



Investment Management ADVISORY ■

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SEC Adopts Final Rules and Guidance Defining “Security-Based Swap Dealer” and “Major Security-Based Swap Participant” in Cross-Border Transactions

On June 25, 2014, the Securities and Exchange Commission (SEC) adopted the first of a series of rules on cross-border security-based swap activities for market participants (the “[Final Rules](#)”). The Final Rules focus on three issues: (1) when a cross-border transaction must be counted toward the de minimis threshold for registration as a security-based swap dealer (SBSD) or the determination of a substantial position in security-based swaps for registration as a major security-based swap participant (MSBSP); (2) procedures for foreign regulators or market participants to apply for substituted compliance, which would allow market participants to comply with comparable foreign requirements as an alternative to complying with U.S. requirements; and (3) the extension of the SEC’s anti-fraud enforcement authority to where the fraud occurs or where the fraud is felt within the United States.

Adopted SEC rules are generally effective 60 days after their publication in the Federal Register. Since the Final Rules are definitional in nature, there is no compliance timeline until future substantive rulemaking is completed. As a result, the Final Rules afford market participants an opportunity to determine, among other considerations, whether their cross-border transactions will require them to register as SBSBs or MSBSPs and to consider the information that entities should require from counterparties and affiliates in order to make such a determination.

Background

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd Frank Act”) generally tasks the SEC and the Commodity Futures Trading Commission (CFTC) with regulating the over-the-counter derivatives market. The SEC has jurisdiction over security-based swaps (swaps—including credit default swaps—tied to a single security, loan, issuer of securities, or narrow-based security index). The CFTC, on the other hand, is responsible for most other swaps, such as interest rate swaps and swaps on currencies, commodities or broad-based security indices.¹

The Final Rules derive from proposed rules issued by the SEC on May 23, 2013 (the “[SEC Proposal](#)”), and are influenced by guidance published by the CFTC on July 26, 2013 (the “[CFTC Guidance](#)”), which, among other proposals and guidelines, clarified whether an entity’s cross-border transactions must be counted toward their thresholds for registration as an SBSB or MSBSP. Though similar, the Final Rules differ from the CFTC guidance in several important areas, including a narrower definition of “U.S. persons” and the exclusion from a non-U.S. person’s registration threshold transactions

¹ The regulation of mixed swaps is impacted by both the CFTC and the SEC.

with non-U.S. affiliates guaranteed by U.S. persons. While the SEC believes that, in practice, the Final Rules and the CFTC Guidance will produce similar results, market participants will need to pay close attention to future SEC and CFTC rules and guidance to ensure that they are complying with both SEC and CFTC regulatory regimes.

Transactions Counted toward the De Minimis Threshold and Substantial Position Calculation

U.S. Person

Subject to certain carve-outs for hedging positions and collateralized positions, the Final Rules require a U.S. person to count all of its security-based swap dealing and security-based swap positions toward its registration thresholds. The Final Rules define a “U.S. person” as²:

- i. any natural person who resides in the United States;
- ii. any partnership, corporation, trust, investment vehicle or other legal person organized, incorporated or established under the laws of the United States or having its principal place of business in the United States;
- iii. any discretionary or non-discretionary account of a U.S. person; or
- iv. any estate of a decedent who was a resident of the United States at the time of death.

An entity’s principal place of business is “the location from which the officers, partners, or managers of the legal person primarily direct, control and coordinate the activities of the legal person.”³ Under this analysis, non-U.S. branches of U.S. banks are considered U.S. persons, while U.S. branches of non-U.S. banks do not qualify as U.S. persons. For externally managed investment vehicles, 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.”⁴

For counterparties, the SEC adopts a “constructive knowledge” standard, meaning that an entity may rely on representations from a counterparty that such a counterparty is or is not a U.S. person as long as the entity does not know or have reason to know that the representation is inaccurate. Since the SEC’s constructive knowledge standard departs from the CFTC’s standard requiring an entity to take into account the general facts and circumstances of both the transaction and the counterparty to rely on a counterparty’s representation, an entity may not rely solely on a counterparty’s representation if the representation is limited to CFTC-related regulations, although this will depend on how the entity has applied the CFTC’s general facts and circumstances inquiry.

