

# ClientAlert

## Capital Markets/Derivatives

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### SEC Proposed Rules on Cross-Border Security-Based Swap Activities



#### Introduction

On May 1, 2013, the Securities and Exchange Commission (“SEC”) adopted and made public for comment proposed rules and interpretive guidance (“Proposed Rules”) to address the application of the provisions of the Securities Exchange Act of 1934, as amended (“Exchange Act”), that were added by Subtitle B of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) to govern cross-border security-based swap (“SBS”) activities. Since Title VII of the Dodd-Frank Act became effective in July 2011, the SEC has received numerous inquiries and comments from foreign regulators and participants involved in the global SBS market who have voiced concerns over how Title VII (and the SEC’s implementing regulations thereunder) will apply to the cross-border activities of US and non-US market participants. The SEC’s Proposed Rules aim to address these important concerns, and are meant to inform parties to SBS transactions which regulatory requirements apply when their transactions occur in part within and in part outside the United States.

Among other things, the Proposed Rules set forth how the SEC will apply the requirements of Title VII and the SEC regulations thereunder to SBSs in the context of cross-border transactions; provide the SEC’s definition of “US person” and introduce the territorial concept of “transaction conducted within the United States”; review the registration requirements of security-based swap dealers (“SBSDs”) and major security-based swap participants (“MSBSPs”); and describe the SEC’s substituted compliance framework and procedures.

The comment period for the Proposed Rules is open until August 21, 2013.

#### Context and Scope of the Proposed Rules

With Subtitle B of Title VII to the Dodd-Frank Act, Congress gave the SEC a broad mandate to implement a regulatory framework that would protect and enhance the stability of the US financial system. This regulatory framework would accomplish its ambitious goal by, among other things, increasing the level of transparency in SBS market transactions (e.g., through reporting and public dissemination requirements) and bolstering counterparty protections (e.g., by extending registration requirements and imposing a variety of business conduct standards on certain market participants). At the same time, as the SEC acknowledges in its release, careful measures would have to be taken to ensure that the regulatory framework is not overly broad or rigid, to the point of causing competitive distortions or harming the liquidity or efficiency of significant markets, including the SBS market.

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Today's SBS market is global in the full sense of the word, with cross-border SBS transactions constituting the norm rather than the exception. Dealers and other market participants are highly interconnected in this global market, creating vibrant and fluid hubs for SBS transactions in the United States and elsewhere, but also complicating the task of drawing effective regulatory boundaries for the activities of SBS market participants.

To reflect the global nature of the SBS market and the fluidity of transactions into and out of the US financial system, the SEC has adopted a "territorial approach" in drafting important aspects of the Proposed Rules, including determining how to apply the SBSD requirements in the cross-border context. Thus, in general, Title VII will apply under the SEC's Proposed Rules to SBS transactions involving (i) a US person and a non-US person, (ii) two non-US persons where one or both are located within the United States or (iii) two non-US persons conducting a security-based swap transaction that otherwise occurs in relevant part within the United States.

### Registration and Regulation of SBSDs

Title VII of the Dodd-Frank Act introduced the concept of SBSDs, and requires entities that meet the definition of an SBSD to register with the SEC.<sup>1</sup> Specifically, in a release adopted jointly by the SEC and the Commodity Futures Trading Commission (CFTC) on April 27, 2012,<sup>2</sup> the SEC set forth a *de minimis* threshold of SBS dealing that is calculated using the notional amount of SBS positions connected with a person's SBS dealing activity over the prior 12 months. A person is required to register with the SEC when the person's SBS dealing positions exceed the *de minimis* threshold. The exact *de minimis* threshold varies depending on the type of SBS involved.<sup>3</sup>

#### Which SBS Dealings Count Toward the *De Minimis* Threshold?

The SEC's *de minimis* threshold for SBSDs applies differently to US persons and non-US persons:

- A US person is required to count all of its SBS transactions (including transactions conducted through a foreign branch of a US bank), conducted in a dealing capacity.

