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

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The SEC has proposed a long-awaited set of rules that provides its own contribution to the running debate over how US rules should apply to cross-border activity in derivatives. In a single release, the SEC's proposed rules (the "Proposed Rules"),¹ issued on May 1, 2013, take a comprehensive approach to addressing the application of Title VII of the Dodd-Frank Act ("Dodd-Frank" or "DFA") to cross-border activity in security-based swaps ("SBS") in a number of areas, including dealer registration and regulation, clearing, exchange trading and reporting. The SEC's Proposed Rules come in the midst of significant discussion, and criticism, of the approach taken by the Commodity Futures Trading Commission (the "CFTC") in its own proposed guidance on cross-border issues (issued approximately 10 months ago) by market participants and non-US regulators.

Introduction and Executive Summary

If adopted, the Proposed Rules would address several key registration and regulatory requirements in the cross-border context:

¹ 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; SEC Proposed Rule (May 23, 2013), 78 FR 30967, available at <http://www.gpo.gov/fdsys/pkg/FR-2013-05-23/pdf/2013-10835.pdf>.

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- **Registration.** Non-US persons would have to count only transactions with US persons and transactions conducted in the United States toward the *de minimis* threshold for security-based swap dealer (“**SBSD**”) registration.
 - **Dealer Regulatory Requirements.** Non-US persons that are registered security-based swap dealers would need to comply with entity-level regulatory requirements and, in connection with transactions with US persons and transactions conducted in the United States, transaction-level regulatory requirements. Substituted compliance would, however, potentially be available for both sets of requirements, even for transactions with US persons.
 - **Mandatory Clearing and Exchange Trading.** When implemented, mandatory clearing and exchange trading requirements would apply to cross-border transactions (whether or not involving registered SBSBs) where one of the counterparties to a transaction is a US person (or a non-US person guaranteed by a US person) **or** the transaction is conducted in the United States, with certain exceptions. Substituted compliance may be available for those requirements.
 - **Reporting.** Regulatory reporting and public dissemination requirements would apply to transactions with a US person counterparty or guarantor, transactions conducted in the United States, transactions involving a registered SBSB or major security-based swap participant (“**MSBSP**”) and transactions cleared through US clearing organizations. Substituted compliance may be available in some circumstances.
- In broad outlines, the SEC’s Proposed Rules take a generally similar approach to the regulation of cross-border activity to that proposed by the CFTC, with some important differences.
- **Broader Use of Substituted Compliance (Potentially).** The SEC’s approach contemplates potentially broader use of substituted compliance for transactions between non-US persons and US persons, where the CFTC had generally proposed that US requirements would apply in those cases.
 - **Focus on US Activity.** In addition to examining whether a market participant is a “US person,” the SEC’s approach focuses on whether relevant activity, including solicitation, negotiation, or execution of a transaction, takes place in the United States. The CFTC’s proposal, by contrast, focuses principally on the location of the parties, rather than the location of related conduct. As a result, the SEC’s approach may result in a broader range of activities and market participants being potentially subject to US jurisdiction, or require changes in the way business is conducted in order to avoid such jurisdiction.
 - **Approach to Cross-Border Clearing, Execution and Reporting.** The Proposed Rules provide specific guidance as to the application of US rules to clearing, execution and reporting requirements, whether or not registered dealers are involved in such

transactions. The Proposed Rules also would set out a framework for potential application of substituted compliance to such requirements.

If adopted, the Proposed Rules will address a number of questions left open by the CFTC proposal. At the same time, several key issues would remain to be addressed, including how the restrictions on US activities would be implemented in practice and the manner in which the SEC would permit substituted compliance. The effectiveness of substituted compliance as a means of limiting the risk of conflicting or overlapping regulation will, of course, depend on the timing and scope of any substituted compliance determinations by the SEC. Significantly, most of the major substantive SEC rulemakings on SBS remain to be finalized, and the ultimate regulatory framework for SBS will depend as much on those final rules as on the cross-border approach proposed by the SEC.²

This client alert summarizes the Proposed Rules as they relate to (1) registration and regulatory requirements for dealers and major market participants, (2) clearing, reporting and trade execution requirements, and (3) the procedures for substituted compliance.

Scope of US Regulatory Requirements: US Persons and US Conduct

The application of various requirements of the Securities Exchange Act of 1934 (the “**Exchange Act**”) to cross-border transactions in SBS under the Proposed Rules depends to a great extent on two principal factors: (1) whether a party to the transaction is a “US person” and (2) whether the transaction is a “transaction conducted within the United States.”

US Person Definition

A “US person” is defined in the Proposed Rules as:

1. any natural person who is a United States resident;³
2. any legal person organized in the United States or having its principal place of business in the United States; or
3. any account (whether discretionary or non-discretionary) of a US person.

The proposed definition excludes certain international organizations, such as the International Monetary Fund, the International Bank for Reconstruction and Development, the United Nations and their respective agencies and pension plans. This proposed definition is a narrower definition than the definition proposed by the CFTC in the CFTC Cross-Border Guidance, and is somewhat simpler than the definition used by the CFTC in its current exemptive order.⁴ The SEC also declined to use its Regulation S definition of “US person,” which has a number of other exemptions (including for US fiduciaries of foreign accounts), as not appropriate for the SBS rules.

² The SEC has reopened the comment period for the major substantive regulations. See Reopening of Comment Periods for Certain Rulemaking Releases and Policy Statement Applicable to Security-Based Swaps Proposed Pursuant to the Securities Exchange Act of 1934 and the Dodd-Frank Wall Street Reform and Consumer Protection Act, Release No. 34-69491 (May 1, 2013), available at <http://www.sec.gov/rules/proposed/2013/34-69491.pdf>.

³ Proposed Rules, 78 FR at 30996. US citizens who are resident abroad would not be considered a US person under the proposed definition.

⁴ Final Exemptive Order Regarding Compliance With Certain Swap Regulations, 78 FR 858 (January 7, 2013) (“**Final Exemptive Order**”). The definition of “US person” in the Final Exemptive Order expires on July 12, 2013.

A comparison between the definition of “US person” as proposed by the CFTC and the SEC follows:

CFTC (Final Exemptive Order)	SEC (Proposed Rules)
<p>Effective until July 12, 2013:</p> <ul style="list-style-type: none"> a natural person who is a US resident; a legal entity (A) organized or incorporated under US laws or (B) <u>effective as of April 1, 2013 for all such entities other than funds or collective investment vehicles</u>, having its principal place of business in the US; 	<ul style="list-style-type: none"> any natural person resident in the US; any legal person organized in the US or having its principal place of business in US; or any account (whether discretionary or non-discretionary) of a US person.
CFTC (Final Exemptive Order)	SEC (Proposed Rules)
<ul style="list-style-type: none"> a pension plan for the employees, officers or principals of a legal entity described in (ii) above, unless the pension plan is primarily for foreign employees of such entity; an estate of a decedent who was a resident of the US at the time of death, or a trust governed by the US laws if a court within the US is able to exercise primary supervision over the administration of the trust; or an 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 one of the above. 	

