



SEC Adopts Cross-Border Security-Based Swap Rules and Guidance

Executive Summary

On June 25, 2014, the Securities and Exchange Commission (SEC or Commission) adopted rules and provided interpretive guidance to address the application of certain provisions of the *Securities Exchange Act of 1934* (the Exchange Act) related to cross-border security-based swap activities that were added by Subtitle B of Title VII of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the Dodd-Frank Act). The final rules address one aspect of a series of rules proposed by the SEC on May 23, 2013 (2013 SEC Cross-Border Proposal), by explaining when cross-border transactions must be counted in determining whether a market participant is required to register as a security-based swap dealer (SBSD) or a major security-based swap participant (MSBSP). The SEC states that it will address other aspects of its 2013 SEC Cross-Border Proposal, including trade reporting and public dissemination of trade details, mandatory clearing and trade execution, rules applicable to registered SBSDs and MSBSPs, and security-based swap market infrastructure, through future rulemaking.

The SEC also adopted a procedural rule for foreign security-based swap market participants to submit “substituted compliance” requests to the Commission. Substituted compliance would permit market participants to satisfy certain Title VII security-based swap regulations by complying with another non-U.S. jurisdiction’s comparable regulatory framework.

Lastly, the final rules address the scope of the SEC’s cross-border anti-fraud law enforcement authority by clarifying that the Commission’s anti-fraud rules apply to conduct occurring (1) within the United States when it constitutes significant steps in furtherance of a violation or (2) outside of the United States when it has a foreseeable substantial effect within the United States.

The rules will become effective 60 days after their publication in the *Federal Register*. However, the SEC notes that both the rules addressing the application of the dealer and major participant definitions and the procedures for submitting substituted compliance requests to the SEC will not impose requirements on market participants until the SEC has completed its relevant substantive rulemakings.

Background

In response to the 2008 financial crisis, Title VII of the Dodd-Frank Act amended the Exchange Act to provide the SEC and the Commodity Futures Trading Commission (CFTC) with enhanced authority to regulate the over-the-counter (OTC) derivatives market. Under this new regulatory framework for swaps and security-based swaps, the SEC was given regulatory authority over “security-based swaps,” the CFTC was given regulatory authority over “swaps,” and both the SEC and the CFTC were designated as having joint regulatory authority over “mixed swaps.”¹ Title VII further granted the SEC with the authority to write rules for certain market participants, including SBSDs and MSBSPs.

The marketplace for security-based swaps is global in practice, with participants that can be subject to multiple sets of regulations across different jurisdictions and counterparties that can be located in different countries, leading to potentially complex regulatory challenges. The 2013 SEC Cross-Border Proposal addressed the application of Title VII in the cross-border context, including issues regarding the requirements applicable to dealers and major participants, and requirements related to mandatory clearing, trade execution, regulatory reporting, and public dissemination.² The final rules address one aspect of this proposal by explaining when cross-border transactions must be counted in determining whether a market participant is required to register as an SBSD or an MSBSP.

In July 2013, the CFTC released an interpretive guidance and policy statement (CFTC Final Cross-Border Guidance) regarding compliance with certain swap regulations in the cross-border context.³ The guidance defined a “U.S. Person” for purposes of the CFTC’s swap regulatory authority and specified which swap activities a “Non-U.S. Person” must include, and can exclude, when determining whether registration with the CFTC as a swap dealer or major swap participant is required.

The CFTC Final Cross-Border Guidance also addressed (1) the treatment of swaps involving certain foreign branches of U.S. banks, (2) the treatment of swaps involving a non-U.S. counterparty guaranteed by a U.S. Person or “affiliate conduit,” (3) the categorization of the Title VII swap provisions as “Entity-Level Requirements” or “Transaction-Level Requirements,” and (4) the availability of “Substituted Compliance” should the CFTC determine that a foreign jurisdiction’s rules are comparable to its own. Similar to the SEC’s final procedural rule for substituted compliance, the CFTC Final Cross-Border Guidance establishes an application process for eligible swap market participants to satisfy certain Title VII swap regulations by complying with their home jurisdictions’ comparable regulatory requirements, under certain circumstances.