- A non-US person, on the other hand, is required to count SBS transactions that are (i) conducted with "US persons" (excluding foreign branches of US banks) or (ii) "conducted within the United States."

Thus, under the Proposed Rules, a non-US person would not be required to count SBS transactions conducted outside the United States with non-US counterparties in making its *de minimis* threshold determination. This is consistent with the SEC's focus on SBS transactions that are likely to impact the US financial system.

#### What Is a "Foreign Branch"?

The Proposed Rules define a "foreign branch" of a US bank to mean a branch that is (i) located outside the United States, (ii) operates for valid business reasons and (iii) is engaged in the business of banking and is subject to substantive banking regulation in the jurisdiction where it is located. These conditions, which require non-US branches to engage in substantive operations in order to fall under the definition of "foreign branch," were likely included to address concerns that some SBS market participants might establish "shell" branches abroad to avoid US regulation.

Under the Proposed Rules, a US entity performing a *de minimis* threshold determination pursuant to the SBSD definition must include the SBS transactions of its foreign branches. According to the SEC, in the context of SBS transactions, it is the US entity as a whole, and not just the foreign branch, that is holding itself out as an SBS dealer and making a market in SBS. Furthermore, it is the US entity as a whole that seeks to profit from the foreign branch's SBS transaction. The foreign branch, moreover, depends on the financial resources and market-making ability of the US entity, of which it is a part.

Non-US entities, however, need not include the SBS transactions entered into with foreign branches of US entities when making a *de minimis* threshold determination. Such a requirement, according to the SEC, would discourage non-US counterparties from entering into SBS transactions with the foreign branches of US banks for fear that the non-US counterparties would have to register as SBSDs.

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1 An SBSD is any person that (i) holds itself out as a dealer in SBSs; (ii) makes a market in SBSs; (iii) regularly enters into SBSs with counterparties as an ordinary course of business for its own account; or (iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in SBSs.

2 See Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," Exchange Act Release No. 66868 (Apr. 27, 2012), 77 FR 30596 (May 23, 2012).

3 The numerical level of the *de minimis* threshold varies depending on whether the SBS transaction is (i) a credit default swap, (ii) an SBS with a "special entity" as a counterparty, or (iii) any other kind of SBS transaction.

### What Is a “US Person”?

Under the Proposed Rules, a “US person” is defined as:

- i. Any natural person resident in the United States
- ii. Any partnership, corporation, trust or other legal person organized or incorporated under the laws of the United States or having its principal place of business in the United States
- iii. Any account (whether discretionary or non-discretionary) of a US person

The Proposed Rules expressly exclude, however, international organizations such as the International Monetary Fund and the Inter-American Development Bank from the definition of “US person.” According to the SEC, though many of these organizations have headquarters in the United States, most of their membership and financial activities are outside the United States, thus justifying a carve-out from the definition.<sup>4</sup>

The definition of “US person” under the SEC’s Proposed Rules is also narrower than the latest corresponding definition proposed by the CFTC.<sup>5</sup> However, as discussed below, the SEC has also proposed to regulate transactions “conducted within the United States,” even if the transactions are conducted by non-US persons, thus expanding the sweep of the SEC’s cross-border regulatory focus.

### When Is a Transaction “Conducted Within the United States”?

Consistent with the SEC’s territorial approach to cross-border SBSs, a transaction is said to be “conducted within the United States” when 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 to the transaction.

