, including any foreign operations. Foreign branches, agencies or offices of a U.S. person are treated as part of the U.S. person since they lack legal independence and since the legal obligations and economic risks associated with their transactions directly affect the entire U.S. person.[14]

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12 In the Adopting Release, the SEC notes an externally managed vehicle should not be excluded from the U.S. person definition merely because the manager that otherwise directs, controls and coordinates its overall activities has effectively shifted responsibility for the vehicle's security-based swap activity to a non-U.S. person.

13 While the CFTC Guidance focuses on the senior personnel responsible for implementing the vehicle's investment strategy and its risk management, it stresses that "[t]he achievement of the [vehicle's] investment objectives may be closely linked to its formation" since "[d]ecisions made in the structuring and formation of the [vehicle] may have a significant effect on the performance of the vehicle."

14 In the Adopting Release, the SEC explains that a trading desk, department, office, branch or other discrete business unit that is not a separately organized legal person will be considered part of the U.S. person since "whenever a U.S. person enters into a security-based swap in a dealing capacity, it is the U.S. person as a whole . . . that holds itself out as a

Key Differences between CFTC and SEC Definitions

Unlike the CFTC Guidance but consistent with the SEC's Proposed Rules, the "U.S. person" definition in the Final Rules does not include a provision covering collective investment vehicles that are majority-owned by one or more U.S. persons.[15] As a result, if an investment vehicle formed outside the United States with its principal place of business outside the United States is majority-owned by U.S. persons and enters into both swaps and security-based swap transactions with non-U.S. persons (other than guaranteed or conduit affiliates), its non-U.S. counterparty would be required to count the swap transactions against the swap dealer and major swap participant registration thresholds but would not be required to count the security-based swap transactions against the SBSD or MSBSP registration thresholds. Moreover, the SEC states in the Adopting Release that the "U.S. person" definition under the Final Rules may be used to determine the scope of substantive requirements applicable to security-based swaps of such an investment vehicle, in which case the vehicle would be subject to the CFTC's substantive requirements that are generally applicable to all entities transacting swaps (*e.g.*, clearing, trade execution, reporting), but may not be subject to the SEC's equivalent requirements since it would not be a U.S. person.

In addition, in contrast to the CFTC Guidance, the SEC's Final Rules do not specifically list pension plans or trusts of any kind.

Finally, the SEC declined to include a provision like the one in the CFTC's definition covering corporations, partnerships or certain other legal entities that are majority-owned by U.S. persons bearing unlimited responsibility for the obligations of the entity.

SECURITY-BASED SWAP DEALER DE MINIMIS EXCEPTION

The Exchange Act provides an exception from the SBSD designation (and the corresponding registration requirement) to entities that engage in a "*de minimis*" quantity of security-based swap dealing activity with or on behalf of customers. Under the joint final rules on Title VII entity definitions adopted by the SEC and the CFTC in April 2012

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dealer . . . [and] that seeks to profit by providing liquidity and making a market in security-based swaps, and it is the financial resources of the U.S. person as a whole that enables it to do so."

15 The CFTC Guidance includes a provision covering collective investment vehicles that are majority-owned by U.S. person(s), other than vehicles that are publicly offered only to non-U.S. persons and are not offered to U.S. persons. The SEC declined to follow the suggestion of some commenters that it exclude from the U.S. person definition investment vehicles that are offered publicly only to non-U.S. persons and not offered to U.S. persons since the SEC's definition does not focus on an investment vehicle's ownership by U.S. persons.

(the "Joint Entity Rules"),[16] a person that engages in dealing activity will qualify for the *de minimis* exception from SBSD registration if the swap positions connected with those dealing activities entered into by such person or its affiliates (controlling, controlled by or under common control with such person) over the immediately preceding 12-month period have an aggregate gross notional amount that does not exceed certain thresholds.[17]

The Final Rules provide different rules for determining whether a person exceeds the SBSD *de minimis* thresholds in a cross-border context, depending on whether a person is a U.S. person, "guaranteed affiliate," "conduit affiliate" or other non-U.S. person. In all cases, transactions between majority-owned affiliates need not be considered for purposes of determining whether a person is a dealer (*i.e.*, a person's security-based swap transactions with its majority-owned affiliates are not deemed to be dealing activities).[18]

U.S. Persons and Foreign Branches

The Final Rules require U.S. persons to count against the SBSD *de minimis* thresholds all of their security-based swap transactions connected with their dealing activity, including transactions conducted through a foreign branch (since, as noted above, a foreign branch is not a separate legal entity). As a result, a legal person with a branch, agency or office that is engaged in dealing activity above the *de minimis* threshold is required to register as an SBSD even if its dealing activity is limited to such branch, agency or office and its counterparties are exclusively non-U.S. persons.