¹ A “security-based swap” is a swap that is tied to a single security, loan, or issuer of securities, a narrow-based security index, or the occurrence of certain events relating to an issuer of securities or the issuers of securities in a narrow-based security index. See the CFTC and SEC joint final rule *Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”*; *Mixed Swaps; Security-Based Swap Agreement Recordkeeping*, 77 Federal Register 48208 (August 13, 2012).

² See *Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants*, 78 Federal Register 30968 (May 23, 2013).

³ See *Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations*, 78 Federal Register 45292 (July 26, 2013).

Description

SEC Definition of a “U.S. Person”

A security-based swap transaction is subject to the Title VII requirements of the Dodd-Frank Act if the transaction is entered into with a “U.S. Person” or is otherwise conducted within the United States. For the purposes of identifying the applicability of these requirements, the final rules include the following criteria in the definition of a U.S. Person under Part 240.3a71-3(a)(4) of the Exchange Act:

- Any natural person who resides in the United States.
- 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.
 - Under the final rules, a “principal place of business” means “the location from which the officers, partners, or managers of the legal person primarily direct, control, and coordinate the activities of the legal person.” This definition also provides that the principal place of business for an externally managed investment vehicle “is the office from which the manager of the vehicle primarily directs, controls, and coordinates the investment activities of the vehicle.”
- Any discretionary or non-discretionary account of a U.S. person.
- Any estate of a decedent who was a resident of the United States at the time of death.

Consistent with the 2013 SEC Cross-Border Proposal, the final rules exclude certain international organizations, regardless of where they are organized or where their primary place of business is located, from the definition of a U.S. person, including 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.

The definition of U.S. Person adopted by the SEC is, in most respects, unchanged from the 2013 SEC Cross-Border Proposal. However, in response to commenters, the final definition reflects the following changes that the Commission states are intended to explain the definition’s scope:

- The final rules clarify that a U.S. Person is a legal person “established” under the laws of the United States, just as if it had been “organized” or “incorporated” under the laws of the United States.
- The final rules add an express reference to “investment vehicles” in the non-exclusive list of legal persons that will be treated as a U.S. Person in order to clarify that they fall within the scope of the rule.
- While the proposed rule did not expressly allow market participants to rely on representations from counterparties as to their counterparties’ U.S. Person status, the final rules do expressly permit market participants to rely on such representations.⁴

⁴ Under the final rule, a person does not need to consider its counterparty to be a U.S. Person for purposes of Title VII, if they receive a representation from the counterparty that the counterparty

SEC and CFTC “U.S. Person” Definition Comparison

The following table contains a comparison of the SEC and CFTC definitions of a U.S. Person under the SEC final rule and CFTC final cross-border guidance:

Entity	SEC Final Rule	CFTC Final Cross-Border Guidance
Natural Persons	A natural person resident in the United States.	Any natural person who is a resident of the United States.
Corporate Entities	A 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.	Any corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund or any form of enterprise similar to any of the foregoing (other than an entity described under ‘Pension Plans’ or ‘Trusts’) (a “legal entity”), in each case that is organized or incorporated under the laws of a state or other jurisdiction in the United States or having its principal place of business in the United States.
Accounts	An account (whether discretionary or non-discretionary) of a U.S. person.	Any individual account or joint account (discretionary or not) where the beneficial owner (or one of the beneficial owners in the case of a joint account) is a person described under ‘Natural Persons,’ ‘Estates,’ ‘Corporate Entities,’ ‘Pension Plans,’ ‘Trusts,’ ‘Investment Vehicles,’ or ‘Unlimited Liability Entities.’
Estates	An estate of a decedent who was a resident of the United States at the time of death.	Any estate of a decedent who was a resident of the United States at the time of death.
Pension Plans	<i>No separate pension plan test. However, the SEC ‘Corporate Entities’ definition includes an “investment vehicle” test.</i>	Any pension plan for the employees, officers or principals of a legal entity described under ‘Corporate Entities,’ unless the pension plan is primarily for foreign employees of such entity.
Trusts	<i>See SEC ‘Corporate Entities.’</i>	Any trust governed by the laws of a state or other jurisdiction in the United States, if a court within the United States is able to exercise primary supervision over the administration of the trust.
Investment Vehicles	<i>No separate investment vehicle majority-ownership test.⁵</i>	Any commodity pool, pooled account, investment fund, or other collective investment vehicle that is not described under ‘Corporate Entities’ and that is majority-owned by one or more persons described under ‘Natural Persons,’ ‘Estates,’ ‘Corporate Entities,’ ‘Pension Plans,’ or ‘Trusts,’ except any commodity pool, pooled account, investment fund, or other collective investment vehicle that is publicly offered only to Non-U.S. Persons and not offered to U.S. Persons.

does not satisfy the criteria set forth in Part 240.3a71-3(a)(4)(ii) of the Exchange Act, unless the person “knows or has reason to know” that the counterparty’s representation is inaccurate.

⁵ The CFTC Final Cross-Border Guidance includes a majority-ownership approach for collective investment vehicles that are offered to U.S. Persons, which presumes that managers of these vehicles would assess, on an ongoing basis, the proportion of ownership by U.S. Persons.

Entity	SEC Final Rule	CFTC Final Cross-Border Guidance
Unlimited Liability Entities	<i>No separate unlimited liability entity majority-ownership test</i>	Any legal entity (other than a limited liability company, limited liability partnership or similar entity where all of the owners of the entity have limited liability) that is directly or indirectly majority-owned by one or more persons described under 'Natural Persons,' 'Estates,' 'Corporate Entities,' 'Pension Plans,' or 'Trusts,' and in which such person(s) bears unlimited responsibility for the obligations and liabilities of the legal entity.

SEC Registration Requirements for SBSDs

In May 2012, the SEC and CFTC adopted rules requiring a market participant to register with the SEC as an SBSD if it engages in security-based swap dealing activities that exceed certain thresholds.⁶ The SEC's final rules explain which cross-border transactions U.S. Persons and Non-U.S. Persons must count in determining whether their activities exceed these thresholds, which include the following considerations under Part 240.3a71-3(a)(5) of the Exchange Act:

- U.S. Persons must count all of their security-based swap transactions towards the SBSD *de minimis* thresholds, including dealing transactions conducted through a foreign branch.
- Non-U.S. Persons must count the following transactions towards the SBSD *de minimis* thresholds:
 - Security-based swap transactions with counterparties that are U.S. Persons, including foreign branches of U.S. banks, but excluding foreign branches of U.S. banks registered as SBSDs.
 - All security-based swap transaction activity, regardless of counterparty, connected with Non-U.S. Persons acting as a "conduit affiliate," whereby the Non-U.S. Person has entered into certain security-based swap transactions on behalf of its U.S. affiliates.⁷
 - Security-based swap transactions connected with any counterparty that has "rights of recourse" against a U.S. affiliate of the Non-U.S. Person. According to the final rules, a counterparty has rights of recourse if it has a conditional or unconditional legally enforceable right, in whole or in part, to receive payments from, or otherwise collect from, the U.S. affiliate in connection with the security-based swap.

SEC Registration Requirements for MSBSPs

The May 2012 rules adopted by the SEC and CFTC require a market participant to register with the SEC as an MSBSP if its security-based swap positions exceed certain thresholds.⁸ The SEC's final rules explain which positions U.S. Persons and

⁶ See Part 240.3a71-2 (*De Minimis* Exception) of the CFTC and SEC joint final rule *Further Definition of "Swap Dealer," "Security-Based Swap Dealer," and "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant,"* 77 Federal Register 30596 (May 23, 2012).