Recognizing the “operational difficulties” that could arise in ensuring a counterparty’s compliance with this rule, the SEC’s Proposed Rules permit parties to an SBS transaction to rely on a representation from a counterparty indicating a given transaction “is not solicited, negotiated, executed, or booked within the United States” by or on behalf of the counterparty. However, reliance is not permitted if the receiving party knows that the representation is not accurate.<sup>6</sup>

### Aggregation of Affiliate SBS Positions

Under certain circumstances, the SEC Proposed Rules require US and non-US persons to aggregate SBS transactions connected with the dealing activity of an affiliate under common control<sup>7</sup> in making a *de minimis* threshold determination:

- A US person is required to count toward its *de minimis* threshold all dealing SBS transactions of (i) US affiliates, unless the US affiliates are registered SBSDs and “operationally independent”<sup>8</sup> from the US person, and (ii) non-US affiliates (a) entered into with US persons (excluding foreign branches of US banks) or (b) conducted within the United States.
- A non-US person, on the other hand, is required to count toward its *de minimis* threshold all dealing SBS transactions of its affiliates, whether US or non-US affiliates, that the affiliates themselves would count toward their respective *de minimis* thresholds (i.e., dealing SBS transactions that are either (i) entered into with US persons (excluding foreign branches of US banks) or (ii) conducted within the United States).

The affiliate aggregation rules for both US and non-US persons are thus consistent with the territorial approach the SEC has adopted in making *de minimis* threshold determinations for SBSDs. According to the SEC, this territorial approach to affiliate aggregation accounts for the impact that affiliate SBS transactions have on the US financial system.

The following table is a reproduction of the table in Appendix B of the Proposed Rules release; it sets out the dealing SBS transactions that a potential SBSD would have to count toward its *de minimis* threshold in the cross-border context:

<sup>4</sup> However, though these international organizations (collectively referred to as “foreign public sector financial institutions” or “FPSFIs”) are excluded from the “US person” definition, they are not exempted from other regulatory requirements under the Proposed Rules.

<sup>5</sup> See Final Exemptive Order Regarding Compliance with Certain Swap Regulations, 78 FR 858 (Jan. 7, 2013).

<sup>6</sup> The SEC has adopted a “knowledge standard” rather than a “reasonable belief standard” with respect to such representations. According to the SEC, the laxer knowledge standard is more appropriate here because the “conducted within the United States” definition applies to both counterparties to an SBS transaction, thus incentivizing each counterparty to ensure the accuracy of its representation.

<sup>7</sup> Affiliates are “under common control” when one of the affiliates controls, is controlled by or is under common control with the other affiliate.

<sup>8</sup> Under the Proposed Rules, an affiliate is “operationally independent” when, for example, it maintains separate sales and trading functions, separate operations (including back offices), and separate risk management.

SBSD Registration				
		Potential SBSD		
		US Person	Non-US Person	
			Potential Dealer/Agent Located Within the US	Potential Dealer/Agent Located Outside the US
Counterparty	US Person (Other than Foreign Branch)	Count	Count	Count
	Non-US Person Within the US	Count	Count	Count
	Non-US Branch of US Bank	Count	Count	Don't Count
	Non-US Person Outside the US	Count	Count	Don't Count

**Transaction-Level and Entity-Level Requirements**

If a US or non-US person is required to register with the SEC as an SBSD, the person may become subject to both transaction-level and entity-level requirements, as described below:

- Transaction-level requirements relate primarily to customer protection, and include both external business conduct standards and requirements relating to segregation of assets held as collateral in SBS transactions. Pursuant to these requirements, SBSDs must, for instance, verify that any counterparty meets the eligibility standards for an eligible contract participant, and provide counterparties with certain disclosures.

Under the Proposed Rules, registered foreign SBSDs and registered US SBSDs engaged in SBS activity through foreign branches with non-US persons and foreign branches of US banks are exempted from certain external business conduct requirements<sup>9</sup> with respect to their “Foreign Business.” A “Foreign Business” is defined as the business of an SBSD other than a “US Business.” “US Business,” in turn, means (i) with respect to a US SBSD, any transaction by or on behalf of such US SBSD other than a transaction conducted through a foreign branch<sup>10</sup> with a non-US person or another foreign branch, and (ii) 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 US person (other than with a foreign branch), or (b) any transaction conducted within the United States.