Conduit Affiliates

The Final Rules, like the CFTC Guidance,[19] require a non-U.S. person that is a "conduit affiliate" (as defined below) of a U.S. person to count, against the SBSD *de minimis* thresholds, all of its security-based swap positions connected with its dealing activity, regardless of the status of their counterparty. This represents a departure from the Proposed Rules which treated conduit affiliates the same as other non-U.S. persons, requiring them to count only their dealing transactions with U.S. persons (other than

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16 See our client memorandum, "CFTC and SEC Release Joint Final Rule on Key Entity Definitions in Title VII of the Dodd-Frank Act" (June 8, 2012) (the "Joint Entity Rules Client Memo"), available at http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=4ed74ee3-8bb2-4efc-9236-b6affd903e98.

17 For credit default swaps ("CDS"), the threshold is $3 billion, subject to a phase-in level of $8 billion. For other (non-CDS) swaps, the threshold is $150 million, subject to a phase-in level of $400 million.

18 See Exchange Act rule 3a71-1(d) and CFTC regulation 1.3(ggg)(6)(i).

19 The CFTC Guidance requires conduit affiliates (of a U.S. person) to count all of their swap dealing activity with U.S. and non-U.S. counterparties (including foreign branches of registered swap dealers) in determining whether they are required to register as a swap dealer.

foreign branches of U.S. banks) and transactions otherwise conducted within the United States.

Unlike the CFTC Guidance, which provides a non-exhaustive list of factors that are relevant to determining whether a non-U.S. person is a conduit affiliate, the Final Rules define "conduit affiliate" as a non-U.S. person that is (directly or indirectly) majority-owned[20] by one or more U.S. persons and that, in the regular course of business, enters into security-based swaps with non-U.S. persons, or with foreign branches of U.S. banks that are registered as SBSDs, for the purpose of hedging or mitigating risks faced by, or otherwise taking positions on behalf of, one or more U.S. person affiliates[21] (other than registered SBSDs or MSBSPs), and enters into offsetting (*i.e.*, back-to-back) transactions with such U.S. affiliate(s) to transfer risks and benefits of those security-based swaps.

Under the Final Rules, the term "conduit affiliate" does not include a non-U.S. person that enters into security-based swaps on behalf of a U.S. person registered as an SBSD or MSBSP. This is generally consistent with the CFTC Guidance, which excludes affiliates of swap dealers (but not affiliates of major swap participants) from the "conduit affiliate" category.

In the Adopting Release, the SEC notes that "in the context of the dealer *de minimis* exception, the relevant rules would require the conduit affiliate to count only its dealing transactions." The rules distinguish dealing activity by a conduit affiliate from a corporate group's use of affiliates for non-dealing purposes, such as a corporate group's use of a single affiliated person to enter into outward facing transactions for risk management not involving dealing activity (accompanied by offsetting interaffiliate transactions).

Other Non-U.S. Persons, Generally

The Final Rules require non-U.S. persons other than conduit affiliates to count the following security-based swap transactions connected with their dealing activity against the SBSD *de minimis* thresholds:

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[20] The Final Rules provide that the majority ownership standard is satisfied if one or more corporations, partnerships, investment vehicles or other legal entities organized in the United States directly or indirectly own a majority interest in the non-U.S. person (note that ownership by natural persons is disregarded for this determination), where "majority interest" is the right to vote or direct the vote of a majority of a class of voting securities, the power to sell or direct the sale of a majority of a class of voting securities or the right to receive upon dissolution , or the contribution of, a majority of the capital of a partnership.

[21] For these purposes, a U.S. person affiliate refers to any U.S. person controlling, controlled by or under common control with the non-U.S. affiliate.

- Transactions with a U.S. person counterparty, other than those "conducted through" a foreign branch of such counterparty where either (1) the counterparty is a registered SBSD or (2) the transaction is entered into prior to 60 days following the earliest date on which the registration of SBSDs is first required under the applicable final rules; and
- Transactions for which the non-U.S. person's counterparty has rights of recourse against a U.S. person that is controlling, controlled by or under common control with the non-U.S. person (such non-U.S. person, a "guaranteed affiliate").

Guaranteed Affiliates

The requirement in the Final Rules that a non-U.S. person must count (against the *de minimis* thresholds) all of its dealing transactions for which its counterparty has "rights of recourse" against a U.S. person affiliate of that non-U.S. person[22] is consistent with the CFTC Guidance, which requires a non-U.S. person that is an affiliate of a U.S. person and that receives a U.S. person's guarantee to count all of its swap dealing transactions against the *de minimis* threshold. This aspect of the Final Rules represents a departure from the Proposed Rules, which would have treated guaranteed affiliates the same as other non-U.S. persons (other than conduit affiliates), requiring them to count only their dealing transactions with U.S. persons (other than foreign branches) and transactions otherwise conducted within the United States.

