

January 17, 2018

SEC Adopts Final Rule Relating to Security-Based Swap Communications

Publication or Distribution of Certain Communications Involving Security-Based Swaps Will Not Be Deemed an Offer for Purposes of Section 5 of the Securities Act

SUMMARY

On January 5, 2018, the Securities and Exchange Commission adopted Rule 135d (the “Final Rule”) under the Securities Act of 1933 (the “Securities Act”) providing that the following communications will not be deemed “offers” for purposes of Section 5 of the Securities Act:

- price quotes relating to security-based swaps that may be purchased only by “eligible contract participants” and are traded or processed on or through a national securities exchange or a security-based swap execution facility; and
- regular course research reports that discuss security-based swaps or the issuers thereof if the security-based swaps may be purchased only by “eligible contract participants” and the reports do not represent the initiation (or reinitiation) of publication of reports regarding such issuer or its securities.

The Final Rule became effective on January 16, 2018, the date of its publication in the Federal Register.¹

BACKGROUND

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) provides the Securities and Exchange Commission (the “SEC”) authority to regulate security-based swap (“SBS”) transactions and participants in the SBS market. Among other matters, Title VII includes SBSs in the definition of “security” for the purposes of the Securities Act and amends Section 5 of the Securities Act to make it unlawful, unless a registration statement is in effect, to offer or sell an SBS to any person who is not an “eligible contract participant” (“ECP”).² Title VII also amends the Securities Exchange Act of 1934 (the “Exchange Act”) to regulate national securities exchanges and SBS execution facilities (“SBSEFs”),

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including by adding provisions relating to the availability of bid, offer or other price information relating to SBSs. National securities exchanges and SBSEFs are generally required to publicly disseminate price quotes relating to SBSs (“SBS price quotes”).³

The effect of the changes to Section 5 and the requirement for national securities exchanges and SBSEFs to publish SBS price quotes has created two registration issues under the Securities Act. First, the SBS price quotes could be deemed an “offer” to non-ECPs which would require the filing of an effective registration statement. Second, many transactions executed with ECPs are done in reliance upon the private placement exemption to the Securities Act which has been interpreted by the SEC and the courts to prohibit general solicitation and advertising. A concern exists that SBS price quotes could constitute an impermissible general solicitation that would render the private placement exemption unavailable.

To address these issues, on September 8, 2014, the SEC proposed a rule (the “Proposed Rule”) to address the treatment of SBS price quotes that may only be purchased by persons who are ECPs that are traded or processed through a national securities exchange or an SBSEF.⁴ Under the Proposed Rule, the publication or distribution of SBS price quotes would not be deemed to constitute an offer, an offer to sell, or a solicitation of an offer to buy for the purposes of Section 5 of the Securities Act.

In connection with the SEC’s request for comment on the Proposed Rule, one commentator requested that the Proposed Rule extend to research reports relating to SBS transactions because the unrestricted publication of research reports implicates the same issues as the publication of SBS price quotes: the publication of a research report on an SBS could be deemed an offer of such SBS to non-ECPs and a general solicitation that would call into question the availability of the private placement exemption for such SBS.

SBS PRICE QUOTES

Under the Final Rule, consistent with the Proposed Rule, the publication or distribution of SBS price quotes would not be deemed to constitute an offer, an offer to sell, or a solicitation of an offer to buy or purchase such SBSs (or any guarantees of such SBSs⁵), for the purposes of the Section 5 of the Securities Act, for SBSs meeting the following requirements (“Covered SBSs”):

- the SBSs may be purchased only by ECPs; and
- the SBSs are traded or processed on or through a trading system or platform that is registered as either a national securities exchange or as an SBSEF, or is exempt from registration as an SBSEF pursuant to a rule, regulation, or order of the SEC (an “eligible trading platform”).

The Final Rule applies to the initial publication or distribution of the SBS price quotes on eligible trading platforms and to any subsequent republication or redistribution of the SBS price quotes on or through other media, such as online information services. The SEC notes that the SBS price quotes covered by

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the Final Rule could take a number of forms, such as indicative quotes, executable quotes, bids and offers and other pricing information and other types of quote information that may develop in the future. The SEC expressly declined to define the specific types of SBS price quotes covered by the Final Rule in order to maintain flexibility as organized markets for SBS trading continue to develop.⁶ Likewise, the SEC indicated that the Final Rule applies to any communication of SBS-related price quotes regardless of whether transactions in the relevant SBSs are effected bilaterally in the over-the-counter market or on swap trading platforms, or are subsequently cleared using an eligible clearing agency.

The SEC notes that the Final Rule is designed to permit SBS transactions between ECPs to continue to be able to rely on available exemptions from the registration requirements of the Securities Act, without unintended consequences from the unrestricted public dissemination of SBS price quotes by eligible trading platforms. The unrestricted access to such SBS price quotes on eligible trading platforms will, according to the SEC, provide increased market transparency by providing all investors with the same information on the pricing of SBS transactions.