The SEC’s “US person” definition does not contain an exclusion for foreign branch offices of a US person. Under the Proposed Rules, an entity’s status as a US person is proposed to be determined at the legal entity level and to apply to the entire entity, including any foreign operations that are not separately organized.⁵

An entity whose principal place of business is located in the United States cannot avoid US person status by organizing under foreign laws. Significantly, the “principal place of business” prong of the SEC definition, unlike the CFTC exemptive order definition, potentially applies to collective investment vehicles and fund entities. (Such entities may also be captured by the “transaction conducted within the United States” prong, as discussed below.)

Finally, accounts, regardless of their location, will bear the status of their owner, and not that of the fiduciary or manager holding or maintaining the account. Under this prong of the definition, client accounts will not be attributed to the asset manager or investment adviser, but rather the beneficial owners.⁶

Transactions Conducted Within the United States

A transaction will be considered a “transaction conducted within the United States” under the Proposed Rules if it is solicited, negotiated, executed **or** booked within the United States, by or on behalf of either counterparty, regardless of

⁵ In contrast, Regulation S looks to the physical location of a branch office rather than the jurisdiction of an entity’s organization. Proposed Rules, fn. 289, 78 FR at 30997.

⁶ This is consistent with the approach to managed accounts adopted by the CFTC and the SEC in their joint rules further defining certain registrant categories. 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, at 30690 (May 23, 2012) (“Intermediary Definitions Adopting Release”).

the location, domicile or residence status of either counterparty.⁷ Accordingly, the involvement of a US branch or associated person (including any US affiliate or US third-party agent) of either counterparty in the transaction may bring the transaction within US jurisdiction. Submission for clearing, reporting a transaction to a SB SDR, or the use of collateral management services in the United States, however, would not on its own constitute conduct within the United States.

As a result of these two concepts, under the Proposed Rules, a transaction between two non-US persons that is conducted outside the United States will generally be outside US jurisdiction (with certain exceptions where a party is guaranteed by a US person). Where a transaction involves a US person, or is conducted within the United States, consideration will have to be given to whether US rules apply and whether substituted compliance may be available, as discussed below.

Substituted Compliance

The SEC is proposing to consider making substituted compliance determinations with respect to four distinct categories of requirements:⁸

- Requirements applicable to registered SBSs in Section 15F of the Exchange Act and related rules (e.g., capital, margin, risk management, recordkeeping and reporting, and diligent supervision requirements);
- Requirements relating to regulatory reporting and public dissemination of information on SBS;
- Requirements relating to clearing of SBS; and
- Requirements relating to trade execution of SBS.

With respect to each of these categories, the Commission is proposing a “comparability” standard as the basis for making a substituted compliance determination. The SEC states that it would endeavor to take a “holistic approach” in making substituted compliance determinations by focusing on regulatory outcomes as a whole for the requirements within a category, rather than a rule-by-rule comparison.

Accordingly, the SEC does not envision making a comparability determination by looking to whether a foreign jurisdiction has implemented specific rules and regulations that correspond to rules and regulations adopted by the Commission. Rather, the SEC would determine whether the foreign regulatory system in a particular area achieves regulatory outcomes that are comparable to the regulatory outcomes of the relevant provisions of the Exchange Act, taking into consideration any relevant principles, regulations, or rules in other areas of the foreign regulatory system to the extent they are relevant to the analysis. As part of this review, the SEC would consider the ways in which a foreign regulatory system achieves its overall goals and purposes, including those undertaken in response to the G20 commitments relating to derivatives.

Although neither the SEC nor the CFTC is proposing to make its comparability determination by looking at the foreign regulatory regime as a whole,⁹ the CFTC has proposed a more restrictive approach that would involve on an individual

⁷ In the context of mandatory clearing, the SEC requested comment on whether a transaction in which the only conduct occurring in the United States is limited to negotiating or soliciting the transaction would carry risk into the US financial system and therefore should be subject to US regulation. Proposed Rules, 78 FR at 31080.

⁸ Applications for substituted compliance must be filed in accordance with a new proposed rule 17 CFR § 240.0-3.

⁹ The SEC states that making a comparability determination by looking at the entire set of SBS requirements on a regime-wide basis with respect to regimes that have implemented regulations consistent with the overall objectives of the G20 commitments would be unworkable in light of the

requirement basis.¹⁰ Under its approach, the CFTC may permit substituted compliance with regulations of the non-US person's home jurisdiction to the extent that the comparability standard is met for certain requirements, but require compliance with certain CFTC rules where comparable home country regulations are lacking.

The SEC would likely make a substituted compliance determination on a class or jurisdiction basis, depending on the foreign regulator and the particular regime, rather than on a firm-by-firm basis.

The proposals with respect to substituted compliance for particular categories of requirements are discussed in further detail below.

Dealer/MSBSP Registration and Regulation

The Proposed Rules address the scope of the SEC's registration and regulatory requirements for non-US SBSs and MSBSPs.

Security-Based Swap Dealers

I. Registration Requirement

The Exchange Act makes it unlawful for any person to act as a SBS unless the person is registered as such with the SEC (unless an exemption applies).¹¹ The SEC has previously adopted joint rules with the CFTC¹² addressing the factors relevant in determining SBS status.¹³ These joint rules also implement the *de minimis* exception from the SBS definition for persons engaged in SBS dealing activity below a certain threshold.¹⁴ Under that exemption, a person will only be required to register as a SBS if the notional amount of SBS positions connected with its SBS dealing activity over the prior 12-month period exceeds the applicable threshold.¹⁵ The SEC has not yet adopted a deadline for SBS registration.

SEC's responsibility to implement the specific statutory provisions of the Exchange Act added by Title VII of the DFA. Proposed Rules, 78 FR at 31086.

¹⁰ CFTC Cross Border Guidance, 77 FR at 41232.

¹¹ 15 USC. 78o-10(a)(1). Section 3(a)(71) of the Exchange Act defines a SBS as a person that engages in any of the following types of activity: (i) holding oneself out as a dealer in SBS, (ii) making a market in SBS, (iii) regularly entering into SBS with counterparties as an ordinary course of business for one's own account, (iv) engaging in any activity causing oneself to be commonly known in the trade as a dealer in SBS. 15 USC. 78c(a)(71).

¹² See Intermediary Definitions Adopting Release, 77 FR 30596.

¹³ SEC Rule 3a71-1. The indicia of dealing activity include: (i) providing liquidity to market professionals or other persons in connection with security-based swaps, (ii) seeking to profit by providing liquidity in connection with security-based swaps, (iii) providing advice in connection with security-based swaps or structuring security-based swaps, (iv) having a regular clientele and actively soliciting clients, (v) using inter-dealer brokers, and (vi) acting as a market maker on an organized security-based swap exchange or trading system. Intermediary Definitions Adopting Release, 77 FR at 30617-18.

¹⁴ Section 3(a)(71)(D) of the Exchange Act; 15 USC. 78c(a)(71)(D).

¹⁵ SEC Rule 3a71-2; Intermediary Definitions Adopting Release, 77 FR at 30626-43.

