SULLIVAN & CROMWELL LLP

May 29, 2019

Cross-Border Security-Based Swap Requirements

The SEC Proposes Amendments and Interpretive Guidance Addressing the Cross-Border Application of Certain Security-Based Swap Requirements

SUMMARY

The Securities and Exchange Commission has proposed rule amendments and interpretive guidance addressing the cross-border application of certain security-based swap requirements of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The release[1] includes proposals addressing four key areas:

- Proposed guidance and rule changes to address whether and how certain requirements under Title VII will apply to security-based swap transactions between two non-U.S. persons that have been "arranged, negotiated, or executed" by personnel of one of the parties located in the U.S., including, among others, two alternative proposals regarding the *de minimis* exception from the security-based swap dealer registration requirement;
- Proposed guidance regarding the terms of and compliance timing for the requirement that non-U.S. security based swap dealers and major security-based swap participants certify and provide an opinion of counsel that the SEC can access their books and records and conduct onsite inspections and examinations;
- Proposed rule amendments related to the application of the relevant SEC statutory disqualification provisions to non-U.S. persons; and
- Proposed rule changes related to the questionnaire or application for employment that security-based swap dealers and major security-based swap participants are required to make and keep current with respect to foreign associated persons.

Comments are due by July 23, 2019.

BACKGROUND

The SEC has proposed and finalized a number of rules to implement requirements under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act providing for the regulation of security-based swap activity. These rules include provisions to address unique concerns raised by security-based swaps entered into by two non-U.S. persons. Under the proposed and finalized rules, security-based swaps entered into by two non-U.S. persons may become subject to certain provisions of Title VII if arranged, negotiated or executed by personnel located in the United States. In particular, dealing transactions in security-based swaps by a non-U.S. person with another non-U.S. person will count towards the *de minimis* swap dealer registration threshold if arranged, negotiated or executed by personnel located in the United States.[2] Market participants and other commenters have raised concerns regarding possible disruptive effects of the arranged, negotiated or executed standard, including:

- the standard may result in non-U.S. entities relocating U.S. personnel outside the United States, resulting in market fragmentation;
- the operational complexity of keeping U.S. personnel out of the process of arranging, negotiating or executing security-based swaps; and
- the inability of non-U.S. entities to take advantage of the expertise of U.S. personnel.

The SEC notes that analyses of 2017 trading data indicate that:

- five additional non-U.S. persons will likely incur assessment costs in connection with the cross-border *de minimis* counting rules;
- one non-U.S. person would fall below the *de minimis* threshold if transactions with non-U.S. counterparties were excluded from the *de minimis* counting test; and
- six U.S. persons, each of which has a majority-owned registered broker-dealer affiliate, may take advantage of the proposed rules and guidance.

Thus, the SEC estimates in total that 12 entities may take advantage of the proposed rules and guidance.

I. ARRANGED, NEGOTIATED, OR EXECUTED

A. PROVISION OF "MARKET COLOR"

The SEC has previously adopted rules that require an entity to include in its calculation of the *de minimis* threshold for security-based swap dealer registration any dealing transactions with non-U.S. counterparties that were "arranged, negotiated, or executed" by personnel located in the U.S. For purposes of the release, the term "U.S. personnel" means personnel located in a branch or office in the U.S. of an entity that is engaged in security-based swap activity, or by personnel of an agent of that entity. The SEC requires a similar analysis and "arranged, negotiated, or executed" test when assessing whether certain security-based swap dealer business conduct provisions and the regulatory reporting and public dissemination provisions under Regulation SBSR will apply to cross-border security-based swaps.

The SEC has now proposed supplemental guidance regarding the types of market-facing activity that would – and would not – constitute "arranging" or "negotiating" a security-based swap for purposes of the Title VII requirements. The release provides no guidance on the "execution" prong of the standard.