The Final Rules provide that a counterparty of a non-U.S. person has rights of recourse against a U.S. person if such counterparty has a conditional or unconditional legally enforceable right, in whole or in part, to receive payments from, or otherwise collect from, the U.S. person in connection with the security-based swap (regardless of the form of the arrangement).

In the Adopting Release, the SEC acknowledges that the CFTC Guidance "appears to broadly opine that non-U.S. persons who receive any express guarantee from a U.S. affiliate should, as a general matter, count all of their dealing activity against the *de minimis* thresholds, regardless of whether the counterparty has recourse against the U.S. person in connection with the swap." The Final Rules are "more targeted" than the CFTC approach in that guaranteed affiliates are required to count only those dealing transactions that are subject to the U.S. affiliate's guarantee.

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[22] This rule does not apply to the reverse scenario—i.e., the determination of whether a non-U.S. person that enters into security-based swaps with a guaranteed affiliate must register as an SBSD. The Final Rules 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.

In the Adopting Release, the SEC emphasizes that "rights of recourse" may arise in a variety of contexts, including:

- Where an arrangement provides a counterparty the legally enforceable right to demand payment from a U.S. person in connection with a security-based swap, without conditioning that right upon the non-U.S. person's non-performance or requiring that the counterparty first make a demand on the non-U.S. person;
- Where a counterparty could exercise legally enforceable rights of collection against a U.S. person in connection with a security-based swap, even when such rights are conditioned upon (1) the non-U.S. person's insolvency or failure to meet its obligations under a security-based swap and/or (2) the counterparty first taking legal action against the non-U.S. person to enforce its collection rights; and
- Where a counterparty, as a matter of law in the relevant jurisdiction, would have legally enforceable rights to payment and/or collection that arise in connection with the non-U.S. person's obligations under the security-based swap.

Under the Final Rules, the terms of the guarantee need not necessarily be included within the security-based swap documentation or even otherwise reduced to writing as long as legally enforceable rights are created under the laws of the relevant jurisdiction.

In the Adopting Release, the SEC notes that it will view the transactions of a non-U.S. person as subject to a recourse guarantee if at least one U.S. person (either individually or jointly and severally with others) bears unlimited responsibility for the non-U.S. person's obligations, including its obligations to security-based swap counterparties.

The SEC explains in the Adopting Release that it has distinguished guaranteed affiliates from other non-U.S. persons in this manner "as a prophylactic measure to help prevent the evasion of the provisions of the Exchange Act added by the Dodd-Frank Act." Without this rule, the SEC believes U.S. persons may have a strong incentive to evade dealer regulation under Title VII by simply establishing an overseas affiliate to conduct their dealing activity and extending a payment guarantee. The SEC further notes that the availability of major participant regulation under Title VII, which focuses on reducing systemic risk, does not mitigate the same concerns as the requirements applicable to swap dealers and SBSDs, which are aimed at the protection of customers and counterparties, as well as promoting effective operations and transparency of the swap and security-based swap markets.

Transactions with Foreign Branches of Security-Based Swap Dealers

The Final Rules require non-U.S. persons (other than conduit affiliates) to count (against the *de minimis* thresholds) their dealing transactions with U.S. persons other than certain transactions with a "foreign branch" of a registered SBSD (and transactions with the foreign branch of any counterparty, if conducted within a 60-day grace period[23] from the effective date of final SBSD registration rules). An equivalent exclusion exists under the CFTC Guidance for transactions with foreign branches of U.S. swap dealers.

The exclusion in the Final Rules is narrower than the proposed exclusion, which would have excluded all of the non-U.S. person's transactions with a foreign branch of a U.S. bank (other than those "conducted within the United States"), regardless of the bank's registration status.

Additionally, the exclusion applies only to transactions "conducted through" the counterparty's foreign branch, which the Final Rules define as any security-based swap transaction that is arranged, negotiated and executed by a U.S. person through its foreign branch if (1) the foreign branch is the counterparty to such transaction and (2) the transaction is arranged, negotiated and executed on behalf of the foreign branch solely by persons located outside the United States. Thus, in order for the exclusion to be effective, persons located within the United States cannot be involved in arranging, negotiating or executing the transaction. However, the Final Rules also provide that a non-U.S. person need not consider the location of the personnel arranging, negotiating and executing the transaction on behalf of its counterparty if the non-U.S. person receives a representation from the counterparty that the transaction is arranged, negotiated and executed solely by persons located outside the United States, unless the person knows or has reason to know (*i.e.*, a reasonable person should know, based on all the facts of which the person is aware) that the representation is inaccurate.