In the Proposed Rules, the SEC provides further guidance as to the application of the *de minimis* test, and related aggregation rules, in the cross-border context.¹⁶

a. De Minimis Threshold Aggregation Rules

Under the Proposed Rules, US persons would be required to count **all** of their SBS dealing transactions toward the *de minimis* threshold, including transactions conducted outside the United States. The SBS definition would apply to a legal entity even if that person's dealing activity is limited to a trading desk or discrete business unit. Accordingly, a US person must include the SBS dealing activity of its foreign branch offices, regardless of the role played by the foreign branch or the location of the SBS dealing activity.

For purposes of the *de minimis* threshold, a non-US person must count SBS positions connected with its SBS dealing activity that is either (i) with US persons (other than with foreign branches of US banks) or (ii) otherwise conducted within the United States. A party may rely on its counterparty's representation that a given transaction is not conducted within the United States, unless such party knows that the representation is inaccurate.

The Proposed Rules thus permit a non-US person to disregard any transaction with another non-US person that is conducted outside the United States for purposes of the *de minimis* test, even if performance of the SBS by either counterparty is guaranteed by a US person. In this respect, the approach differs from that of the CFTC, which has proposed to require that all swaps of a non-US person guaranteed by a US person be counted toward the *de minimis* threshold.¹⁷

The Proposed Rules also permit a non-US person to disregard transactions with a foreign branch of a US person. To qualify, the transaction must not be solicited, negotiated or executed within the United States and the branch must (1) be located outside the United States, (2) operate for valid business reasons, (3) be engaged in the business of banking and be subject to substantive banking regulation in its jurisdiction, and (4) be the named counterparty to the transaction. Again, a party may rely on its counterparty's representation that a given transaction is not conducted within the United States, unless such party knows that the representation is inaccurate. The approach on this issue is similar to that of the CFTC, with the exception of the limitation for transactions solicited, negotiated or executed within the United States.

Finally, the SEC expressly declined to permit a non-US person to disregard SBS dealing activity with US persons if such dealing is intermediated by a registered SBS. The SEC thus was unwilling to extend the approach available to non-US broker-dealers in Rule 15a-6 to SBS activity of non-US dealers.

b. Affiliated Group Transactions

SBS dealing transactions entered into by an affiliate controlling, controlled by or under common control¹⁸ with a person must be aggregated when determining whether that person is a SBS.¹⁹ Consistent with this approach, the Proposed

¹⁶ Proposed Rules, 78 FR at 30985. This is generally consistent with the SEC's traditional approach to the regulation of brokers and dealers under the Exchange Act, in which registration and other requirements are triggered by a person operating physically in the United States, or conducting sales activities within the United States from outside the United States.

¹⁷ While a non-US person need not count its SBS transactions with foreign branches of US banks for purposes of determining its SBS status, such transactions will be considered in determining MSBSP status (for the non-US person or the guarantor, as applicable).

¹⁸ "Control" is defined as the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through ownership of voting securities, by contract or otherwise. Intermediary Definitions Adopting Release, 77 FR 30631, fn. 437.

Rules require aggregation of an affiliate's US dealing activity regardless of whether such affiliate is a US or non-US person. Transactions of non-US person affiliates with counterparties who are also non-US persons (or foreign branches of US banks) conducted outside the United States would not be aggregated for purposes of the *de minimis* exception.

A person may also disregard the dealing activity of an affiliate controlling, controlled by or under common control with that person for purposes of calculating the *de minimis* threshold if such affiliate is registered as a SBSB with the SEC. (This exemption is similar to one provided the CFTC in its Final Exemptive Order,²⁰ and is intended to address the concern that multiple entities within the same corporate family would be required to register as a SBSB if the activities of one entity exceeds the *de minimis* threshold.) However, affiliates of registered SBSBs may take advantage of this exemption only if they are "operationally independent" from the registered SBSB, *i.e.*, the affiliates maintain separate sales and trading functions, operations (including separate back offices) and risk management with respect to the relevant SBS dealing activity. The exemption is unavailable if such operations are shared by the two affiliates or managed centrally within the corporate group. This may significantly limit the usefulness of the exemption for many financial institution groups, or require that such groups impose greater operational separation between entities than often currently exists.

c. Inter-Affiliate and Guaranteed Transactions

Consistent with the Intermediary Definitions Adopting Release, cross-border SBS transactions between majority-owned affiliates would be excluded from the consideration of whether a person is a SBSB. Such inter-affiliate SBS transactions need not be aggregated even if they are back-to-back transactions where a foreign affiliate acts as a "conduit" for the US person. Thus, an entity that operates a "central booking system" where swaps are booked into a single legal entity would not be required to aggregate positions that it enters into indirectly with its non-US affiliate or subsidiary through back-to-back transactions.²¹

With respect to guaranteed transactions, the Proposed Rules provide that a non-US person that is guaranteed by a US person may disregard its SBS dealing transactions conducted outside the United States with non-US persons. Conversely, a non-US person may disregard its SBS dealing transaction conducted outside the United States with a non-US person even though that person is guaranteed by a US person. The attribution of guaranteed transactions is discussed in further detail below in the context of calculating the MSBSP registration threshold.

II. Regulatory Requirements Applicable to SBSBs

Registered SBSBs are subject to a number of regulatory requirements, which the SEC has divided into two categories as shown in the chart below. Transaction-level requirements apply to SBSBs with respect to each SBS transaction with specific counterparties, whereas entity-level requirements apply to SBSBs as a whole. The SEC's categorization of various requirements as transaction-level or entity-level differs in some respects from that proposed by the CFTC, as shown in the tables below. Notably, margin requirements are an entity-level requirement under SEC Proposed Rules, whereas they are a transaction-level requirement under the CFTC Cross-Border Guidance.

¹⁹ See 17 CFR § 240.3a71-2(a); Intermediary Definitions Adopting Release, 77 FR at 30631.

²⁰ Final Exemptive Order, 78 FR at 868-9.

²¹ In contrast, the CFTC's Cross-Border Guidance would require a US entity to aggregate inter-affiliate transactions with an affiliated foreign swap dealer that is transferring swaps to the US entity through back-to-back transactions. CFTC Cross Border Guidance, 77 FR at 41222.

Entity-Level Requirements	
SEC	CFTC
Capital Requirements ²²	Capital Requirements
Margin Requirements ²³	
Risk Management ²⁴	Risk Management
Recordkeeping and Reporting ²⁵	Swap Data Recordkeeping
Internal System and Controls ²⁶	Swap Data Reporting

Entity-Level Requirements	
SEC	CFTC
Diligent Supervision ²⁷	Physical Commodity Swaps Reporting (<i>i.e.</i> , Large Trader Reporting)
Conflicts of Interest ²⁸	
Chief Compliance Officer ²⁹	Chief Compliance Officer

²² For SBSBs that are not regulated banks, the SEC has proposed a net liquid assets test modeled on the broker-dealer capital standard. Proposed Rules Governing Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Exchange Act Release No. 68071 (Oct. 18, 2012) 77 FR 70214, at 70274-88 (Nov. 23, 2012) (“Capital, Margin, and Segregation Proposing Release”).

