First take
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Ten key points from the SEC's final cross-border rule

The SEC provided the "who" but not much else in its final rule regarding cross-border security-based swap activities ("final rule"), released at the SEC's June 25, 2014 open meeting. Although most firms have already implemented a significant portion of the CFTC's swaps regulatory regime (which governs well over 90% of the market), the SEC's oversight of *security-based* swaps means that the SEC's cross-border framework and its outstanding substantive rulemakings (e.g., clearing, reporting, etc.) have the potential to create rules that conflict with the CFTC's approach. The impact that the SEC's regulatory framework will have on the market remains uncertain, but the final rule at least begins to lay out the SEC's cross-border position.

What the SEC's final rule does

1. **Focuses only on cross-border issues, and not comprehensively:** The final rule essentially does two things: (a) it defines "US person" and (b) it identifies the types of transactions that must be included in threshold amounts for determining whether registration as a security-based swap dealer is required ("*de minimis* threshold"). The SEC postpones other cross-border decisions in order to apply them as part of its upcoming substantive rulemakings.
2. **Defines US person with less extraterritorial reach than the CFTC's 2013 final cross-border guidance ("CFTC guidance"):**[1] The SEC's definition of US person does not include the "look through" provision that the CFTC guidance does, so investment vehicles organized outside of the US that are majority-owned by US persons remain outside of the SEC's definition of a US person.
3. **Veers from the SEC's 2013 proposed rule's[2] application of the *de minimis* threshold, to more closely align with the CFTC guidance:** The final rule pulls back from its proposed version by eliminating the requirement that a securities-based swap dealer and its affiliate be "operationally independent" (e.g., not share back office functions), or else the dealer's transactions would have to be part of the affiliate's *de minimis* threshold calculation (i.e., the SEC's proposed version would have required more affiliates to register with the SEC). Additionally, the final rule also generally aligns with the CFTC guidance when applying the *de minimis* threshold, as the final rule (unlike the proposed version) includes transactions entered into by foreign affiliates which are guaranteed by a US entity and also includes conduit affiliates (e.g., non-US affiliates of a US person serving an intermediary function).

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[1] See PwC's *A closer look, Derivatives: Global convergence becomes global confusion* (September 2013).

[2] See PwC's *Regulatory Brief, SEC on Cross-Border Derivatives Rules: Catalyst for global moderation or unwelcome complication?* (May 2013).

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4. **Adds transparency to substituted compliance determinations:** The final rule includes a mandatory comment period on applications submitted to the SEC that will invite foreign jurisdictions, market participants, and others into a formal process for providing input. This contrasts with the less transparent approach that the CFTC has been criticized for.

5. **Conducted a cost-benefit analysis on the economic impact of the regulation, which many complained that the CFTC did not:** SEC staff at the meeting acknowledged the potential impact on liquidity (and market fragmentation) resulting from market participants restructuring their activities to avoid being subject to US regulation. However, the staff indicated its view that its regulatory approach appropriately balances the need for regulation with adverse economic impact, noting that such market distortions are at least partially mitigated by the fact that US-regulated entities will have better risk management and other safeguards than non-regulated entities.

What the final rule does NOT do

6. **Unsurprisingly, sheds little light on the question of whether the CFTC's controversial advisory seeking to apply the US regulatory regime to two non-US counterparties would stand:**[3] The SEC chose not to finalize the provision of its proposed rule (the "transaction conducted within the US" test) which would have required transactions between two non-US counterparties with a modest US nexus (e.g., an employee involved in the transaction who is located on US soil) to be treated as trades implicating the US regulatory regime. Given that the SEC sidestepped this controversy (seeking additional comment on the issue, instead) and the possibility of a different approach by a new CFTC Chairman (which also solicited comment on its advisory earlier this year), we believe the SEC and CFTC will be inclined to scale back its approach. The CFTC has already provided no-action relief for its advisory several times, while market actors have been holding off on implementing the advisory (but have been analyzing the advisory's impact on their business).

7. **Does not include "implicit" guarantees when defining foreign affiliates guaranteed by a US entity, thus establishing less extraterritorial reach than the CFTC guidance:** The final rule (unlike the CFTC guidance) requires there to be an explicit and legally enforceable right or contract in connection with the foreign affiliate's swap activity in order for the activity to be included in determining the affiliate's *de minimis* threshold calculation. The commissioners at the meeting debated extensively as to whether the SEC could have legally extended its regulatory authority further to include transactions of foreign affiliates that have the "implicit" guarantee of a US entity (similar to the CFTC guidance). Some commissioners argued that the adopted strict interpretation of the SEC's authority allows for a gap to be exploited by market participants (as firms have been "de-guaranteeing" affiliates); however, the SEC's general counsel maintained that the SEC lacked legal authority to go further.

8. **Does not finalize its approach for making substituted compliance determinations:** The SEC said that it will address the availability of substituted compliance as part of future substantive rulemakings. The failure to finalize this aspect of the proposal (while moving forward with procedures on how to apply for substituted compliance) leaves the industry with an empty plate, which further entrenches the industry's focus on the CFTC's substituted compliance determinations.[4]

What's next?

9. **Confusion regarding the timing of future rulemakings:** Most commissioners at the meeting agreed on the need for the agency to continue to complete it cross-border and substantive regulations; however, there was a difference in opinion regarding the pace of rulemaking. Commissioner Piwowar stressed that the agency must take the time necessary to make sure the regulations are accurate and strike a proper balance, utilizing the analogy "slow and steady wins the race." Commissioner Aguilar, on the other hand, stated his hope that the SEC's adoption of the final rule "will be quickly followed" by other rule adoptions. The most meaningful bit of clarity was perhaps provided by Chair White who noted that the SEC will follow its previously issued policy statement on the issuance of final rules – therefore, data reporting and security-based swap data repository ("SDR") registration are on deck.

[3] See PwC's *Regulatory Brief, Derivatives: Regulatory roulette* (December 2013).

[4] See PwC's *Regulatory Brief, Derivatives: A first take on cross-border comparability* (December 2013).

10. **SEC and CFTC harmonization?** The SEC appears to have taken note that the marketplace has largely adapted to the new regulatory regime enacted by the CFTC, as commissioners indicated during the meeting that the majority of comments received from the industry request alignment with the CFTC guidance. Although Commissioner Aguilar suggested that the final rule made any misalignments "workable" for market participants, directly acknowledging the concern, the market will likely have a different view going forward. As the SEC continues to issue relevant rules, market participants will need to continually assess the new rules' impact on their business, stay on top of whatever new compliance challenges arise, and be wary that the SEC will be making its rules with the benefit of observing those gaps in the CFTC's regime that may point to the need for tighter regulation.

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