The proposed guidance would permit U.S. personnel to provide "market color" without such activity constituting "arranging" or "negotiating" security-based swap transactions for purposes of the *de minimis* threshold, the cross-border application of business conduct rules, regulatory reporting and public dissemination requirements, and major security-based swap participant rules.

The term "market color" is defined in the proposed guidance as background information regarding pricing or market conditions associated with particular instruments or with markets more generally, including information regarding current or historical pricing, volatility or market depth, and trends or predictions regarding pricing, volatility or market depth, as well as other types of information reflecting market conditions and trends. For conduct to qualify as providing "market color," the U.S. personnel providing the market color must not:

- be assigned to or otherwise exercise client responsibility in connection with the transaction; or
- receive compensation based on or otherwise linked to the completion of transactions on which the U.S. personnel provide market color.

The SEC notes that the compensation test would not prohibit compensation bonus arrangements where the amount of the bonus is based on the overall profit or loss of the division, office or firm.

B. TWO PROPOSED EXCEPTIONS TO THE *DE MINIMIS* DEALER REGISTRATION CALCULATION

The SEC is also soliciting public comment on two alternative proposals for a conditional exception from the *de minimis* dealer registration calculation for security-based swap transactions entered into between non-U.S. persons that are arranged or negotiated by personnel located in the United States. These alternative proposals are intended to protect the policy goals associated with security-based swap dealer regulation by focusing relevant requirements on the arranging, negotiating and executing activity occurring in the U.S., while avoiding potentially problematic consequences – such as relocation of personnel outside the U.S. that may lead to fragmentation that reduces market access available to persons within the U.S.

ALTERNATIVE PROPOSAL 1

The first alternative proposal would conditionally permit a non-U.S. person to exclude relevant security-based swap dealing transactions from the *de minimis* dealing threshold so long as all arranging, negotiating or executing activity within the U.S. is performed by personnel associated with an affiliated entity that is registered with the SEC as a security-based swap dealer. In order to rely on this exception,

the non-U.S. person and the affiliated registered entity would be required to comply with the following additional conditions:

- All such arranging, negotiating and executing activity in the U.S. would be conducted by personnel located in a U.S. branch or office in their capacity as associated persons of a majority-owned affiliate[3] that is registered with the SEC as a security-based swap dealer.
- The registered security-based swap dealer would have to comply with specific requirements applicable to security-based swap dealers as if the entity were a counterparty to the non-U.S. person's counterparties. This includes disclosing risk, characteristics of the security-based swap and the material incentives or conflicts of interests of the security-based swap dealer, including the material incentives and conflicts of interest associated with the non-U.S. person relying on the exception. The registered security-based swap dealer must also comply with requirements regarding the suitability of any recommendations that its associated person may make, fair and balanced communication requirements, trade acknowledgment and verification requirements and portfolio reconciliation requirements.[4]
- The SEC could access relevant books, records and testimony of the non-U.S. person, and the registered security-based swap dealer would be required to obtain from the non-U.S. person relying on the exception, and maintain, documentation encompassing all terms governing the trading relationship between the non-U.S. person and its counterparty related to the transaction.
- The registered security-based swap dealer would have to obtain from the non-U.S. person written consent to service of process for any civil action brought by or proceeding before the SEC.
- The registered security-based swap dealer would provide certain disclosures to the counterparties of the non-U.S. person contemporaneously with the arrangement, negotiation or execution, including notifying the counterparties of the non-U.S. person relying on the exception that the non-U.S. person is not registered as a security-based swap dealer, and that certain provisions or rules under the Securities Exchange Act of 1934 (the "Exchange Act") addressing the regulation of security-based swaps would not be applicable to the non-U.S. person in connection with the transaction (for example, clearing rights).
- The non-U.S. person must be subject to the margin and capital requirements of a "listed jurisdiction. The SEC may conditionally or unconditionally determine listed jurisdictions by order, in response to applications or upon the SEC's own initiative. The SEC anticipates that the initial set of listed jurisdiction determinations may include some or all of the following jurisdictions: Australia, Canada, France, Germany, Hong Kong, Japan, Singapore, Switzerland and the United Kingdom.