⁷ See "conduit affiliate" definition under Part 240.3a71-3(a)(1) of the Exchange Act.

⁸ Under Part 240.3a67-1 of the Exchange Act, a "major security-based swap participant" is defined as any person that is not an SBSD, but that maintains a substantial position in security-based swaps or whose positions create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets.

Non-U.S. Persons must count in determining whether its positions exceed these thresholds in the cross-border context, which include the following considerations under Part 240.3a67-10(b) of the Exchange Act:

- U.S. Persons must include all of their security-based swap positions when calculating their status as an MSBSP, including positions entered into through a foreign branch.
- Non-U.S. Persons must include the following positions against the MSBSP thresholds:
 - Security-based swap positions that are entered into with a U.S. Person, including foreign branches of U.S. banks, but excluding foreign branches of U.S. banks registered as SBSDs.
 - All security-based swap positions, regardless of counterparty, entered into if the Non-U.S. Persons are acting as conduit affiliates.
 - Security-based swap positions connected with any counterparty that has “rights of recourse” against a U.S. Person. According to the final rules, a counterparty has rights of recourse if it 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.

Affiliate Transaction Aggregation

The SEC’s final rules include an exception from aggregation for affiliated groups with registered SBSDs. Under Part 240.3a71-4 of the Exchange Act, a person may exclude from its dealer threshold calculations the security-based swap transactions of an affiliate that is registered with the SEC as an SBSD or deemed not to be an SBSD under Part 240.3a71-2(b) of the Exchange Act.

In response to comments received on its 2013 SEC Cross-Border Proposal, the Commission modified the final rules to no longer require that the person and its affiliate be “operationally independent.”

Cleared Anonymous Transactions on Swap Execution Facilities

The SEC’s final rules add an exclusion related to cleared, anonymous transactions by specifically including an exception for cleared transactions executed on a swap execution facility (SEF). Under Part 240.3a71-5 of the Exchange Act, a Non-U.S. Person, other than a conduit affiliate, may exclude its security-based swap transactions that are entered into anonymously on a SEF or national securities exchange and are cleared through a clearing agency.

Procedural Rule for Substituted Compliance Requests

Under the 2013 SEC Cross-Border Proposal, market participants would have been permitted to comply with certain Title VII SBSD obligations by substituting foreign financial regulatory requirements in circumstances where the SEC has deemed them to be comparable to U.S. requirements. For circumstances in which the SEC does not determine comparability, market participants would have to comply with the U.S. requirements.

The final rules do not address the requirements from the 2013 SEC Cross-Border Proposal under which substituted compliance may be used. Rather, the Commission adopted the procedural rule 240.0-13 for foreign regulators and market participants to file applications requesting a substituted compliance order under the Exchange Act. Under the final procedural rule, foreign regulators and market participants must submit an application describing, in writing and in the English language, the comparable requirement in their jurisdiction, as well as the methods used by the foreign regulatory authorities to monitor and enforce compliance with the applicable rules. The SEC states that it will not consider “hypothetical or anonymous” requests for a substituted compliance order.

The SEC will then publish a notice in the *Federal Register* announcing the submission of a complete application, subject to public comment for a period of 25 days. Once the complete application has been reviewed and a determination has been made, the SEC will issue its response and notify the applicant. The SEC may also choose to schedule a hearing on the substituted compliance request.

The SEC states that this rule represents a “first step” in its efforts to establish a framework to address the concern that market participants may be subject to more than one set of comparable regulations across different jurisdictions. The SEC intends to address the potential availability of substituted compliance for certain Title VII requirements through future rulemakings.