²³ The SEC is proposing to treat margin as an entity-level requirement applicable to all SBS transactions of a registered SBSB, regardless of the counterparty’s location. Proposed Rules, 78 FR at 31011.

For SBSBs that are not regulated banks, the SEC has proposed margin requirement modeled on margin rules applicable to broker-dealers.

²⁴ Capital, Margin, and Segregation Proposing Release, 77 FR at 70250-51. While the SEC has proposed risk-management standards required for nonbank SBSBs, it has not proposed such rules for bank SBSBs.

²⁵ The SEC has not yet proposed rules regarding recordkeeping and reporting requirements. Proposed Rules, 78 FR at 31013.

²⁶ The SEC has proposed a rule requiring a registered SBSB to establish policies and procedures that are reasonably designed to comply with its responsibilities under the Exchange Act. Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, Exchange Act Release No. 64766 (June 29, 2011), 76 FR 42396, at 42420 (July 18, 2011) (“**External Business Conduct Standards Proposing Release**”).

²⁷ External Business Conduct Standards Proposing Release, 76 FR at 42419-21.

²⁸ External Business Conduct Standards Proposing Release, 76 FR at 42420.

²⁹ External Business Conduct Standards Proposing Release, 76 FR at 42435-38.

Inspection and Examination³⁰

Licensing Requirements and Statutory Disqualification³¹

Transaction-Level Requirements	
SEC	CFTC
External Business Conduct Standards ³²	External Business Conduct Standards
Segregation Requirements ³³	Margin and Segregation Requirements for Uncleared Swaps
Clearing	Clearing and Swap Processing
Trade Execution Requirement	Trade Execution Requirement
	Swap Trading Relationship Documentation
	Portfolio Reconciliation and Compression
Regulatory Reporting and Public Dissemination	Real-Time Public Reporting
	Trade Confirmation
	Daily Trading records

a. Application of the Transaction-Level Requirements

The Proposed Rules provide general relief from compliance with the external business conduct standards for registered foreign SBSDs and foreign branches of a US SBS, with respect to their “foreign business.” However, such SBSDs are still required to comply with the supervision obligations imposed under the Exchange Act and SEC rules, and would also still be subject to the general antifraud provisions of the federal securities laws.

³⁰ The proposed rule would require “nonresident SBS” registrants to appoint an agent in the United States for service of process and to certify that the SBS can submit to onsite inspection and examination by the SEC. External Business Conduct Standards Proposing Release, 76 FR at 42435-36.

³¹ The SEC has not proposed licensing requirements for associated persons of SBSs. However, SBSs are required to certify that no associated person is subject to a statutory disqualification. Proposed Rules, 78 FR at 31015.

³² The SEC has proposed rules to implement the external business conduct requirements applicable to SBSs, including (1) verification that SBS counterparties meet the eligibility standards for an eligible contract participant, disclosure of material information about the SBS to the counterparty, including material risks and characteristics of the SBS, and material incentives and conflicts of interest of the SBS in connection with the SBS; and (2) provision of information concerning the daily mark for the SBS. In addition, the Proposed Rules impose certain “know your counterparty” and suitability obligations on SBSs, and restrict SBSs from engaging in certain “pay to play” activities. External Business Conduct Standards Proposing Release, 76 FR at 42423-25 and 42399.

³³ Capital, Margin, and Segregation Proposing Release, 77 FR at 70274-88.

“Foreign business” has the following meaning: (1) with respect to a foreign SBSB, any transaction conducted outside the United States with a non-US person or a foreign branch of a US person; and (2) with respect to a US SBSB, only transactions conducted through a foreign branch with a non-US person or a foreign branch of a US person. A US SBSB would be considered to have conducted a SBS transaction through a foreign branch if the foreign branch is a party to the transaction **and** no person located in the United States is directly involved in soliciting, negotiating or executing the SBS transaction on behalf of the foreign branch or its counterparty. Although registered SBSBs must comply with the external business conduct requirements with respect to their US business, substituted compliance with comparable requirements in a foreign jurisdiction may be permitted (in contrast to the CFTC’s proposed approach).

The SEC is also proposing that registered foreign SBSBs would not be required to comply with its segregation requirements with respect to transactions with non-US persons in certain circumstances. As shown in the table below, segregation requirements imposed by the Proposed Rules depend on (1) whether the SBS is cleared or uncleared, and (2) whether the foreign SBSB is also a registered broker-dealer and/or a bank with a US branch. In any case, the foreign SBSB would be required to disclose the potential treatment of segregated assets in insolvency proceedings under US and applicable foreign laws.

	Non-Cleared SBS	Cleared SBS
Registered Broker-Dealer	Registered broker-dealer must segregate SBS margin collected from any counterparty.	Registered broker-dealer must segregate SBS margin collected from any counterparty.
Non-Registered Broker-Dealer	Non-registered broker-dealer must segregate SBS margin only if collected from US persons. ³⁴	Non-registered broker-dealer must segregate SBS margin collected from any US person. Certain additional requirements apply to non-registered broker-dealers that are foreign banks with a US branch.

In contrast to the CFTC’s approach in its CFTC Cross-Border Guidance,³⁵ the SEC would not treat a non-US person guaranteed by a US person and “conduit affiliates”³⁶ as US persons for purposes of determining whether the transaction-level requirements apply.

b. Application of the Entity-Level Requirements

Rather than provide specific relief for foreign SBSBs from the entity-level requirements, the SEC has proposed to enable them to substitute compliance with comparable requirements in a foreign jurisdiction. In connection with the proposed

³⁴ The foreign SBSB would be required to maintain a special account for the exclusive benefit of US person SBS customers. Proposed Rules, 78 FR at 31016.

³⁵ CFTC Cross-Border Guidance, 77 FR at 41228-29.

³⁶ “Conduit affiliate” is defined as (1) a non-US person that is majority-owned, directly or indirectly, by a US person where (2) the non-US person regularly enters into swaps with one or more US affiliates or subsidiaries of the US person, and (3) the financial statements of the non-US person are included in the consolidated financial statements of the US person. Proposed Rules, 78 FR at 31024.

substituted compliance framework, the SEC is re-proposing the registration applications for SBSs and MSBSPs to require foreign registrants to state any intent to rely on substituted compliance.

c. Substituted Compliance

A foreign SBS that is registered with the SEC would be permitted to satisfy the entity-level and transaction-level requirements by complying with the corresponding rules and regulations established in a foreign jurisdiction as to which the SEC makes a substituted compliance determination. The SEC states that it envisions making a substituted compliance determination for the entire package of entity-level regulations (including capital, margin, risk management, recordkeeping and reporting, and diligent supervision) for a jurisdiction.

