

# CLIENT UPDATE

## SEC PROPOSED RULE FOR TREATMENT OF CERTAIN COMMUNICATIONS OF SECURITY-BASED SWAP QUOTES

### NEW YORK

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On September 8, 2014, the Securities and Exchange Commission (the “SEC”) published a proposed rule (the “Proposed Rule”) providing that certain communications involving quotes of security-based swaps will not be deemed to constitute offers of such security-based swaps or of any guarantees of such security-based swaps that are securities for purposes of the registration requirements applicable to offers or sales of securities under section 5 of the Securities Act of 1933 (the “Securities Act”), if the security-based swaps may be purchased only by eligible contract participants (“ECPs”)<sup>1</sup> and are traded on or processed through a trading system or platform that either is a registered national securities exchange or on a security-based swap execution facility (a “SBSEF”) or is exempt from registration as a SBSEF.

Comments on the Proposed Rule are due on or before November 10, 2014.

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<sup>1</sup> The term “eligible contract participant” is defined in section 1a(18) of the Commodity Exchange Act and includes a number of categories of persons, such as financial institutions; insurance companies; registered investment companies; commodity pools with total assets exceeding \$5 million; registered broker dealers; registered futures commission merchants; registered investment advisors; certain employee benefit plans with more than \$5 million in assets; certain corporations, partnerships and trusts with more than \$10 million in assets; government entities such as the United States, a state or local municipality, a foreign government, a multinational or supranational governmental entity, or an instrumentality, agency or department of such entities; and individuals with more than \$10 million invested on a discretionary basis (or more than \$5 million, if such individual enters into an agreement or transaction to manage the associated risks).

## BACKGROUND

### *Security-Based Swaps as Securities*

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) amended the Securities Act and the Securities Exchange Act of 1934 (the “Exchange Act”) to include “security-based swaps” in the definition of “security,” thereby subjecting security-based swaps to the provisions of those statutes and the rules and regulations of the SEC thereunder applicable to securities.<sup>2</sup>

As section 5 of the Securities Act requires that any offer and sale of a security either be registered under the Securities Act or be made pursuant to an exemption from registration, counterparties to security-based swaps are required to either register such transactions or rely on an available exemption. Further, Title VII amended the Securities Act to require that security-based swaps involving persons who are not ECPs (“non-ECPs”) be registered under the Securities Act.

### *Expanded Access to Quotes on SBSEFs and Exemption from Registration of Security-Based Swaps*

Title VII also added a requirement that security-based swaps be traded on regulated trading platforms or exchanges in certain situations, as well as a mandatory clearing requirement for certain security-based swaps designated by the SEC. Additionally, Title VII requires security-based swaps that are subject to the clearing requirement to be executed on either a national securities exchange or on a SBSEF that is either registered as such or exempt from such registration, unless no exchange or SBSEF makes such security-based swap available for trading (the “trade execution requirement”).

Title VII requires that any facility for trading or processing security-based swaps, including some of the electronic trading platforms currently used by security-based swap dealers (“SBSDs”) to disseminate quotes to their clients, must be registered as a SBSEF or as a national securities exchange. Additionally, Title VII amended the Exchange Act to add various provisions governing regulation of SBSEFs, including provisions relating to the availability of bid, offer or other price information for security-based swaps, as well as an

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<sup>2</sup> Swaps are regulated by the Commodity Futures Trading Commission (the “CFTC”), security-based swaps are regulated by the SEC and certain other derivatives (*i.e.*, mixed swaps) are jointly regulated by both agencies. CFTC and SEC, Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48208 (August 13, 2012).

“impartial access requirement,” requiring a SBSEF to establish objective standards for granting impartial access to trading on its facility.

The SEC’s proposed rules for regulating SBSEFs require SBSEFs to admit as participants all ECPs that meet such standards for becoming a participant, and to provide at least a basic functionality to allow any participant the ability to make and display executable bids or offers accessible to all other participants.<sup>3</sup> In the release accompanying the Proposed Rule (the “Proposing Release”), the SEC notes that these requirements may prevent certain facilities that are required to register as SBSEFs from limiting the number or types of persons that have access to quotes on their trading platforms, as the rules for SBSEFs and national securities exchanges, once finalized, may require the publication or distribution of quotes for security-based swaps to be available to all participants in these platforms, and such participants may be able to further disseminate such quotes without restriction (via online services or otherwise).

Similar concerns were raised by commenters on the SEC’s 2011 interim final rules (the “interim final exemptions”) exempting certain security-based swaps from certain provisions of the Securities Act, the Exchange Act and the Trust Indenture Act of 1939 (the “Trust Indenture Act”).<sup>4</sup> Commenters expressed concerns that certain communications involving security-based swaps, such as publication or distribution of price quotes, may be available on or through trading platforms on an unrestricted basis following the full implementation of Title VII, and that this unrestricted access could affect the availability of exemptions from the registration requirements of the Securities Act, such as the exemption in section 4(a)(2), for such security-based swaps.<sup>5</sup> Specifically, the publication or distribution of price quotes for security-based swaps traded or processed on or through

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<sup>3</sup> See section 761 of the Dodd-Frank Act (adding section 3(a)(77) of the Exchange Act); see also SEC “Registration and Regulation of Security-Based Swap Execution Facilities,” 76 Fed. Reg. 10948 (Feb. 28, 2011).