Consistent with the Proposed Rules, the Final Rules define "foreign branch" as any branch of a U.S. bank that (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 it is located.

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[23] The SEC explains in the Adopting Release that, during that 60-day period, the non-U.S. person could not know with certainly whether the bank will register in the future as an SBSD.

Non-U.S. Persons' Transactions with Guaranteed and Conduit Affiliates

Consistent with the Proposed Rules, the Final Rules do not require a non-U.S. person (other than a guaranteed or conduit affiliate) to count, against the *de minimis* thresholds, its dealing transactions with counterparties that are guaranteed affiliates or conduit affiliates since such a requirement would impose compliance costs on certain non-U.S. persons. The CFTC Guidance also permits such non-U.S. persons to exclude their transactions with conduit affiliates; however, with respect to guaranteed affiliates, the SEC's decision to not require non-U.S. persons to count these transactions is different from the CFTC Guidance, which requires that these transactions be counted, subject to exceptions for guaranteed affiliates that are swap dealers or non-financial entities[24] (or affiliates of either).

"Transactions Conducted Within the United States"

While the Proposed Rules would have required non-U.S. persons to count against the relevant *de minimis* thresholds their dealing activity involving "transactions conducted within the United States" (even where both parties are non-U.S. persons), the SEC chose not to include this requirement in the Final Rules.

In the Adopting Release, the SEC notes that while it continues to believe that the cross-border application of the SBSD definition should account for activities in the United States related to dealing "even when neither party to the transaction is a U.S. person," the significant issues raised by commenters related to this proposed requirement (including issues regarding the SEC's authority to impose it and the costs associated with it) demonstrate that "the final resolution of this issue can benefit from further consideration and public comment."[25] The SEC states that it anticipates soliciting additional public comment regarding how the cross-border application of the SBSD definition can reflect activity between two non-U.S. persons where one or both are conducting dealing activity within the United States.

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[24] The term "financial entity" is defined in section 2(h)(7)(C) of the Commodity Exchange Act.

[25] Indeed, the CFTC Guidance is the subject of ongoing litigation arising in part from claims by industry groups (SIFMA, ISDA and IIB) that the CFTC exceeded its statutory jurisdiction by providing that certain Title VII requirements may apply to a non-U.S. swap dealer's transactions with a non-U.S. counterparty where personnel or agents located in the United States are used to regularly arrange, negotiate or execute swaps on behalf of the swap dealer. See also footnote 513 of the CFTC Guidance in which the CFTC stresses its "strong supervisory interest" in regulating dealing activities occurring within the United States, "irrespective of counterparty." See also CFTC Letter No. 13-69 (Nov. 14, 2013), in which the CFTC staff provided its interpretation of footnote 513. See also CFTC letter No. 13-71 (Nov. 26, 2013) granting temporary relief to non-U.S. swap dealers from certain transaction-level requirements for swaps with non-U.S. person counterparties where personnel located in the United States are used to arrange, negotiate or execute such swaps. See also CFTC Letter No. 14-01 and CFTC Letter No. 14-74 extending such relief. The latter is available at: http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-74.pdf

Aggregation Requirement

The Final Rules also address the cross-border implementation of a previously adopted rule requiring a person to count dealing transactions entered into by its affiliates against its own *de minimis* thresholds. The CFTC Guidance includes a similar aggregation requirement.

Under the Final Rules, a person must include the following security-based swap transactions in its own *de minimis* threshold determination:

- Transactions connected with the dealing activity of any U.S. person (including through a foreign branch) controlling, controlled by or under common control with such person;
- Transactions connected with the dealing activity of any conduit affiliate controlling, controlled by or under common control with such person; and
- Transactions connected with the dealing activity of any non-U.S. affiliate (other than a conduit affiliate) that (1) are entered into with U.S. persons (other than those conducted through (a) the foreign branch of a registered SBSD or (b) during a 60-day grace period from the date on which SBSD registration is first required, any foreign branch) or (2) constitute dealing activity subject to a guarantee giving such non-U.S. affiliate's counterparty rights of recourse against a U.S. person affiliated with the non-U.S. person.

In the Adopting Release, the SEC notes that the aggregation requirement serves to prevent evasion of the dealer registration requirements by persons that otherwise may seek to avoid SBSD registration by simply dividing up dealing activity in excess of the *de minimis* thresholds among multiple affiliates. In keeping with that purpose, the Final Rules require a person's affiliates to count the same dealing transactions that the person itself would be required to count for purposes of the *de minimis* exception,[26] unless the person is a registered SBSD or has exceeded the relevant *de minimis* threshold but is in the process of registering as an SBSD.[27]

While the Proposed Rules included a similar exception from aggregation for transactions of affiliates registered as SBSDs, the proposed exception would have applied only if a person's dealing activity was "operationally independent" of the dealer's activity and

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[26] Under the Final Rules, the security-based swaps that are attributed to another person under the Final Rules must also be counted against the SBSD *de minimis* thresholds of the person that is a party to such security-based swaps.