ALTERNATIVE PROPOSAL 2

The second alternative would be supplemental to the first proposal and would also exclude transactions arranged, negotiated or executed in the U.S. by an entity that is registered as a broker, without requiring that entity to also register as a security-based swap dealer.

Certain proposed conditions to Alternative 2 would be the same as those to Alternative 1, while others would be modified to reflect the potential for the activity in the U.S. to be conducted by a registered broker that is not also registered as a security-based swap dealer. Alternative 2 would therefore rely on the SEC's existing broker regulation to provide for oversight of the transactions at issue while adding certain conditions to fill gaps in regulation that may otherwise arise absent the involvement of a registered

security-based swap dealer. The difference between the two alternatives is that a broker relying on Alternative 2 would need to treat itself as registered as a security-based swap dealer.

II. PROPOSED GUIDANCE AND AMENDMENT RELATED TO THE CERTIFICATION AND OPINION OF COUNSEL REQUIREMENTS

Exchange Act Rule 15Fb2-4 requires, among other things, that each non-U.S. security-based swap dealer and major security-based swap participant ("Security-Based Swap Entity") registering with the SEC certify that it will provide the SEC with prompt access to its books and records and submit to on-site inspection and examination by the SEC. The rule also requires that the non-U.S. Security-Based Swap Entity provide the SEC an opinion of counsel to support this certification. The SEC is proposing guidance regarding the certification and opinion of counsel requirements.[5]

The SEC is proposing guidance to Exchange Act Rule 15Fb2-4 with respect to:

- the foreign laws that must be covered by the certification and opinion of counsel;
- the scope of the books and records that are the subject of the certification and opinion of counsel,
- the predication of a Security-Based Swap Entity's certification and opinion of counsel, as necessary, on the non-U.S. Security-Based Swap Entity obtaining prior consent of the persons whose information is or will be included in the books and records that are provided to the SEC;
- whether the certification and opinion of counsel submitted by a non-U.S. Security-Based Swap Entity can take into account approvals, authorizations, waivers or consents provided by local regulators; and
- applicability of the certification and opinion of counsel to contracts entered into prior to the date on which the Security-Based Swap Entity submits an application for registration.

A. FOREIGN LAWS COVERED

Under the proposed guidance, it would be appropriate for the certification and opinion of counsel to address only the laws of the jurisdiction or jurisdictions in which the non-U.S. Security-Based Swap Entity maintains the covered books and records. Therefore, the certification and opinion of counsel would not need to cover other jurisdictions where customers or counterparties of the non-U.S. Security-Based Swap Entity may be located or where the non-U.S. Security-Based Swap Entity may have additional offices or conduct business. If the non-U.S. Security-Based Swap Entity maintains its covered books and records in a jurisdiction or jurisdictions other than where it is incorporated or has its principal place of business (e.g., in a jurisdiction where it maintains a foreign branch office that conducts its security-based swap activities), the guidance would require the certification and opinion of counsel to address such jurisdiction or jurisdictions, provided that the laws of the jurisdiction where the Security-Based Swap Entity is incorporated or jurisdictions in which it is doing business would not prevent the SEC from having direct access to the covered books and records, nor prevent the non-U.S. Security-Based Swap Entity from

promptly furnishing them to the SEC or opening them up to the SEC for an on-site inspection or examination.

B. COVERED BOOKS AND RECORDS

In order to clarify the scope of books and records that must be covered by the certification and opinion of counsel, the SEC is proposing guidance that the certification and opinion of counsel need only address:

- books and records that relate to the "U.S. business"[6] of the non-U.S. Security-Based Swap Entity; and
- financial records necessary for the SEC to assess the compliance of the non-U.S. Security-Based Swap Entity with capital and margin requirements under the Exchange Act and rules promulgated under the Exchange Act, if these capital and margin requirements apply to the non-U.S. Security-Based Swap Entity.