<sup>4</sup> Concern over possible disruptions to the operation of the security-based swaps market while the SEC evaluated the implications of treating security-based swaps as “securities” under the Securities Act and Exchange Act led to the adoption by the SEC in 2011 of interim final rules exempting security-based swaps from certain provisions of the Securities Act, the Exchange Act and the Trust Indenture Act. SEC, “Exemptions for Security-Based Swaps,” 76 Fed. Reg. 40605 (July 11, 2011). These exemptions apply to security-based swaps that prior to July 16, 2011, the effective date of Title VII, were “security-based swap agreements” and are defined as “securities” under the Securities Act and the Exchange Act as of such date due solely to the provisions of Title VII. The interim final exemptions exempt offers and sales of security-based swap agreements that became security-based swaps on the Title VII effective date from all provisions of the Securities Act, other than the anti-fraud provisions in section 17(a), as well as from the Exchange Act registration requirements and from provisions of the Trust Indenture Act, provided certain conditions are met. These exemptions were subsequently extended to February 11, 2017. In the Proposing Release, the SEC notes it may, as part of any final rules adopting the Proposed Rules, shorten or otherwise alter the expiration dates of the interim final exemptions.

<sup>5</sup> Currently, such communications are not available on the trading platforms on an unrestricted basis because trading platform operators and SBSs have discretion over authorizing participants to access trading platforms and to see quotes for security-based swaps from SBSs using such platforms.

trading platforms could be viewed as “offers” of those security-based swaps under the Securities Act, and such offers would require registration under the Securities Act or reliance on an available exemption. Such communications could also be considered offers to non-ECPs, even if non-ECPs are not permitted to purchase the security-based swaps.

## PROPOSED RULE

The Proposed Rule provides that, for purposes of section 5 of the Securities Act, the publication or distribution of quotes relating to security-based swaps will not be deemed to constitute an offer, an offer to sell or a solicitation of an offer to buy or purchase such security-based swaps or any guarantees of such security-based swap that are securities, if such security-based swaps:

- May be purchased only by ECPs, and
- Are traded or processed on or through a trading system or platform that either (a) is registered as a national securities exchange (under section 6(a) of the Exchange Act) or (b) is registered as a SBSEF (under section 3D(a) of the Exchange Act) or exempt from such registration (pursuant to a rule, regulation or order of the SEC).

## PURPOSE AND SCOPE OF PROPOSED RULE

The Proposed Rule is intended to further the goal of Title VII of bringing the trading of security-based swaps onto regulated trading platforms and to avoid unintended consequences arising from the operation of such platforms by permitting security-based swaps to be executed on and processed through such platforms without concern that price quotes made with respect to such transactions may implicate the Securities Act registration requirements.

The Proposed Rule applies both to the initial publication or distribution of price quotes<sup>6</sup> for security-based swaps on eligible trading platforms, as well as any subsequent republication or redistribution of such price quotes on or through mediums other than eligible trading platforms, including online information services. Further disseminations of such price quotes by participants in such platforms would also be permitted without restriction. As the SEC clarifies in the Proposing Release, the treatment of such price quotes should not depend on who publishes or distributes the quotes or where the quotes

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<sup>6</sup> To allow for flexibility and to avoid limiting the types of trading platforms that currently exist or may in the future exist, the SEC has not defined the specific type of price quotes covered by the Proposed Rule. (They could take a number of forms depending on the type of trading platform models, including indicative quotes, executable quotes, bids and offers, and other pricing information and other types of quote information that may develop in the future).

are published or distributed, so long as only ECPs are permitted to purchase the security-based swaps that are the subject of such price quotes.

Certain commenters on the interim final exemptions expressed concern about the effect on the availability of Securities Act exemptions of other published communications they characterized as research. The SEC is considering whether the exclusion under the Proposed Rule for price quotes should be expanded to cover other types of communications and is requesting comment on the types of research materials that are distributed, the manner in which such research materials are distributed and the basis for characterizing such communications as research.

In addition, some commenters requested broader exemptions from the registration requirements of the Securities Act and the Exchange Act, and the indenture qualification provisions of the Trust Indenture Act, for security-based swaps entered into solely by ECPs, but the SEC declined to provide such broader exemptions.

Furthermore, the Proposed Rule is limited to the treatment of certain price quotes and would not otherwise affect the provisions of any exemptions from the registration requirements of the Securities Act. Thus, market participants must still make a determination as to whether an exemption from the registration provisions of the Securities Act is available with respect to a security-based swap, including whether such transaction complies with any applicable conditions of the exemption. Finally, the Proposed Rule does not limit in any way the scope or applicability of any other provisions of the federal securities laws, including the antifraud provisions in section 17(a) of the Securities Act, relating to both oral and written material misstatements and omissions in the offer and sale of securities, including security-based swaps.

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Please do not hesitate to contact us with any questions.

September 23, 2014