In addition, the SEC has provided in the Proposed Rules that a foreign SBSD may, under certain circumstances, be exempt from the segregation requirements with respect to SBS transactions with non-US counterparties. Application of the segregation requirement varies with the particular characteristics of the foreign SBSD. All registered foreign SBSDs, however, are required to disclose to their counterparties the potential treatment of the assets segregated by the registered foreign SBSDs in insolvency proceedings under the US bankruptcy laws and applicable foreign insolvency laws.

- Entity-level requirements apply to an SBSDs at the entity level; these requirements relate primarily to capital, margin,<sup>11</sup> risk management procedures, recordkeeping and reporting, supervision and designation of a chief compliance officer.

As described below, some foreign SBSDs may be able to benefit from a substituted compliance determination from the SEC with respect to their entity-level obligations. Under the Proposed Rules, if the SEC issues such a substituted compliance order, a foreign SBSD would be able to satisfy relevant entity-level requirements by substituting compliance with corresponding requirements under a foreign regulatory system.

<sup>9</sup> The exempted external business conduct standards include standards relating to fraud, manipulation and other abusive practices involving SBSs; verification that any counterparty meets the eligibility standards for an eligible contract participant; and certain required disclosures by SBSDs. SBSDs, however, would not be exempt from the business conduct standard requiring diligent supervision of an SBSD’s business. In addition, the general antifraud rules of federal securities laws would continue to apply.

<sup>10</sup> Important terms used in the Proposed Rules, including “foreign branch,” “US person,” and “transaction conducted within the United States,” have the same meaning across the different sections of the Proposed Rules.

<sup>11</sup> We note that margin is treated as a transaction-level requirement in the CFTC proposed rules.

## Registration and Regulation of MSBSPs

Like SBSBs, MSBSPs are a new type of entity defined in Title VII of the Dodd-Frank Act. MSBSPs are persons whose SBS activities do not cause them to be dealers, but whose activities could nonetheless pose a high degree of risk to the US financial system. Unlike the SBSB definition, the definition of MSBSPs does not focus on the quality of a person’s swap market activities, or on how the person presents itself to the market; rather, using objective numerical standards, the focus is on assessing the potential MSBSP’s market impact and the risks associated with the person’s SBS positions. As with SBSBs, though, a person can avoid registration as an MSBSP if the person’s SBS positions fall below certain *de minimis* numerical thresholds.

### Which SBS Dealings Count Toward the *De Minimis* Threshold?

Once again, in making a *de minimis* threshold determination for MSBSP status, the SEC distinguishes between US and non-US persons:

- A US person must consider all SBS transactions it enters into with any counterparty. In addition, if the US person acts as guarantor of a non-US person that is a party to an SBS transaction, the US person guarantor must attribute the guaranteed SBS transaction to itself for purposes of determining its MSBSP status.

However, a US person need not attribute to itself a guarantee made to support a non-US person’s obligations under an SBS transaction if such non-US person is subject to capital regulation

by the SEC or the CFTC or is subject to home country regulations consistent with the Capital Accord of the Basel Committee on Banking Supervision.

- A non-US person, on the other hand, must consider only those SBS transactions entered into with US counterparties (including foreign branches of US banks). In addition, if the non-US person acts as guarantor for a US person that is a counterparty to an SBS transaction, the non-US person guarantor must attribute the guaranteed SBS transaction to itself for purposes of making the MSBSP *de minimis* threshold determination. Similarly, a non-US person guaranteeing the SBS transaction of another non-US person must count the SBS transaction toward its *de minimis* threshold if the counterparty to the transaction is a US person.

However, a non-US person need not attribute to itself a guarantee made for a US person that is a counterparty to an SBS transaction if such US person is subject to capital regulation by the SEC or the CFTC or is a US entity regulated as a bank in the United States.