C. PREDICATION ON RECEIPT OF CONSENTS

The SEC notes that in certain jurisdictions, a non-resident security-based swap entity may provide books and records directly to the SEC and may submit to an on-site inspection and examination at the offices of the Security-Based Swap Entity if it has obtained consent from the natural person whose information is documented in the books and records. The SEC's proposed guidance would provide that it is appropriate for the Security-Based Swap Entity's certification and opinion of counsel to be predicated, as necessary, on the non-U.S. Security-Based Swap Entity obtaining the prior consent of the persons whose information is or will be included in the books and records to allow the Security-Based Swap Entity to promptly provide the SEC with direct access to its books and records and to submit to on-site inspection and examination. The guidance notes that if a non-U.S. Security-Based Swap Entity intends to rely on consents, it should obtain such consents prior to registering with the SEC, so that it will be able to provide the SEC with direct access to its books and records while it is conditionally registered. In addition, if a non-U.S. Security-Based Swap Entity certifies that it may rely on consents, it should continue to obtain consents on an ongoing basis. If a non-U.S. Security-Based Swap Entity is unable to obtain consent, or if a customer or counterparty provides a consent and then later withdraws that consent, the SEC indicates that the non-U.S. Security-Based Swap Entity may need to cease its security-based swap activities.

D. SEC ARRANGEMENTS WITH FOREIGN REGULATORY AUTHORITIES FOR APPROVALS, AUTHORIZATIONS, WAIVERS OR CONSENTS

The SEC preliminarily believes that it would be appropriate, under the factors discussed below, for the certification and opinion of counsel to take into account whether the relevant regulatory authority in the foreign jurisdiction has:

- issued an approval, authorization waiver or consent; or
- entered into an memorandum of understanding ("MOU") or other arrangement with the SEC facilitating direct access to the books and records of Security-Based Swap Entities located in that jurisdiction, including the SEC's inspections and examinations at the offices of Security-Based Swap Entities located in that jurisdiction.

However, consideration of such an approval or MOU would require providing the SEC direct access to the books and records of non-U.S. Security-Based Swap Entities; the SEC indicates that going through a third party, such as a foreign regulatory authority, would not be sufficient. Thus, it would not be appropriate for the certification or opinion of counsel to take into account such an approval or MOU if it contemplates that the non-U.S. Security-Based Swap Entity must provide the covered books and records to the foreign regulatory authority in order for that body then to provide them to the SEC.

On the other hand, the SEC believes it would be permissible for the MOU or other arrangement to require the SEC to notify the relevant foreign regulatory authority of its intent to conduct an onsite inspection or examination and require staff from the foreign regulatory authority to accompany the SEC when it visits the foreign office of the non-U.S. Security-Based Swap Entity. Nevertheless, the MOU or other arrangement must not, whether by the terms of any relevant agreement, under provisions of local law, or in light of prior practice, restrict the SEC's ability to conduct timely inspections and examinations of the books and records in the foreign office of the non-U.S. Security-Based Swap Entity.

E. OPEN CONTRACTS

The SEC guidance would clarify that the certification and opinion of counsel need not address the books and records of security-based swap transactions that were entered into prior to the date on which a non-U.S. Security-Based Swap Entity submits an application for registration.

F. THE TIMING OF CERTIFICATION AND OPINION OF COUNSEL

The SEC is proposing to provide additional time for a non-U.S. Security-Based Swap Entity to submit the certification and opinion of counsel required under Rule 15Fb2-4(c)(1). Specifically, the SEC is proposing to permit a non-U.S. Security-Based Swap Entity up to 24 months after conditional registration to provide the certification and opinion of counsel. Under the proposed rule, once conditionally registered, the non-U.S. Security-Based Swap Entity would remain conditionally registered until the SEC acts to grant or deny ongoing registration, and if the non-U.S. Security-Based Swap Entity failed to provide the certification and opinion of counsel within 24 months, the SEC could institute proceedings to determine whether the conditional registration should be denied.