Scope of the SEC’s Cross-Border Anti-Fraud Authority

In a response to a recent federal district court that expressed the view that the SEC’s prior statutory language may be unclear, the Commission adopted Part 250.1 of the Exchange Act to address the cross-border substantive reach of the its anti-fraud law enforcement authority under Section 929P(b) of the Dodd-Frank Act. Part 250.1 explains that, notwithstanding any other SEC rule or regulation, the SEC’s anti-fraud provisions of the securities laws apply to the following circumstances:

- Conduct occurring within the United States that constitutes significant steps in furtherance of a violation. The SEC states that its anti-fraud provisions will apply even if the violation:
 - Relates to securities transactions taking place outside of the United States that involve only foreign investors; or
 - Is committed by a foreign advisor and only involves foreign investors.
- Conduct occurring outside of the United States that has a foreseeable substantial effect within the United States.

Violations of these anti-fraud rules may be pursued in judicial proceedings to be brought by either the SEC or the United States.

Commentary

After considering responses from commenters, the Commission has modified several important aspects of its 2013 SEC Cross-Border Proposal. A few key changes to the SEC's cross-border proposal regarding a participant's MSBSP threshold calculations include the following: (1) an additional requirement that a conduit affiliate must include all of its security-based swap positions, (2) an additional requirement that a Non-U.S. Person, other than a conduit affiliate, must include all of its security-based swap positions where its counterparty has rights of recourse against a U.S. Person, and (3) a modification to the proposed requirement that a Non-U.S. Person must include its security-based swap positions with foreign branches of U.S. banks.

With respect to the transparency of their substituted compliance processes, the SEC and CFTC have developed different approaches, despite political pressure for increased harmonization of derivatives rulemaking between the two regulators. The SEC has established a more transparent process with its decision to publish applications for public comment, while the CFTC's review of overseas applications is a private process under the CFTC Final Cross-Border Guidance.

To the extent that the SEC's final rules seek similar information from security-based swap market participants that the CFTC Final Cross-Border Guidance seeks from swap market participants, entities participating in both markets may be able to leverage their existing infrastructure to comply with the SEC's new regulations. As a result, these market participants may experience lower costs associated with assessing which cross-border security-based swap activity counts against the dealer *de minimis* exception or towards the MSBSP threshold. However, in instances where the SEC's final rules diverge from the CFTC's approach, participants in both markets may experience increased assessment costs related to information collection and data storage requirements, despite being in accordance with the CFTC Final Cross-Border Guidance.

This is a publication of KPMG's Financial Services Regulatory Risk Practice and the Americas' Financial Services Regulatory Center of Excellence

For additional information, please contact:

Tracy Whille, Principal: twhille@kpmg.com

Pamela Martin, Managing Director:

pamelamartin@kpmg.com

Daniel McIsaac, Director: dmcisaac@kpmg.com

Author: Lisa Newport, Assoc. Director, Americas' Financial Services Regulatory Center of Excellence

Earlier editions are available at:

www.kpmg.com/us/regulatorypracticeletters

ALL INFORMATION PROVIDED HERE IS OF A GENERAL NATURE AND IS NOT INTENDED TO ADDRESS THE CIRCUMSTANCES OF ANY PARTICULAR INDIVIDUAL OR ENTITY. ALTHOUGH WE ENDEAVOR TO PROVIDE ACCURATE AND TIMELY INFORMATION, THERE CAN BE NO GUARANTEE THAT SUCH INFORMATION IS ACCURATE AS OF THE DATE IT IS RECEIVED OR THAT IT WILL CONTINUE TO BE ACCURATE IN THE FUTURE. NO ONE SHOULD ACT UPON SUCH INFORMATION WITHOUT APPROPRIATE PROFESSIONAL ADVICE AFTER A THOROUGH EXAMINATION OF THE FACTS OF THE PARTICULAR SITUATION.

© 2014 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. The KPMG name, logo and "cutting through complexity" are registered trademarks or trademarks of KPMG International. 33323WDC