With respect to transaction-level requirements (e.g., external business conduct standards), substituted compliance could potentially apply to transactions with US persons. This marks a significantly different approach from the approach of the CFTC, which would require compliance with US requirements in that circumstance, and would potentially allow non-US SBSs to avoid having to treat US counterparties different from those in their home (and other) jurisdictions.³⁷

Although the request for a substituted compliance determination could come from a particular foreign SBS or group of SBSs, the SEC anticipates that it would make such a determination on a class or jurisdiction basis, depending on the regulator(s) and the foreign regulatory regime (rather than on a firm-by-firm basis). Accordingly, once a determination is made with respect to a particular foreign jurisdiction, it is expected that it would apply to every foreign SBS in the specified class or classes registered and regulated in that jurisdiction, subject to the conditions specified in the SEC's substituted compliance order. The SEC could, however, condition the substituted compliance determination by limiting it to a particular class or classes of registrants in the foreign jurisdiction based on, for instance, the foreign jurisdiction's different levels of supervisory oversight with respect to different classes of entities conducting SBS dealing activity.

Before making a substituted compliance determination, the SEC will require a supervisory and enforcement memorandum of understanding or other arrangement with the appropriate financial regulatory authority or authorities in that jurisdiction addressing oversight and supervision of applicable SBSs subject to the substituted compliance determination.

The SEC is not proposing to allow substituted compliance for the registration requirement itself for SBSs.

Major Security-Based Swap Participants

The Exchange Act provides for registration and regulation of MSBSPs, whose SBS activities do not constitute SBS dealing, but nevertheless pose a higher degree of risk to the US financial system. The Intermediary Definitions Adopting Release established certain SBS trading thresholds that, if exceeded, would require registration.³⁸ In the Proposed Rules, the SEC addresses how cross-border SBS transactions count for purposes of the MSBSP threshold.

³⁷ CFTC Cross-Border Guidance, 77 FR at 41230.

³⁸ The SEC established the following three thresholds for MSBSP registration:

(1) \$1 billion current uncollateralized exposure or \$2 billion combined current uncollateralized exposure and potential future exposure in a major category of SBS (excluding certain hedging positions);

(2) \$2 billion current uncollateralized exposure or \$4 billion combined current uncollateralized exposure and potential future exposure in all SBS;

or

I. MSBSP Threshold Aggregation Rules

Generally, under the Proposed Rules, a US person must count all SBS transactions entered into by it, while a non-US person must only count transactions with US persons (including foreign branches of US banks), when determining whether the person falls within the MSBSP definition.³⁹ All SBS transactions by a non-US person with other non-US persons are excluded from the threshold calculation, regardless of whether they are conducted within the United States or guaranteed by a US person. The treatment of foreign public sector financial institutions (such as multilateral development banks) is not specifically addressed in the Proposed Rules.

With respect to transactions that are guaranteed, the Intermediary Definitions Adopting Release took the position that SBS positions are attributed to the guarantor to the extent that the counterparty to such positions has recourse to the guarantor.⁴⁰ In the cross-border context, the Proposed Rules would provide that transactions entered into by a non-US person and guaranteed by a US person would be attributed to the guarantor. Similarly, transactions entered into by a US person and guaranteed by a non-US person would be attributed to the guarantor. In contrast, where a non-US person guarantees the performance of another non-US person, the guarantor is only required to attribute SBS positions entered into by the guaranteed party with a US person counterparty. Finally, attribution to the guarantor would not be required if the principal entering into the SBS transaction is already subject to capital regulation by the SEC or CFTC, or is regulated as a US bank (or is subject to foreign capital standards that are consistent with the Capital Accord of the Basel Committee on Banking Supervision). This would likely exclude US guarantors of foreign dealing entities that are regulated in their local jurisdictions from having to aggregate their positions for MSBSP purposes.

II. Regulatory Requirements Applicable to MSBSPs

Like SBSs, registered MSBSPs are required to comply with both entity-level and transaction-level requirements under the Exchange Act. However, foreign MSBSPs would not be required to comply with external business conduct standards (other than the diligent supervision requirements) in transactions with non-US persons. In addition, foreign MSBSPs that are not registered broker-dealers are not required to comply with segregation requirements with respect to transactions with non-US persons. With respect to guaranteed SBS transactions where the MSBSP is the guarantor, the MSBSP may delegate operational compliance with transaction-level requirements to entities that are direct parties to the transaction, but would remain ultimately responsible for ensuring compliance.

Under the Proposed Rules, US and foreign MSBSPs alike would be required to comply with the entity-level requirements. In contrast to SBSs, MSBSPs will not be permitted to rely on substituted compliance with comparable regulatory requirements in a foreign jurisdiction. The SEC is taking this position based on its view that it currently has limited information regarding what types of foreign entities may become MSBSPs. (The SEC may also have an expectation that few entities will become MSBSPs.) The SEC notes a concern that unlike foreign SBSs whose primary businesses are in securities, SBS, swaps, banking and other financial and investment banking activities, the MSBSPs may engage in a more

(3) highly leveraged financial entities with \$1 billion current uncollateralized exposure or \$2 billion combined current uncollateralized exposure and potential future exposure in a major category of SBS. See 17 CFR § 240.3a67-1.

³⁹ Proposed Rules, 78 FR at 31030. The Proposed Rules uses the same definition of "US person" as proposed in the context of SBS registration.

⁴⁰ Intermediary Definitions Adopting Release, 77 FR at 30689.

diverse range of business activities, *e.g.*, commercial activities, that raise different risks and may warrant different treatment.

Security-Based Swap Requirements and Related Infrastructure

The following sections outline the rules and interpretive guidance proposed by the SEC for the SBS clearing requirement through security-based swaps clearing agencies (“**SB SCAs**”), the trade execution requirement through security-based swap execution facilities (“**SB SEFs**”), and the SBS trade reporting requirement through security-based swap data repositories (“**SB SDRs**”).

Clearing

I. Registration of Clearing Agencies

The Proposed Rules would require all SB SCAs that perform the functions of a central counterparty (“**CCP**”) for SBS within the United States to register with the SEC. Pursuant to the SEC’s interpretive guidance, a foreign SB SCA that has a US person clearing member would be considered to be performing such functions “within the United States” for this purpose, and would be required to register or obtain an exemption. By contrast, a foreign SB SCA would not be required to register if it provides CCP services to a US person only indirectly through non-US person clearing members.

A foreign SB SCA that would otherwise be required to register may alternatively be eligible for an exemption from registration if the SEC determines that it is subject to comparable, comprehensive supervision and regulation by appropriate government authorities in its home country and the nature of its activities within the United States are such that registration is not necessary. However, the Proposed Rules do not specify in detail how the SEC might make such a comparability determination.

II. Application of the Mandatory Clearing Requirements

Section 3C(a)(1) of the Exchange Act provides that SBS subject to a mandatory clearing designation by the SEC must be cleared through an SB SCA that is registered under the Exchange Act or a clearing agency that is exempt from registration under the Exchange Act, as described above.⁴¹ The SEC has not yet imposed (or even proposed) mandatory clearing for any SBS, although voluntary clearing in SBS that are credit default swaps (“**CDS**”) is occurring on a voluntary basis through registered SB SCAs.⁴²

Under the Proposed Rules, if the SEC imposes mandatory clearing on a class of SBS, the requirement would apply to any person that engages in a SBS transaction:

- in which at least one of the counterparties to the transaction is: (A) A US person or (B) a non-US person whose performance under the SBS is guaranteed by a US person; or
- that is a “transaction conducted within the United States.”⁴³

⁴¹ 15 USC. 78c-3(a)(1).