[27] See Exchange Act rule 3a71-2(b).

would not have applied to transactions of a person in the process of registering as an SBSD.[28]

Exception for Cleared Anonymous Transactions

Like the CFTC Guidance, the Final Rules provide that a non-U.S. person (other than a conduit affiliate)[29] need not count (against the *de minimis* thresholds) its dealing transactions that are executed anonymously on an execution facility or national securities exchange and that are cleared through a clearing agency. The Final Rules also permit a U.S. or non-U.S. affiliate of a non-U.S. person (other than a conduit affiliate) to not count such transactions of the non-U.S. person against the affiliate's own thresholds for aggregation purposes. A transaction is "anonymous" for these purposes only if the counterparty is, in fact, unknown to the non-U.S. person prior to the transaction.[30]

These exclusions were granted in response to concerns that certain aspects of the *de minimis* rules turn on the domicile of the counterparty to the non-U.S. person and that, in an anonymous transaction, market participants would not have information available regarding a counterparty's identity. In the Adopting Release, the SEC also notes that absent an exclusion for cleared anonymous transactions, non-U.S. liquidity providers might be deterred from participating on security-based swap markets that provide access to U.S. persons, and that execution facilities might even exclude U.S. participants to prevent their non-U.S. members from having to face the prospect of dealer registration.

MAJOR SECURITY-BASED SWAP PARTICIPANT THRESHOLDS

The Exchange Act definition of "major security-based swap participant" focuses on systemic risk issues by targeting persons that maintain "substantial positions" that are "systemically important," or whose positions create "substantial counterparty exposure that could have serious effects on the financial stability of the United States banking

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28 The Final Rules expand the proposed exception from aggregation to cover transactions of persons that have exceeded the *de minimis* threshold but are not deemed to be SBSDs because they are in the process of registering as such in order to avoid market disruption that might otherwise result due to the prospect of a person intermittently exceeding the *de minimis* thresholds when its affiliates are in the process of registering. While the CFTC Guidance includes a similar exception from aggregation for transactions of registered swap dealer affiliates, this exception does not apply to transactions of affiliates that have exceeded the swap dealer *de minimis* thresholds but are not deemed swap dealers because they are in the process of registering as such.

29 The SEC explains in the Adopting Release that since conduit affiliates are required to count all of their dealing transactions regardless of whether their counterparty is a U.S. or a non-U.S. person, the anonymous nature of such a transaction would not cause implementation issues for conduit affiliates.

30 As an example, the SEC notes that where a person submits a transaction to an execution facility after accepting a request for quotation from a known counterparty or known group of potential counterparties, the transaction would not be anonymous, even if the process for submitting the transaction itself did not involve the named counterparty.

system or financial markets." The Exchange Act further directs the SEC to define the term "substantial position," for MSBSP registration purposes, at the threshold that the SEC deems to be prudent for the effective monitoring, management and oversight of systemically important entities.[31]

The Joint Entity Rules define "substantial position" and "substantial counterparty exposure" such that a person will be exempt from registration as an MSBSP if (1) its current uncollateralized outward exposure remains below certain thresholds and (2) the combined amount of such current exposure and its future potential outward exposure remains below certain other thresholds.

For each category of entity (i.e., U.S. person, conduit affiliate and other non-U.S. person), the Final Rules for the cross-border application of the MSBSP threshold calculations impose the same requirements as set forth above for the SBSD *de minimis* threshold calculations. As noted above with respect to SBSD *de minimis* calculations, the requirements set forth in the Final Rules for MSBSP threshold calculations are subject to the general principle that transactions between majority-owned affiliates need not be counted.

U.S. Persons and their Foreign Branches

The Final Rules require U.S. persons to include, in their MSBSP threshold calculations, all of their security-based swap positions, including positions entered into through their foreign branches. As a result, a person with a branch, agency or office that exceeds the MSBSP thresholds is required to register as an MSBSP, even if the legal person's positions are limited to such branch, agency or office and its counterparties are exclusively non-U.S. persons.

Conduit Affiliate

The Final Rules, like the CFTC Guidance, require conduit affiliates to count, against the MSBSP thresholds, all of their security-based swap positions, regardless of counterparty. This represents a departure from the Proposed Rules which treated conduit affiliates the same as other non-U.S. persons, requiring them to count only their positions with U.S. persons.

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[31] See Exchange Act section 3(a)(67)(B). In contrast to the "security-based swap dealer" definition, which focuses on activities that raise concerns that dealer regulation is intended to address, the statutory definition of "major security-based swap participant" focuses on positions that may raise systemic risk concerns within the United States.