Unlike SBSBs, when making a *de minimis* threshold determination under the MSBSP definition, a non-US person is not subject to a “conducted within the United States” test. Thus, for purposes of determining the MSBSP status of non-US persons, the SEC has loosened somewhat its territorial approach to the *de minimis* determination. In practice, under the Proposed Rules, all SBS transactions by a non-US person with other non-US person counterparties, regardless of whether they are conducted within the United States or whether the non-US person counterparties are guaranteed by a US person, would be excluded from the *de minimis* determination of the non-US person.

MSBSP Registration <sup>12</sup>							
Counterparty		US Person			Non-US Person		
		Direct Counterparty	Guarantor		Direct Counterparty	Guarantor	
			For US Party	For Non-US Party		For US Party	For Non-US Party
		US Person (Including a Foreign Branch of a US Person)	Count	Count (1)	Count (2)	Count	Count (3)
Non-US Person (Regardless of Whether Within or Outside the US)	Count	Count (1)	Count (2)	Don't Count	Count (3)	Don't Count	

1. This SBS transaction would be attributed to the US person guarantor if there is recourse to such guarantor; however, no attribution would occur if the US person being guaranteed is subject to capital regulation by the SEC or the CFTC or is a US entity regulated as a bank in the United States.
2. This SBS transaction would not be counted if the non-US party being guaranteed is subject to capital regulation by the SEC or the CFTC or is subject to home-country regulations consistent with the Capital Accord of the Basel Committee on Banking Supervision.
3. This SBS transaction would not be counted if the US party being guaranteed is subject to capital regulation by the SEC or the CFTC or is a US entity regulated as a bank in the United States.

<sup>12</sup> Unlike SBSBs, potential MSBSPs conducting *de minimis* threshold determinations need not distinguish between transactions conducted within or outside the United States.

#### Transaction-Level and Entity-Level Requirements

Under the Proposed Rules, US MSBSPs would be subject to the same transaction-level and entity-level requirements as SBSs. Non-US MSBSPs entering into SBS transactions with US counterparties would also be subject to the same requirements.

However, the SEC has provided in the Proposed Rules for an exemption from certain transaction-level requirements for non-US MSBSPs entering into SBS transactions with non-US counterparties. Specifically, in such a scenario, the non-US MSBSPs would not need to comply with certain external business conduct standards<sup>13</sup> other than diligent supervision. Furthermore, if the non-US MSBSP is not a registered broker-dealer, it would not have to comply with requirements related to the segregation of assets held as collateral with respect to transactions with non-US persons.

Non-US MSBSPs do not receive, however, a similar exemption with respect to entity-level requirements. Neither do the Proposed Rules provide for a substituted compliance determination for non-US MSBSPs. According to the SEC, because MSBSPs engage in a diverse range of business activities other than SBS dealing activities, it is not clear that such MSBSPs are subject to entity-level regulatory oversight in their respective foreign jurisdiction that would justify a substituted compliance determination.

#### Registration of Clearing Agencies, Swap Data Repositories (“SDRs”) and Security-Based Swap Exchange Facilities (“SB SEFs”)

##### Clearing Agencies

Under the Proposed Rules, clearing agencies providing clearance and settlement services, or central counterparty (“CCP”) services, in cross-border SBS transactions must register with the SEC under the following circumstances:

- i. The clearing agency acts as a CCP within the United States or
- ii. A foreign clearing agency acts as a CCP to a member that is a US person

However, a foreign clearing agency may be exempt from registration if (a) the clearing agency is subject to comparable regulation by appropriate government authorities in the home country of the clearing agency, and (b) the nature of the clearing agency’s activities and performance of functions within the United States suggest that registration is not necessary to achieve the SEC’s regulatory objectives.

##### SDRs

The Exchange Act defines an “SDR” as “any person that collects and maintains information or records” with respect to SBS transactions for the purpose of providing “a centralized recordkeeping facility.” SDRs may provide this information to both US and foreign authorities. Under the Exchange Act, each entity that receives information from an SDR must agree to indemnify the SDR and the SEC for any expenses arising from litigation relating to the information provided.