RESEARCH REPORTS

The only substantive addition to the Final Rule, originating from comments to the Proposed Rule, addresses written communications that discuss covered SBSs and meet certain conditions. Under the Final Rule, a broker, dealer, or SBS dealer's publication or distribution of a research report (as defined in Rule 139(d) of the Securities Act) discussing covered SBSs ("SBS research reports") will not be deemed to constitute an offer, an offer to sell, or a solicitation of an offer to buy or purchase any SBS (or guarantee of such SBS) if:

- the broker, dealer, or SBS dealer publishes or distributes research reports on the issuer underlying the SBS or its securities in the regular course of its business; and
- the publication or distribution of the research report does not represent the initiation of publication of research reports about such issuer or its securities or the reinitiation of such publication following discontinuation of publication of such research reports.

The Final Rule clarifies that the term "issuer" as used in the definition of "research report" means:

- the issuer of any security or loan referenced in the SBS;
- each issuer of a security in a narrow-based security index referenced in the security-based swap; or
- each issuer referenced in the SBS.

This clarifies that the term "issuer" does not include the counterparties to the SBS, which could have potentially been viewed as issuers given the bilateral, privately negotiated nature of many SBSs.

The SEC believes that the continuous publication and distribution of SBS-related research reports provides essential information to the SBS market and the securities markets generally. Accordingly, the

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SEC believes that the Final Rule is necessary to ensure this unrestricted publication and distribution of SBS-related research reports.

The Final Rule does not affect the treatment of research reports under existing Securities Act Rules 137, 138 and 139 (the “Research Rules”), which address when a broker or dealer may publish or distribute securities research around a securities offering without violating Section 5 of the Securities Act. As a result, communications relating to offerings of securities underlying SBSs must be analyzed separately under the Research Rules. In that case, any discussion of an SBS in a research report would be analyzed under the Final Rule, while any discussion of securities underlying such SBS (which could be in the same research report discussing the SBS) would be analyzed under the Research Rules.

INTERIM FINAL EXEMPTIONS

In response to a comment, the SEC declined to extend the expiration date of certain interim final rules that have provided exemptions under the Securities Act, the Exchange Act and the Trust Indenture Act of 1939 for SBSs that were “security-based swap agreements” prior to the effective date of Title VII of Dodd-Frank, and are defined as “securities” due solely to the provisions of Title VII (the “Interim Final Exemptions”). According to the SEC, the Interim Final Exemptions were adopted due to, among other things, concern about disrupting the operation of the SBS market while the implications of the Dodd-Frank Act were evaluated. The Interim Final Exemptions expire on February 11, 2018.

EFFECTIVE DATE

The Final Rule became effective upon publication in the Federal Register on January 16, 2018.

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ENDNOTES

- ¹ See “Treatment of Certain Communications Involving Security-Based Swaps That May Be Purchased Only by Eligible Contract Participants,” Release No. 33-10450 (Jan. 5, 2018), 83 FR 2046 (Jan. 16, 2018), available at <https://www.gpo.gov/fdsys/pkg/FR-2018-01-16/pdf/2018-00347.pdf>.
- ² For the SEC’s and CFTC’s joint final rules regarding the classification of ECPs, see “Further Definition of ‘Swap Dealer,’ ‘Security-Based Swap Dealer,’ ‘Major Swap Participant,’ ‘Major Security-Based Swap Participant’ and ‘Eligible Contract Participant,’” Release No. 34-66868 (April 27, 2012), 77 FR 30596 (May 23, 2012), available at <https://www.gpo.gov/fdsys/pkg/FR-2012-05-23/pdf/2012-10562.pdf>. For more information regarding the classification of entities as ECPs, see our Memorandum to Clients, dated June 8, 2012, entitled “CFTC and SEC Issue Final Swap-Related Rules Under Title VII of Dodd-Frank: CFTC and SEC Issue Final Rules and Guidance to Further Define the Terms ‘Swap Dealer,’ ‘Security-Based Swap Dealer,’ ‘Major Swap Participant,’ ‘Major Security-Based Swap Participant’ and ‘Eligible Contract Participant,’” available at https://www.sullcrom.com/siteFiles/Publications/SC_Publication_CFTC_and_SEC_Issue_Final_Swap_Related_Rules.pdf.
- ³ See “Regulation SBSR – Reporting and Dissemination of Security-Based Swap Information,” Release No. 34-74244 (Feb. 11, 2015), 80 FR 14564 (Mar. 19, 2015), and Release No. 34-78321 (Jul. 14, 2016), 81 FR 53545 (Aug. 12, 2016).
- ⁴ See “Treatment of Certain Communications Involving Security-Based Swaps That May Be Purchased Only By Eligible Contract Participants,” Release No. 33-9643 (September 8, 2014), 79 FR 54224 (Sep. 11, 2014), available at <http://www.sec.gov/rules/proposed/2014/33-9643.pdf>. For more information regarding the Proposed Rule, see our Memorandum to Clients, dated September 10, 2014, entitled “Security-Based Swaps: SEC Proposes Rule Regarding Communications Involving Security-Based Swaps Entered Into Solely by Eligible Contract Participants,” available at https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Security_Based_Swaps_09_10_2014.pdf.
- ⁵ The Final Rule would also extend to guarantees of SBS transactions since the guarantee of an SBS transaction is itself a security under the Securities Act.
- ⁶ While the SEC indicated in the Proposed Rule that there are at least five types of eligible trading platforms – single dealer request for quotes, aggregators, multi-dealer request for quotes, limit order book systems, and electronic brokering, the SEC notes in the Final Rule that these examples may not represent every single trading method in existence.

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