⁴² Proposed Rules, 78 FR at 30978. There is currently no central clearing in the United States for non-CDS products, such as SBS based on equity securities.

⁴³ The mandatory clearing requirement will not apply unless and until the Commission makes a determination that a SBS is required to be cleared, and the Commission has not yet made any such determination.

To limit the scope of the requirement in the cross-border context, the SEC is proposing two exceptions to the requirements:

- If the SBS transaction is not a “transaction conducted within the United States,” the mandatory clearing requirement would not apply if one counterparty to the transaction is (1) a foreign branch of a US bank or (2) a non-US person whose performance under the SBS is guaranteed by a US person ***and*** if the other counterparty to the transaction is a non-US person (1) whose performance is not guaranteed by a US person and (2) who is not a foreign SBS.D.
- If the SBS transaction is a “transaction conducted within the United States,” the mandatory clearing requirement would not apply if:
 - Neither counterparty is a US person;
 - Neither counterparty’s performance under the SBS is guaranteed by a US person; ***and***
 - Neither counterparty is a foreign SBS.D.

In proposing the latter exemption, the SEC focused on the fact that the financial risks of the transaction would reside with non-US persons outside the United States. While the operational risks associated with the transaction may reside in the United States and would potentially be reduced by mandatory clearing, because the financial risks of the transaction would reside with non-US persons outside the United States, the SEC took the position that the mandatory clearing requirement should not apply to a transaction between two non-US persons solely because the transaction is a “transaction conducted within the United States.”

However, the SEC is proposing to exempt persons from the clearing requirement if a relevant transaction is submitted to a foreign clearing agency that is the subject of a substituted compliance determination by the SEC. This would apply to counterparties who may seek to clear SBS subject to mandatory clearing at a clearing agency that is neither registered with the SEC nor exempt from registration (such as a clearing agency that has no US members). The Proposed Rules do not address the procedures for such a substituted compliance determination in detail (in part because the SEC appears to expect that most such contracts will be cleared through registered or exempt clearing agencies). Substituted compliance of this type would be limited to foreign clearing agencies that (i) do not have any US members and (ii) do not clear transactions conducted within the United States.

Trade Execution

I. Registration of SB SEFs

Section 3C(h) of the Exchange Act requires that SBS that are subject to mandatory clearing also be traded on a registered SB SEF or national securities exchange, absent certain exemptions. Under the Proposed Rules, a foreign SBS market that provides US persons or non-US persons located in the United States with the direct ability to trade or execute SBS by accepting bids and offers from the participants on the foreign SBS market must register as an SB SEF. Such activity is interpreted to include providing proprietary computer terminals and other technological devices for trading SBS, or granting electronic access to the SB SEF’s trading system. Further, SB SEFs may also fall within the scope of the registration requirement if they take affirmative actions to induce the execution or trading of SBS on the market by US persons or non-US person located in the United States, such as through marketing the SB SEF’s services or otherwise initiating contact with such persons to induce their use of the services. Alternatively, a foreign SB SEFs that is subject to comparable, comprehensive supervision and regulation under appropriate governmental authorities may be entitled to an

exemption from registration, which will likely require a memorandum of understanding addressing the oversight and supervision of the SB SEF.

II. Cross-Border Application of the Trade Execution Requirement

In the case of cross-border transactions, the Proposed Rules would apply the trade execution requirement in the same circumstances described above for the clearing requirement.

In addition, the SEC is proposing to permit a person subject to the mandatory trade execution requirement to execute such transaction, or have such transaction executed on their behalf, on a qualifying foreign SBS market (or class of markets) that is neither registered under the Exchange Act nor exempt from registration under the Exchange Act. This exemption would only apply if the SEC determines that such SBS market (or class of markets) is subject to comparable, comprehensive supervision and regulation by a foreign financial regulatory authority or authorities in such foreign jurisdiction.

Such substituted compliance for trade execution would only be available for a SBS transaction where both of the following conditions apply to at least one counterparty to the transaction:

- The counterparty is either a non-US person or a foreign branch of a US bank; and
- The SBS transaction is not solicited, negotiated, or executed by a person within the United States on behalf of such counterparty.

Trade Reporting

I. Registration of SB SDRs

SB SDRs are intended to retain complete, centralized records of SBS transactions and provide the relevant authorities with access to transaction information. The SEC has previously proposed rules governing the SB SDR registration process and other regulatory requirements, including data maintenance and regulatory access.⁴⁴ The Proposed Rules re-propose certain of rules related to SB SDRs and provide further guidance on the application of these requirements in the cross-border context.

a. Cross-Border Application of SB SDR Registration

Consistent with the general approach taken in the Proposed Rules, any US person performing SB SDR functions would have to register with the SEC, regardless of the location of the services. In contrast, the SEC would be prepared to grant certain exemptive relief to non-US persons performing the SDR functions within the United States,⁴⁵ provided that each regulator with supervisory authority over such person has entered into a supervisory and enforcement memorandum of understanding with the SEC addressing confidentiality, access and other issues. However, counterparties would generally not be able to satisfy their reporting requirements under the Exchange Act by submitting transaction data to an exempt foreign SB SDR. The exemption for foreign SB SDRs would thus likely be only useful for entities that are providing foreign

⁴⁴ Security-Based Swap Data Repository Registration, Duties, and Core Principles, Exchange Act Release No. 63347 (Nov. 19, 2010), 75 FR 77306 (Dec. 10, 2010), corrected at 75 FR 79320 (Dec. 20, 2010) and 76 FR 2287 (Jan. 13, 2011).

⁴⁵ A foreign SB SDR would be "performing SB SDR functions within the United States" if it receives SBS data from US persons or has physical operations within the United States, e.g., maintaining SBS data on US servers. Proposed Rules, 78 FR at 31043.

reporting services to US persons. As noted below, the SEC has proposed, as part of a separate process, allowing substituted compliance for reporting requirements for some cross-border transactions.

b. Data Access by Other Regulatory Authorities

The SEC has previously proposed that, upon request by another appropriate regulatory authority and after notifying the SEC of such request, an SB SDR must provide access to all available transaction data, subject to obtaining a written confidentiality statement and an agreement to indemnify the SB SDR and the SEC from any claims related to the information provided.⁴⁶ Regulatory authorities will be able to request a determination by the SEC that they are the “appropriate authority” for requesting SBS data from an SDR. The SEC will likely condition such a determination on executing a supervisory and enforcement memorandum of understanding with the relevant authority. The Proposed Rules also provide an exemption from the indemnification requirement if the relevant authority is making a request within its jurisdiction to fulfill a regulatory mandate and has entered into a supervisory and enforcement memorandum of understanding with the SEC addressing confidentiality and other matters. This is intended to alleviate significant concerns raised by foreign regulators with the indemnification requirement.