Other Non-U.S. Persons, Generally

The Final Rules require non-U.S. persons other than conduit affiliates to count the following security-based swap positions against the MSBSP thresholds:

- Positions entered into with a U.S. person counterparty, other than positions arising from transactions "conducted through" a foreign branch of such counterparty where either (1) the counterparty is a registered SBSD or (2) the transaction is entered into prior to 60 days following the earliest date on which the registration of SBSDs is first required under the applicable final rules; and
- Positions for which the non-U.S. person's counterparty has rights of recourse against a U.S. person (such non-U.S. person, a "guaranteed affiliate").

Guaranteed Affiliates

The requirement in the Final Rules that a non-U.S. person must count (against the MSBSP thresholds) all of its positions for which its counterparty has "rights of recourse" against a U.S. person is consistent with(albeit more targeted than) the CFTC Guidance, which requires a non-U.S. person that is an affiliate of a U.S. person and that receives a U.S. person's guarantee to count all of its swaps positions against the MSBSP thresholds. This aspect of the Final Rules represents a departure from the Proposed Rules, which would have treated guaranteed affiliates the same as other non-U.S. persons (other than conduit affiliates), requiring them to count only their positions with U.S. persons.

The Proposed Rules addressed the risk posed by the existence of a guarantee against a U.S. person by requiring that all security-based swaps entered into by a non-U.S. person and guaranteed by a U.S. person be attributed to the US. guarantor for purposes of determining such U.S. guarantor's MSBSP status. As discussed below, the Final Rules maintain this requirement in addition to the direct regulation of the guaranteed affiliate.

The Final Rules define "rights of recourse" in the same manner as for SBSD *de minimis* purposes.[32]

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[32] The Adopting Release lists the same examples of the different contexts in which such rights may arise as it lists in the context of recourse guarantees for SBSD *de minimis* purposes and clarifies once again that the terms of the guarantee need not necessarily be included within the security-based swap documentation or even otherwise reduced to writing (as long as legally enforceable rights are created under the laws of the relevant jurisdiction). Finally, as is the case for recourse guarantees in the SBSD *de minimis* context, the SEC will view the transactions of a non-U.S. person as subject to a recourse guarantee for MSBSP purposes if at least one U.S. person (either individually or jointly and severally with others) bears unlimited responsibility for the non-U.S. person's obligations, including its obligations to security-based swap counterparties.

Transactions with Foreign Branches of Security-Based Swap Dealers

The Final Rules require non-U.S. persons (other than conduit affiliates) to count (against the MSBSP thresholds) their positions with U.S. persons other than positions arising from certain transactions with a "foreign branch" of a registered SBSD (and positions arising from transactions with a foreign branch of any counterparty, if conducted within a 60-day grace period from the effective date of final SBSD registration rules). An equivalent exclusion from the MSBSP threshold calculations exists under the CFTC Guidance for transactions with foreign branches of U.S. swap dealers (though the CFTC exclusion is available only to non-U.S. persons that are financial entities under the Commodity Exchange Act).[33]

The exclusion in the Final Rules represents a departure from the Proposed Rules, which would have required non-U.S. persons (other than conduit affiliates) to count all of their positions with U.S. persons, including positions with foreign branches of U.S. banks.

For the exclusion under the Final Rules to be effective, the foreign branch must be part of a U.S. bank that is registered as an SBSD (following a 60-day grace period from the effective date of final SBSD registration rules).

Additionally, the exclusion applies only to positions arising from transactions "conducted through" the counterparty's foreign branch, which the Final Rules define by reference to the definition applicable to SBSD *de minimis* calculations. Thus, in order for the exclusion to be effective, persons located within the United States cannot be involved in arranging, negotiating or executing the transaction. However, as with the Final Rules applicable to SBSD *de minimis* calculations, the Final Rules applicable to MSBSP threshold calculations provide that a non-U.S. person need not consider the location of the personnel arranging, negotiating and executing the transaction on behalf of its counterparty if the non-U.S. person receives a representation from the counterparty that the transaction is arranged, negotiated and executed solely by persons located outside the United States, unless the person knows or has reason to know (*i.e.*, a reasonable person should know, based on all the facts of which the person is aware) that the representation is inaccurate.

Non-U.S. Persons' Transactions with Guaranteed and Conduit Affiliates

Consistent with the Proposed Rules and with the Final Rules' treatment of SBSD calculations, the Final Rules for MSBSP calculations do not require a non-U.S. person

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[33] The term "financial entity" is defined in section 2(h)(7)(C) of the Commodity Exchange Act.