The proposed rule is a very limited dispensation: the relevant registration application must be completed in all respects except for the certification and opinion of counsel. Further, once a non-U.S. Security-Based Swap Entity is conditionally registered, the Security-Based Swap Entity must comply with all of the relevant rules and regulations.

III. PROPOSED AMENDMENT TO SEC RULE OF PRACTICE 194 PROVIDING RELIEF TO CERTAIN ASSOCIATED PERSONS FROM STATUTORY DISQUALIFICATION

Exchange Act Section 15F(b)(6) makes it unlawful for a Security-Based Swap Entity to permit an associated person who is subject to a statutory disqualification to effect or be involved in effecting[7]

security-based swaps on behalf of the Security-Based Swap Entity if the Security-Based Swap Entity knew, or in the exercise of reasonable care should have known, of the statutory disqualification. Exchange Act Section 3(a)(70) generally defines the term "person associated with" a Security-Based Swap Entity to include

- any partner, officer, director, or branch manager of a Security-Based Swap Entity (or any person occupying a similar status or performing similar functions);
- any person directly or indirectly controlling, controlled by, or under common control with a Security-Based Swap Entity; or
- any employee of a Security-Based Swap Entity.

The definition generally excludes persons whose functions are solely clerical or ministerial. As part of implementing Section 15F(b)(6) the SEC adopted Rule of Practice 194, which provides, among other things, a process by which a Security-Based Swap Entity could apply to the SEC to permit an associated person who is a natural person and who is subject to a statutory disqualification to effect or be involved in effecting security-based swaps on behalf of the Security-Based Swap Entity.

The SEC is now proposing to amend Rule of Practice 194 to exclude from Exchange Act Section 15F(b)(6) an associated person who is a natural person[8] who

- is not a U.S. person; and
- does not effect and is not involved in effecting security-based swap transactions with or for counterparties that are U.S. persons, other than a security-based swap transaction conducted through a foreign branch of a counterparty that is a U.S. person.

This modification seeks to harmonize the SEC's rules with the CFTC's approach to statutory disqualification as it applies to the activities of non-U.S.-associated persons of CFTC-registered swap entities.

However, a Security-Based Swap Entity would not be able to avail itself of this exclusion if the associated person of that Security-Based Swap Entity is currently subject to:

- an order expelling or suspending such person from membership in or participation in self-regulatory organizations or foreign equivalents; or
- any order of the SEC or other appropriate domestic regulatory agency, or a foreign financial regulatory authority in the jurisdiction where the associated person is employed or located, which denies or bars an individual from participation as a broker or dealer.

IV. PROPOSED MODIFICATIONS TO PROPOSED RULE 18a-5 PROVIDING CERTAIN EXEMPTIONS TO QUESTIONNAIRE REQUIREMENTS

The SEC is proposing to amend proposed Rule 18a-5, which requires a Security-Based Swap Entity to make and keep current a questionnaire or application for employment for each associated person who is

a natural person. The questionnaire or application for employment would be required to include the associated person's identifying information, business affiliations for the past ten years, relevant disciplinary history, relevant criminal record, and place of business, among other things. This questionnaire requirement is intended to serve as a basis for a background check of the associated person who is a natural person and who effects or is involved in effecting security-based swap transactions on behalf of the Security-Based Swap Entity to verify that the person is not subject to statutory disqualification.

The SEC is proposing to add two set of exemptions to proposed Rule 18a-5. The first exemption provides that a stand-alone or bank Security-Based Swap Entity is not required to make and keep current a questionnaire or application for employment executed by an associated person if the Security-Based Swap Entity is excluded from the prohibition in Section 15F(b)(6) of the Exchange Act with respect to such associated person. This exclusion is intended to complement the proposed amendments to Rule 194 discussed in Section III.