II. Regulation SBSR

a. Background

Regulation SBSR, which covers regulatory reporting and public dissemination, was originally proposed on November 19, 2010⁴⁷ but is being re-proposed in the Proposed Rules to clarify reporting requirements in the cross-border context.

In the Proposed Rules, the SEC makes two significant modifications to the initially proposed Regulation SBSR. First, SBS transactions of non-US persons whose performance obligations are *guaranteed* by US persons would be subject to Regulation SBSR, *i.e.*, a guarantor to a SBS that is a US person would be considered a counterparty to the SBS for purposes of the regulatory reporting requirements. (Although not a “direct counterparty” to a SBS, the US guarantor would be an “indirect counterparty” for this purpose.)

Second, the SEC would include a “substituted compliance” regime, which would allow certain Title VII requirements to be satisfied by compliance with the rules of a foreign jurisdiction rather than the SEC requirements. This is discussed in further detail below.

b. Regulatory Reporting

Re-proposed Rule 908(a) provides that a SBS would be subject to regulatory reporting under Regulation SBSR if:

- The SBS is a “transaction conducted within the United States”;⁴⁸
- There is a direct or indirect counterparty that is a US person on either side of the transaction;

⁴⁶ Proposed Rules, 78 FR at 31044-45. Alternatively, other regulatory authorities may indirectly obtain information held by SB SDRs without providing an indemnity through the SEC’s authority to share information.

⁴⁷ See Regulation SBSR – Reporting and Dissemination of Security-Based Swap information; Proposed Rule, 75 FR 75208 (December 2, 2010).

⁴⁸ This requirement, as initially proposed, was a transaction that was “executed in the United States or through any means of interstate commerce”. Upon further consideration, the SEC was concerned that this language could unduly require a SBS to be reported if it had only the slightest connection with the United States. Thus, the SEC adopted this new term in the Proposed Rules.

- There is a direct or indirect counterparty that is a SBS or MSBSP on either side of the transaction; or
- The SBS is cleared through a clearing agency having its principal place of business in the United States.

The SEC was concerned about instances where, because of a guarantee extended by a US person, the risk of a transaction would reside in the United States even if the direct counterparties are domiciled outside the United States. Thus, the SEC is proposing that regulatory reporting requirements would apply to a SBS in which at least one counterparty, even an indirect party such as a guarantor, is a US person. This is in contrast to the CFTC Cross-Border Guidance, which provides that a swap between two unregistered non-US persons, each of which is guaranteed by a US person, would not be subject to regulatory reporting or public dissemination. This would also be the case if only one side is guaranteed by a US person. As discussed below, the requirements for public dissemination, as opposed to regulatory reporting, are proposed to be somewhat narrower.

The SEC is also proposing to require regulatory reporting of all SBS entered into by non-US SBSs and MSBSPs, regardless of where they may be executed or where these entities are organized or have their principal place of business.

c. Public Dissemination

Re-proposed Rule 908(a)(2) provides that a SBS would be subject to public dissemination if:

- The SBS is a transaction conducted within the United States;
- There is a direct or indirect counterparty that is a US person on each side of the transaction;
- At least one direct counterparty is a US person (except in the case of a transaction conducted through a guaranteed foreign affiliate or foreign branch of a US bank);⁴⁹
- One side includes a US person and the other side includes a non-US person that is a SBS; or
- The SBS is cleared through a clearing agency having its principal place of business in the United States.

The SEC was unwilling to limit public dissemination to transactions that are wholly conducted within the United States or to transactions where both direct counterparties are US persons, on the theory that such a limitation would significantly reduce the potential benefits of post-trade transparency in the SBS market.

Although narrower than the regulatory reporting requirements, the proposed rule would subject a range of cross-border transactions to public dissemination. An SBS would be subject to public dissemination if there is a direct or indirect counterparty that is a US person on **each** side of the transaction. The SEC included an exception for a transaction conducted through a foreign branch based on its concern that, absent this exception, non-US market participants might avoid entering into SBS with foreign branches of US banks so as to avoid their SBS being publicly disseminated.

The SEC also clarified that an SBS transacted outside the United States between two non-US SBSs (assuming that neither side is guaranteed by a US person) would not be subject to the public dissemination requirement.

d. “Reporting Side” Rules and Assigning Duty to Report

As discussed above, the re-proposal extends the reporting requirements to SBS executed outside the United States if the performance of one or both direct counterparties is guaranteed by a US person.

⁴⁹ Registration with the local regulatory authority to engage in banking business is inherent in the proposed definition of “foreign branch.”

As defined in re-proposed Rule 900, a “**counterparty**” would be defined as “a person that is a direct counterparty or indirect counterparty of a SBS”; a “**direct counterparty**” would be “a person that enters directly with another person into a contract that constitutes a SBS”; and an “**indirect counterparty**” would be “a person that guarantees the performance of a direct counterparty to a SBS or that otherwise provides recourse to the other side for the failure of the direct counterparty to perform any obligation under the SBS.” Thus, rather than there being a reporting counterparty, there will be a “**reporting side**”, which would be the side of a SBS having the duty to report information in accordance with Regulation SBSR to a SB SDR.

If a “reporting side” has the duty to report a SBS transaction, any counterparty on that side would have the responsibility for carrying out the reporting obligation, and the decision as to who would report will be decided between the direct counterparty and the indirect counterparty. Alternatively, the direct and indirect counterparties could elect to have a third party carry out the duty to report on their behalf, although the legal liability for the agent’s failure to report would remain with the direct and indirect counterparties.

The reporting side would be determined as follows:

- If both sides of the SBS include a SBSD or if both sides of the SBS include a MSBSP, the sides would be required to select the reporting side.
- If only one side of the SBS includes a SBSD, that side would be the reporting side.
- If one side of the SBS includes a MSBSP and the other side includes neither a SBSD nor a MSBSP, the side including the MSBSP would be the reporting side.
- If neither side of the SBS includes a SBSD or MSBSP: (1) if both sides include a US person or neither side includes a US person, the sides would be required to select the reporting side; and (2) if only one side includes a US person, that side would be the reporting side.⁵⁰

Thus, as re-proposed, a non-US SBSD or MSBSP, although not a US person, could incur the duty to report. This is in contrast to the initial proposal in which the non-registered US counterparty would have to report a SBS it enters into with

⁵⁰ The following examples provided by SEC in the Proposed Rules, 78 FR at 31067, are helpful in illustrating the operation of re-proposed Rule 901(a):

Example 1. Between a non-registered US counterparty and a non-US SBSD in which neither side has a guarantor, the non-US SBSD would be the reporting side.

Example 2. Same facts as Example 1, except that the non-registered US counterparty is guaranteed by a SBSD. Because both sides include a SBSD, the sides would be required to select which is the reporting side.

Example 3. A SBS is executed in London between a foreign subsidiary of a US person and a French hedge fund. The performance of the foreign subsidiary is guaranteed by its US parent, a MSBSP. The side consisting of the MSBSP and its foreign subsidiary would be the reporting side.