For the purpose of registration with the SEC, the Proposed Rules distinguish between US and non-US persons acting as SDRs:

- Any US person that performs the functions of an SDR is required to register with the SEC.
- Absent an exemption, any non-US person that performs the functions of an SDR within the United States is required to register with the SEC. A non-US person is said to perform the function of an SDR within the United States when, for example, the non-US person enters into contracts (such as user or technical agreements) with a US person or maintains SBS data on servers physically located in the United States.

The SEC has proposed exemptive relief, however, for non-US person SDRs under the Exchange Act, provided that each foreign regulator with supervisory authority over the non-US person SDR has entered into a supervisory and enforcement memorandum of understanding (“MOU”) or other arrangement with the SEC that addresses, among other things, data confidentiality and access rights by the SEC.

In addition, because certain domestic and foreign entities may not be able to satisfy the SEC’s indemnification requirement, the SEC has proposed exemptive relief for these entities when (a) the entities request SBS information from the SDR to fulfill a regulatory mandate or legal responsibility, (b) the request pertains to a person or financial product subject to the jurisdiction or oversight of the entities, and (c) the entities have entered into an MOU or other arrangement with the SEC.

##### SB SEFs

The Exchange Act defines “SB SEFs” as trading systems or platforms, other than national exchanges, in which multiple participants can execute or trade SBSs “through any means of interstate commerce.” In previous releases on SB SEFs, the SEC did not expressly address the circumstances under which foreign SB SEFs would be required to register with the SEC under the Exchange Act.

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<sup>13</sup> See note 9, *supra*.

The Proposed Rules now provide that foreign SB SEFs would be required to register under the following circumstances:

- i. The foreign SB SEF performs certain activities in the United States. For example, the foreign SB SEF provides proprietary electronic screens, market terminals, monitors or other devices for trading SBSs in its market, grants direct electronic access to the foreign SBSs market's trading system or network, and grants membership or participation in the foreign SBS market or
- ii. The foreign SB SEF induces the execution or trading of SBSs on its market by US persons or non-US persons located in the United States. For example, the foreign SB SEF markets its services relating to the ability to execute or trade SBSs, or initiates contact with such persons for the purpose of inducing execution or trading

The SEC is considering offering an exemption for foreign SB SEFs from registration, however, under certain circumstances. For example, the SEC is considering exempting from registration foreign SB SEFs that are subject to comparable regulation under appropriate governmental authorities in their home countries.

### Mandatory Clearing and Trade Execution Requirements

Section 3C(a)(1) of the Exchange Act provides that, if an SBS must be cleared, it "shall be unlawful for any person to engage in" the SBS unless that person submits the SBS for clearing to a registered clearing agency or an exempt clearing agency. The Exchange Act further provides that, if the SBS transaction is subject to the clearing requirement, the counterparties must also execute the transaction on an exchange or a registered or exempt SB SEF.

#### When Is a Person "Engaged in" SBSs?

Under the Proposed Rules, and subject to certain exceptions, a person is said to be "engaged in" SBSs for the purposes of the mandatory clearing requirement (and consequently, for purposes of the trade execution requirement) under the following circumstances:

- i. Subject to certain exceptions, the SBS transaction involves a US counterparty, or else a US person guarantees the performance of a non-US person under the transaction

– Exceptions: neither the clearing nor trade execution requirements apply if:

- a. One counterparty to the transaction is either a foreign branch of a US bank or a non-US person whose performance under the SBS is guaranteed by a US person and
  - b. The other party to the transaction is a non-US person whose performance under the SBS is not guaranteed by a US person and who is not a foreign SBSD
- ii. Subject to certain exceptions, the SBS transaction is "conducted within the United States," that is, the transaction is solicited, negotiated, executed or booked within the United States

– Exceptions: neither the clearing nor trade execution requirements would apply if:

- a. The transaction is between non-US counterparties
- b. Neither counterparty's performance under the SBS is guaranteed by a US person and
- c. Neither counterparty to the transaction is a foreign SBSD

### Substituted Compliance

The Proposed Rules set out a framework for "substituted compliance," a policy under which the SEC may permit parties to comply with comparable regulatory requirements in a foreign jurisdiction in substitution for compliance with certain requirements of the Exchange Act. Generally, pursuant to this policy, a foreign market participant would be permitted to comply with the requirements imposed by its own home country so long as those requirements achieve regulatory outcomes comparable to the regulatory outcomes of the relevant provisions of Title VII. However, in the absence of home-country regulations that achieve comparable regulatory outcomes, substituted compliance would not be permitted and the foreign market participant would be required to comply with the applicable US requirements.

Furthermore, despite a grant of permission to follow home-country regulations under the substituted compliance framework, a foreign market participant remains subject to the Exchange Act; a violation of home-country rules by the foreign market participant therefore results in a violation of the Exchange Act. In addition, the general antifraud rules of US federal securities laws continue to apply to foreign market participants complying with the requirements of a substituted compliance regime.

#### Substituted Compliance Determination Process

Under the Proposed Rules, market participants would submit written requests to the Office of the Secretary of the SEC, seeking a substituted compliance determination. The market participants must also submit supporting documentation that the participants believe is necessary for a substituted compliance determination, including information on the applicable requirements established by the foreign regulatory authority and the methods used by the foreign authority to monitor compliance with, and enforce, its requirements. The SEC will not consider anonymous requests, though market participants can seek confidential treatment of their applications.

Important features of the substituted compliance determination include:

- A Holistic approach. In making a substituted compliance determination, the SEC will not perform a rule-by-rule comparison with the requirements of a foreign regulatory system. Rather, the SEC will examine relevant principles, regulations or rules in the foreign regulatory system to determine whether the foreign regulatory system achieves similar “regulatory outcomes” as SEC regulations.
- Determinations on a class/jurisdiction basis. Generally, the SEC’s substituted compliance determinations will be made on a class or jurisdiction basis, and not on a firm-by-firm basis. Thus, once the SEC has made a substituted compliance determination with respect to a particular foreign jurisdiction, the determination would apply to every foreign SBS in the specified class or classes registered and regulated in that jurisdiction.
- Ability to modify or withdraw determination. On its own initiative, the SEC may modify or withdraw a substituted compliance determination for a particular foreign jurisdiction, after appropriate notice and opportunity for comment. Reasons to modify or withdraw a determination include changes in the foreign regulatory regime, or a failure by the foreign regulator to exercise its supervisory or enforcement authority effectively.

#### Substituted Compliance Categories

Substituted compliance determinations will be available with respect to four categories or “buckets,” described below. The SEC may grant a substituted compliance order with respect to all these categories, or with respect to individual categories; hence, the substituted compliance determination is not an “all or nothing” decision.

- i. Regulation of registered non-US SBSs.
  - The SEC may, conditionally or unconditionally, make a substituted compliance determination permitting non-US SBSs to comply with a foreign regulatory authority’s requirements that satisfy the transaction and entity-level requirements under Section 15F of the Exchange Act. Substituted compliance is not available, however, with respect to a non-US SBS’s registration requirements, which, according to the SEC, serve important notice functions.
- ii. Regulatory reporting and public dissemination of SBS information.
  - The release containing the SEC’s Proposed Rules also contains a re-proposal of Regulation SBSR, which provides for the reporting of SBS information to registered swap data repositories (“SDRs”) or the SEC and the public dissemination of certain SBS information. Substituted compliance may relieve SBS parties of these requirements, however, so long as at least one direct counterparty to the SBS (a) is a non-US person or a foreign branch of US bank, and (b) no person within the United States is directly involved in executing, soliciting or negotiating the terms of the SBS on behalf of such counterparty. No substituted compliance is available, though, if the SBS is between two US persons (even if conducted outside of the United States), or the direct counterparties to the SBS solicit, negotiate, execute or book the transaction within the United States.
- iii. SBS clearing requirements.
  - As the SEC does not expect a large number of requests for substituted compliance in this area,<sup>14</sup> the SEC’s Proposed Rules do not provide specific rules for substituted compliance in relation to clearing. However, the Proposed Rules do clarify that, if the SEC makes a substituted compliance determination with respect to a particular foreign clearing agency, a counterparty to an SBS transaction that is subject to the mandatory clearing requirement would be able to rely on the SEC’s determination to satisfy the mandatory clearing requirement by clearing the transaction on the specified foreign clearing agency.<sup>15</sup> As a condition to substituted compliance, the foreign clearing agency (a) must have no US person members, and (b) must perform no relevant activity in the United States.