(other than a guaranteed or conduit affiliate) to count, against the MSBSP thresholds, its positions with counterparties that are guaranteed affiliates or conduit affiliates. The CFTC Guidance also permits such non-U.S. persons to exclude their transactions with conduit affiliates in the MSBSP context (and the SBSD context); however, with respect to guaranteed affiliates, the SEC's decision to not require non-U.S. persons to count these transactions for MSBSP (or SBSD) purposes is at odds with the CFTC Guidance, which requires that these transactions be counted, subject to the same exceptions noted above in the SBSD context.

Aggregation Requirement

The aggregation requirements under the Final Rules for MSBSP calculations are less strict than those applicable to SBSD *de minimis* calculations. Whereas the Final Rules for SBSD *de minimis* calculations require a person to attribute to itself all transactions entered into by its affiliates that such affiliates would themselves be required to count to determine their own SBSD status (unless the affiliate is a registered SBSD or a person in the process of registering as such), the Final Rules for MSBSP calculations require aggregation only where the relevant positions are subject to a recourse guarantee in favor of the counterparty.

Specifically, the Final Rules, consistent with the Proposed Rules, require a U.S. person to attribute to itself any security-based swap positions of a non-U.S. person for which the non-U.S. person's counterparty has rights of recourse against the U.S. person. Aggregation is not required in the absence of such recourse.[34]

Additionally, consistent with the Proposed Rules, the Final Rules require a non-U.S. person to attribute to itself (subject to the exceptions noted in the succeeding paragraph):[35]

- Any security-based swap position of a U.S. person for which the counterparty has rights of recourse against the non-U.S. person; and

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[34] The Final Rules include a note explaining that this interpretation addresses attribution only with respect to the guarantee of a non-U.S. person's obligations, since an existing interpretation provided by the SEC and the CFTC in the Joint Entity Rules already provides that an U.S. entity's swap or security-based swap positions in general will be attributed to a U.S. parent, other affiliate or guarantor for purposes of the major participant analysis to the extent that the counterparties to those positions would have recourse against such parent, other affiliate or guarantor in connection with the position (but not in the absence of such recourse). See our Joint Entity Rules Client Memo, available at http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=4ed74ee3-8bb2-4efc-9236-b6affd903e98.

[35] As noted above with respect to SBSD de minimis calculations, the security-based swaps that are attributed to another person under the Final Rules must also be counted against the MSBSP thresholds of the person that is a party to such security-based swaps.

- Any security-based swap position of another non-U.S. person entered into with a U.S. person counterparty who has rights of recourse against the first non-U.S. person (other than positions arising from transactions conducted through (1) a foreign branch of a registered SBSD counterparty or (2) during a 60-day grace period following the earliest date on which the registration of SBSDs is first required, any foreign branch).

Like the Proposed Rules, the Final Rules provide exceptions from the foregoing aggregation requirements where:

- The guaranteed person is subject to capital regulation by the SEC or the CFTC (including, but not limited to, regulation as a swap dealer, major swap participant, SBSD, MSBSP, futures commission merchant, broker or dealer); or
- The guaranteed person is regulated as a bank in the United States, or is subject to capital standards adopted by its home country supervisor that are consistent in all respects with the Capital Accord of the Basel Committee on Banking Supervision.[36]

Consistent with the exception from aggregation noted above for transactions of persons that are in the process of registering as an SBSD, the Final Rules also provide an exception for U.S. guarantors from the aggregation requirement (for MSBSP calculations) where the guaranteed person's registration as an MSBSP is pending.

SUBSTITUTED COMPLIANCE

Generally

The Final Rules include a set of procedures that must be followed to request a substituted compliance order under the Exchange Act. This procedural rule represents the first step in the SEC's efforts to establish a framework to permit market participants that are subject to more than one set of comparable regulations across different jurisdictions (as a result of their cross-border security-based swaps activities) to comply with the foreign jurisdiction's requirements as a substitute for compliance with the relevant Title VII requirements.

The rule addresses only the process for submitting substituted compliance requests, not whether or under what conditions substituted compliance would be available for particular regulatory requirements. The SEC plans to address the potential availability of substituted compliance for specific Title VII requirements in connection with subsequent rulemakings regarding each such requirement.

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[36] In the Adopting Release, the SEC notes that this approach is consistent with the capital standards of the prudential regulators with respect to foreign banks that are bank holding companies subject to the Federal Reserve Board of Governors' supervision.

Submission of Applications

Under the Final Rules, an application requesting substituted compliance may be submitted by either (1) a party that potentially would comply with the relevant Exchange Act requirements pursuant to a substituted compliance order (*i.e.*, a market participant) or (2) the relevant foreign financial regulatory authority or authorities.[37]

Applications must be submitted to the Office of the Secretary of the SEC, must be in writing in the form of a letter (although requests may be submitted electronically), [38] must be in English[39] and must comply with the SEC's general rules regarding the filing of materials with the SEC.[40] Applications must include any supporting documents necessary to make the application complete (*i.e.*, any information necessary for the SEC to make a determination), including information regarding applicable requirements established by the foreign financial regulatory authority or authorities, as well as the methods used by such foreign authority or authorities to monitor and enforce compliance with such rules.[41] Applicants should also cite to and discuss applicable precedent.