Example 4. The NY branch of a German bank executes, in NY, a SBS with the NY branch of a Brazilian bank. Neither foreign bank is a SBSD or a MSBSP and neither direct counterparty is guaranteed by a US person. The sides must select which would be the reporting side.

Example 5. A US hedge fund executes a SBS in London with a foreign bank that is a registered dealer in its home jurisdiction, but is not a SBSD or MSBSP under Title VII. Neither direct counterparty is guaranteed by a US person. The US hedge fund would be the reporting side, because its side includes the only US person.

a non-US SBS or MSBS). The re-proposal reflects the position of commenters that non-US SBS or MSBS would have greater technological capability than non-registered US counterparties to carry out the reporting function, and that non-registered US counterparties would have to incur significant costs to build the system necessary to report SBS transactions.

The SEC also clarified that foreign public sector financial institutions, such as foreign central banks and multilateral development banks, are not exempt from reporting and public disseminating an SBS to which such an institution is a party. However, the SEC noted that it is open to receiving further information that might support an exemption.

e. Other Changes to Regulation SBSR

i. Cross-Border Inter-Affiliate Transactions

Cross-border inter-affiliate SBS are generally subject to Regulation SBSR. Many commenters expressed concerns with reporting inter-affiliate SBS, particularly public reporting, could confuse market participants with irrelevant information as inter-affiliate transactions are typically risk transfers with no market impact and thus no price discovery value. The market-facing transactions would have already been publicly reported, so that requiring that inter-affiliate transactions also be publicly reported would duplicate information already known to the public and distort information that is critical for price discovery and measuring liquidity, the depth of trading, and exposure to swaps in the market. Also, there was concern that public dissemination could interfere with internal risk management of a corporate group.⁵¹

Despite these comments, the SEC took the position that regulators should have access to information about the precise legal entities that hold risk positions in all SBS. With respect to public dissemination, in situations where the initial market-facing transaction has not been publicly disseminated, public dissemination of the subsequent inter-affiliate transaction may be the only way for the market to obtain any pricing information about the series of transactions. Rather than exempting inter-affiliate transactions from public dissemination altogether, the SEC proposed tailoring data elements to include information that the transaction does not accurately reflect the market (*i.e.*, it was not entered into in an arm's length basis) and delaying dissemination to address the potential impact of public dissemination of the inter-affiliate transaction on a corporate group's ability to properly hedge the position.

The SEC noted that concerns expressed by commenters could be addressed through substituted compliance and as part of the final rules for public dissemination, which the SEC anticipates will further address the issue of dissemination of inter-affiliate transactions.

ii. Foreign Privacy Laws versus Duty to Report Counterparty ID

Proposed Rule 901(d) requires that both counterparties to a SBS transaction report their "participant ID" as part of regulatory reporting (but such information is not to be included in the publicly disseminated report). Although only the reporting side would be obligated to report, the reporting side would have to disclose its counterparty's identity. Several commenters expressed concerns about this disclosure, including the challenges of having to obtain consent under UK and French law. Wrongful disclosure of information could carry criminal penalties under certain foreign privacy laws.

⁵¹ For example, one entity in a group may be better positioned to take on a certain type of risk, even though another entity must, for unrelated reasons, actually enter into the transaction with an external counterparty. Public disclosure of a transaction between affiliates could prompt other market participants to act in a way that would prevent the corporate group from following through with its risk management strategy by, for instance, causing adverse price movements in the market that the risk-carrying affiliate would use to hedge.

However, before the SEC makes any determinations on whether an exception to reporting the counterparty's identity might be necessary or appropriate, it is seeking additional information to understand more precisely if and how requiring a counterparty to report the transaction pursuant to Regulation SBSR might cause it to violate local law in a foreign jurisdiction where it operates.

f. Substituted Compliance for Regulation SBSR

The SEC is re-proposing Rule 908(c)(1) to provide that compliance with the regulatory reporting and public dissemination requirements may be satisfied by compliance with the rules of a foreign jurisdiction that is the subject of a substituted compliance determination of the SEC, provided that, with respect to at least one of the direct counterparties to the SBS:

- Such counterparty is either a non-US person or a foreign branch; ***and***
- No person within the United States is directly involved in executing, soliciting, or negotiating the terms of the SBS on behalf of such counterparty.

Thus, a SBS between two non-US persons would not be eligible for substituted compliance if the SBS were solicited, negotiated, or executed in the United States (including through agents).

The SEC would not make a substituted compliance determination with respect to regulatory reporting and public dissemination unless the SEC found that:

- The data elements that are required to be reported pursuant to the rules of the foreign jurisdiction are comparable to those required by the Exchange Act;
- The rules of the foreign jurisdiction require the SBS to be reported and publicly disseminated in a manner and a timeframe comparable to those required by the Exchange Act;
- The SEC has direct electronic access to the SBS data held by a trade repository or foreign regulatory authority; and
- Any trade repository or foreign regulatory authority that receives and maintains required transaction reports is subject to requirements regarding data collection and maintenance; systems capacity, resiliency, and security; and recordkeeping that are comparable to the requirements imposed on SDRs by the Exchange Act.

The SEC has also clarified that it would permit substituted compliance for a foreign jurisdiction only when that foreign jurisdiction has rules for both regulatory reporting ***and*** public dissemination. The SEC determined that it could not implement Title VII's regulatory reporting and public dissemination requirements as effectively unless it considered these requirements together.

Conclusion

With the release of the Proposed Rules, the SEC has provided its preliminary view as to how US rules should apply to the cross-border SBS market. The Proposed Rules, if adopted, would provide a comprehensive framework for addressing these issues (even though many of the substantive rules are not yet finalized). Significantly, the SEC has taken a different approach from the CFTC in several important respects, and has addressed several issues not covered by the CFTC's proposed guidance. The significant level of detail may give market participants greater predictability as to how their derivatives businesses will be impacted by SEC regulations regarding SBS cross-border activities as the SEC finalizes its rules.

The inconsistencies between the SEC's and CFTC's respective approaches will complicate matters for market participants, however. In some areas, such as the greater potential use of substituted compliance, the SEC's approach may have significant benefits for market participants with cross-border business. The greater focus on activity and conduct in the US, however, may bring many cross-border activities in SBS within US jurisdiction. These differences may compound the already different treatment under the securities and commodities laws for derivatives products. As a result, market participants would benefit from continued coordination between the two agencies as they finalize their rules and cross-border approaches. In addition, there is still a need for greater coordination among G20 countries committed to global improvements in the functioning, transparency, and regulatory oversight of OTC derivatives markets.

As both commissions continue to work through their rule-making process, market participants, especially those who may face potential registration with both the SEC and the CFTC, may wish to participate in the public comment process regarding the Proposed Rules. Market participants have until August 21, 2013 to submit comments. In addition, the SEC has reopened the comment periods for substantive SBS-related rulemaking releases, and market participants will have until July 22, 2013 to submit comments on those rules. We will continue to monitor and report on developments in this area.

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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