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<sup>14</sup> The SEC’s stance in this case is based on the small number of SBS clearing agencies in the market.

<sup>15</sup> In addition, as discussed above, the SEC’s clearing agency registration regime already contains an exemption procedure under which exempt clearing agencies can satisfy the mandatory clearing requirement. The registration exemption and the substituted compliance determination are thus complementary to each other in this context.



- iv. SBS trade execution requirements.
- Under the Proposed Rules, a person subject to the mandatory trade execution requirement may execute the transaction, or have the transaction executed on their behalf, on a foreign SBS market that is neither registered nor exempt from registration under the Exchange Act if the SEC determines that the foreign market is subject to comparable supervision and regulation by a foreign regulatory authority. However, substituted compliance would only be available for SBS transactions where at least one counterparty to the transaction (a) is either a non-US person or foreign branch of a US bank, and (b) the SBS transaction is not solicited, negotiated or executed by a person within the United States on behalf of the counterparty.

### Relation to the Proposed CFTC Cross-Border Rules

The SEC's Proposed Rules differ in some important respects from orders and proposed guidance issued by the CFTC, which govern cross-border swap activities. Even though the Dodd-Frank Act directs US regulators to consult and coordinate with each other to ensure "regulatory consistency and comparability, to the extent possible," some of the differences in the respective cross-border approaches of the CFTC and the SEC may be explained by differences in the statutory text of the Commodity Exchange Act ("CEA") and the Exchange Act, each agency's governing legislation. Section 722 of the Dodd-Frank Act, for instance, states that the CEA's provisions introduced by the Dodd-Frank Act apply to swap activities outside the United States only when the activities "have a direct and significant connection with activities in, or effect on, commerce of the United States." By contrast, the Dodd-Frank Act established a more "territorial" standard in Section 772, which states that the Exchange Act does not apply to SBSs "without the jurisdiction of the United States," unless that business is transacted in contravention of rules prescribed to prevent evasion of Title VII.

Some notable differences between the cross-border approaches of the SEC and the CFTC include:

- Definition of "US person." The SEC has proposed a narrower definition of "US person" than the CFTC, affecting swap dealers' respective *de minimis* threshold calculations under the respective rules.
- The territorial concept of "transactions conducted within the United States." Unlike the SEC's Proposed Rules, the CFTC's proposed rules do not contain a "territoriality" prong—that is, unlike the SEC, the CFTC does not consider whether swap dealing activity is conducted inside or outside the United States when determining whether a swap dealer's *de minimis* threshold is met.
- The treatment of transaction-level and entity-level requirements. The SEC, for example, treats margin as an entity-level requirement, while the CFTC considers margin a transactional-level requirement.
- Availability of substituted compliance. The SEC's and CFTC's respective rules also differ with respect to substituted compliance, with the SEC, for instance, not allowing MSBSPs to use the substituted compliance procedure.

For a discussion of the CFTC's Final Exemptive Order Regarding Compliance with Certain Swap Regulations, please click [here](#).

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