For applications submitted in paper format, five copies of the application (and of each amendment) must be submitted to the Office of the Secretary at 100 F Street, NE, Washington, DC 20549.[42]

All applications (electronic or paper) must contain the name, address, telephone number and email address of each applicant and the name, address, telephone number and email

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37 The Proposed Rules permitted only market participants, not foreign regulators, to submit substituted compliance requests. In the Adopting Release, the SEC notes that this revision to the Final Rules to permit foreign regulators to submit substituted compliance requests "helps address goals of increased coordination" with the CFTC.

38 The electronic mailbox to use for these applications is described on the SEC's website at www.sec.gov in the "Exchange Act Substituted Compliance Applications" section. In the event electronic mailboxes are revised in the future, applicants can find the appropriate mailbox by accessing the "Electronic Mailboxes at the Commission" section.

39 If a filing or submission requires the inclusion of a document that is in a foreign language, a party must submit instead a fair and accurate English translation of the entire foreign language document. A party may submit a copy of the unabridged foreign language document when including an English translation of a foreign language document in a filing.

40 See Exchange Act rule 240.0-3.

41 In the Adopting Release, the SEC notes that it expects that supporting documentation regarding the methods that foreign regulators use to enforce compliance with the applicable rules "would be best provided by the relevant foreign regulator." The SEC also notes that this requirement is consistent with the fact that the SEC's substituted compliance assessments will not be limited to a comparison of applicable rules and their underlying goals, but also will take into account the capability of a foreign regulator to monitor compliance with its rules and take appropriate enforcement action in response to violations of such rules.

42 Applications must be on white paper no larger than 8½ by 11 inches in size, with left margins at least 1½ wide (and, if the application is bound, it must be bound on the left side). All typewritten or printed material must be in black ink to permit photocopying.

address of a person to whom any questions regarding the application should be directed. The SEC will not consider hypothetical or anonymous requests for substituted compliance.

In the Adopting Release, the SEC clarifies that requests for confidential treatment may be submitted (in connection with a substituted compliance application) pursuant to any applicable provisions governing confidentiality under the Exchange Act.[43]

Amendments, Incomplete Applications and SEC Review and Issuance of Orders

Amendments to an application should be prepared and submitted in accordance with these same procedures and should be marked to show changes made to the prior version.

If an application is incomplete, the SEC may request that the application be withdrawn unless the applicant can justify, based on all the facts and circumstances, why supporting materials have not been submitted and undertakes to submit the omitted materials promptly.

Once a filing is complete, SEC staff will review the application and will publish in the Federal Register a notice that a complete application has been submitted. The notice will provide that any person may, within the period specific therein, submit to the SEC any information that relates to the action requested in the application. The notice will indicate the earliest date on which the SEC would take final action on the application, but in no event will such action be taken earlier than 25 days after publication of the notice in the Federal Register.

The SEC may, in its sole discretion, schedule a hearing on the matter addressed by the application.

Once all questions and issues pertaining to a completed application have been answered to the staff's satisfaction, the staff will make an appropriate recommendation to the SEC. After a vote by the SEC, the Office of the Secretary will issue an appropriate response and will notify the applicant.

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[43] The Proposed Rules would have permitted requesters to seek confidential treatment of their application only to the extent permitted under Exchange Act rule 200.81 (governing the submission of no-action requests and requests for exemptive relief or interpretative guidance). In the Adopting Release, the SEC notes that this change reflects the fact that the Final Rules permit foreign regulators to submit substituted compliance applications, and recognizes the importance of having the assessment consider potentially sensitive information regarding a foreign regime's compliance and enforcement capabilities and practices.

ANTIFRAUD AUTHORITY

The SEC clarifies that the Final Rules do not limit the cross-border reach of the antifraud or other provisions of the federal securities laws that are not specifically addressed by the Final Rules.

The Final Rules clarify that the SEC's antifraud enforcement authority under the securities laws (*i.e.*, the Securities Act, the Exchange Act and the Investment Advisers Act) extends to:

- Conduct within the United States that constitutes significant steps in furtherance of the violation, even if (a) the violation relates to a securities transaction or transactions occurring outside the United States that involves only foreign investors or (b) the violation is committed by a foreign adviser and involves only foreign investors; and
- Conduct occurring outside the United States that has a foreseeable substantial effect within the United States.

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Please do not hesitate to contact us with any questions.

July 3, 2014