Conduit Affiliates

As in the case of U.S. persons, the Final Rules require conduit affiliates to count all security-based swap transactions toward their de minimis threshold or substantial position calculation. The Final Rules define “conduit affiliates” as any non-U.S. affiliate of a U.S. person that, in the regular course of business, enters into security-based swap transactions with non-U.S. persons (or foreign branches of U.S. banks registered as security-based swap dealers) and enters into offsetting security-based swaps or other arrangements with their U.S. affiliate. This requirement serves as an anti-evasion measure designed to prevent U.S. persons using an affiliate that is a non-U.S. person as an intermediary to

² The Final Rules specifically exclude from the definition of a U.S. person international organizations, such as the International Monetary Fund, the African Development Bank, and the United Nations, as well as such organizations’ agencies and pension plans.

³ Application of “Security-Based Swap Dealer” and “Major Security-Based Swap Participant” Definitions to Cross-Border Security-Based Swap Activities, Release No. 34-72472 at 93 (June 25, 2014).

⁴ *Id.* at 107.

transfer risks and benefits associated with security-based swaps with other non-U.S. persons without counting such transactions toward the U.S. person's de minimis threshold or substantial position calculation.

Security-Based Swap Dealer Registration

Through a jointly issued rule, the SEC and CFTC define a "security-based swap dealer" as any person that:

- i. holds itself out as a dealer in security-based swaps;
- ii. makes a market in security-based swaps;
- iii. regularly enters into security-based swaps with counterparties as an ordinary course of business for one's own account; or
- iv. engages in any activity causing oneself to be commonly known in the trade as a dealer or market maker in security-based swaps.⁵

A market participant falling within the definition of an SBSB must register with the SEC if the market participant's security-based swap transactions exceed a de minimis threshold. Currently, the de minimis threshold is under a phase-in period that is subject to change.⁶ The de minimis threshold is as follows:

- i. \$8 billion in aggregate notional amount of security-based credit default swaps to be reduced to \$3 billion upon the termination of the phase-in period;
- ii. \$400 million in aggregate notional amount of other types of security-based swaps, to be reduced to \$150 million upon the termination of the phase-in period; or
- iii. \$25 million in aggregate notional amount of any type of security-based swap in which the counterparty is a "special entity."

As noted above, subject to certain carve-outs for hedging positions and collateralized positions, all SBSBs that are U.S. persons must count all security-based swap dealing activity toward their de minimis threshold.

Non-U.S. entities that are not conduit affiliates must count the following transactions related to their security-based swap dealing activity toward their de minimis threshold: (i) transactions with U.S. persons⁷; (ii) transactions with conduit affiliates; and (iii) transactions with any counterparty that has a right of recourse, or legally enforceable right, against a U.S. affiliate of the non-U.S. person regarding the non-U.S. person's obligation under the security-based swap.⁸ The Final Rules exclude from the de minimis threshold transactions that are entered into anonymously and are cleared through a clearing agency.

⁵ <http://www.sec.gov/rules/final/2012/34-66868.pdf>.

⁶ The SEC may terminate the phase-in period for the de minimis threshold in September of 2015 (nine months after the SEC publishes a study of the swap markets, which the SEC plans to finish in January 2015). Alternatively, the SEC may elect to propose new rules to change the de minimis threshold. The phase-in period will terminate automatically if the SEC does not terminate the phase-in period within five years after data begins to be reported to swap data repositories.

⁷ The non-U.S. person must count transactions with foreign branches of U.S. banks toward the de minimis threshold unless the transaction occurs less than 60 days prior to the effective date of the final rules setting forth the registration of security-based swap dealers or the counterparty is a foreign branch that (i) is a branch of a registered security-based swap dealer; (ii) is subject to substantive banking regulation in the jurisdiction where it is located; (iii) operates for valid business reasons; and (iv) is engaged in the business of banking.

⁸ The SEC's "right of recourse" approach is narrower in scope than the CFTC's requirement that market participants must include transactions with all non-U.S. persons guaranteed by U.S. persons toward their de minimis threshold.

Major Security-Based Swap Participant Definition

Through a jointly issued rule, the SEC and CFTC generally define “major security-based swap participant” as any person that is not an SBSB and:

- i. maintains a substantial position⁹ in security-based swaps;
- ii. has security-based swap positions that create substantial counterparty exposure that could have adverse effects on the U.S. banking system or financial markets; or
- iii. is a financial entity that is highly leveraged and maintains a substantial position in outstanding security-based swaps.

Subject to certain carve-outs for hedge positions and collateralized positions, entities that are U.S. persons must count all security-based swap transactions toward their determination of whether they maintain a substantial position in security-based swaps.

Non-U.S. entities that are not conduit affiliates must count the following transactions toward their determination of whether they maintain a substantial position in security-based swaps: (i) transactions with U.S. persons (subject to the same foreign branch exclusion for the de minimis threshold for SBSBs); (ii) transactions with conduit affiliates; and (iii) transactions with any counterparty that has a right of recourse against *any* U.S. person. The Final Rules exclude from this inquiry transactions involving U.S. persons regulated as banks or counterparties deemed not to be an MSBSP. This carve-out also includes security-based swaps subject to capital regulation by the SEC, CFTC, or the non-U.S. person’s home country regulator if the non-U.S. person’s local regulations are consistent with the Capital Accord of the Basel Committee on Banking Supervision.

Aggregation

The Final Rules require an entity to count toward its de minimis threshold and substantial position calculation security-based swap transactions conducted by affiliates that the entity controls and affiliates that control the entity to the extent that such affiliates are required to include such transactions in their own de minimis thresholds or substantial position calculations. This aggregation requirement exempts entities not registered as SBSBs or MSBSPs from including in their de minimis threshold or substantial position calculation transactions with counterparties that are registered as SBSBs or that have breached the Final Rules and are preparing to register as SBSBs.

Transactions in the United States between Non-U.S. Persons

The SEC Proposal required non-U.S. persons to count toward their de minimis thresholds and substantial position calculations security-based transactions with non-U.S. persons that are conducted within the United States. Though the Final Rules place no such requirement on non-U.S. persons, the SEC has requested comments on whether a territory-based requirement should exist and how such a requirement should be implemented.

Substituted Compliance Requests

Under the Final Rules, foreign regulators and non-U.S. persons may apply for “substituted compliance,” which allows market participants to forgo the SEC security-based swap rules and instead comply with local laws that the SEC deems sufficient. Though the Final Rules do not define the circumstances under which a foreign regulator or non-U.S. person

⁹ In determining whether an entity maintains a “substantial position” in security-based swaps, the SEC and CFTC apply a two-pronged numerical test considering the entity’s current and potential future uncollateralized exposures to security-based swaps.

may apply for substituted compliance, the Final Rules provide procedures for such an application. In particular, the Final Rules require the application to include supporting documentation reflecting the requirements of the foreign regulatory regime along with the methods used by the regime to monitor and enforce compliance with the rules.

Anti-Fraud Rules

The Final Rules also define the scope of the SEC's cross-border anti-fraud civil enforcement authority to include (i) conduct occurring within the United States in furtherance of fraud or (ii) conduct occurring outside the United States where sufficient effects of the fraud are felt within the United States.

Practical Concerns for Certain Types of Entities

Hedge Funds and Corporations

Although the Final Rules impact the swap dealer community, other market players may find themselves swept under SEC scrutiny. For example, non-U.S. hedge funds engaged in security-based swap dealing activity that enter into transactions with U.S. persons will need to count such transactions toward the de minimis threshold. Non-U.S. hedge funds not involved in security-based swap dealing activity will also need to count security-based swap transactions with U.S. persons toward their substantial position calculations if such transactions do not fall under the hedging carve-out. In both cases, SBSB or MSBSP status is more likely to be achieved, thereby requiring registration as such with the SEC. In addition, imposing a territory-based requirement for determining non-U.S. persons, should one be implemented, will make those tests even easier to achieve, particularly for non-U.S.-based hedge funds with offices in the United States. Moreover, the differences between the CFTC and SEC definitions of U.S. persons and the divergent standards used by the commissions to determine such status will create more work—and impose additional costs—for compliance departments.

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