The second set of exclusions would permit the stand-alone or bank Security-Based Swap Entities to exclude certain information mandated by the questionnaire requirement with respect to associated persons if the receipt of that information, or the creation or maintenance of records reflecting such information, would result in a violation of applicable law in the jurisdiction in which the associated person is employed or located. Rather than fully excluding these associated persons from the questionnaire requirement, the exclusion is limited only to the information that would result in a violation of applicable law in the jurisdiction in which the associated person is employed or located. Further, if a Security-Based Swap Entity would be able to obtain the information required by the questionnaire or application requirement if it obtained the consent of the associated person, the Security-Based Swap Entity generally should try to obtain such consent before relying on the proposed exclusion.

V. COMMENTS

The SEC solicits comments on all aspects of the proposed guidance and rules. In particular, the SEC has requested any updated economic analyses on the impact of the proposed rules. Comments are due by July 23, 2019.

* * *

ENDNOTES

[1] For the full text of the release, *see Proposed Rule Amendments and Guidance Addressing Cross-Border Application of Security-Based Swap Requirements*, SEC Release No. 34-85823, *available at* https://www.sec.gov/rules/proposed/2019/34-85823.pdf (May 10, 2018).

[2] The *de minimis* thresholds are:

- $3 billion (subject to an $8 billion phase-in) aggregate gross notional amount with regard to credit default swap transactions;
- $150 million (subject to a $400 million phase-in) aggregate gross notional amount of other security-based swaps; and
- an aggregate gross notional amount of no more than $25 million with regard to all security-based swaps with "special entities."

[3] Majority-owned affiliate is proposed to be defined as an entity that directly or indirectly owns a majority interest in both parties or one party that directly or indirectly owns a majority interest in the other. Majority interest would be defined as the right to vote or direct the vote of a majority of a class of voting securities, the power to sell or direct the sale of a majority of a class of voting securities or the right to receive upon dissolution, or the contribution of, a majority of the capital of a partnership.

[4] However, this condition would not extend to "know your counterparty" requirements, clearing rights disclosure, daily mark disclosure or certain risk mitigation rules.

[5] The proposed guidance would also apply to Exchange Act Rule 3a71-6, which allows Security-Based Swap Entities to comply with certain requirements under Section 15F of the Exchange Act through substituted compliance.

[6] U.S. business is defined under the Exchange Act as:

- Any security-based swap transaction entered into, or offered to be entered into, by or on behalf of a foreign security-based swap dealer, with a U.S. person (other than a transaction conducted through a foreign branch of that person); or
- Any security-based swap transaction arranged, negotiated, or executed by personnel of the foreign security-based swap dealer located in a U.S. branch or office, or by personnel of an agent of the foreign security-based swap dealer located in a U.S. branch or office.

[7] The SEC has stated that the term "involved in effecting security-based swaps" generally means engaged in functions necessary to facilitate the Security-Based Swap Entity's security-based swap business, including, but not limited to the following activities:

- drafting and negotiating master agreements and confirmations;
- recommending security-based swap transactions to counterparties;
- being involved in executing security-based swap transactions on a trading desk;
- pricing security-based swap positions;
- managing collateral for the Security-Based Swap Entity; and
- directly supervising persons engaged in the above-described activities.

[8] Rule of Practice 194 already provides an exclusion for non-U.S. entities.

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 875 lawyers on four continents, with four offices in the U.S., including its headquarters in New York, four offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed below, or to any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future publications by sending an e-mail to SCPublications@sullcrom.com.

CONTACTS

New York		
Robert E. Buckholz	+1-212-558-3876	buckholzr@sullcrom.com
Robert W. Downes	+1-212-558-4312	downesr@sullcrom.com
David J. Gilberg	+1-212-558-4680	gilbergd@sullcrom.com
Joseph A. Hearn	+1-212-558-4457	hearnj@sullcrom.com
Korey R. Inglin	+1-212-558-3597	inglink@sullcrom.com
Ryne V. Miller	+1-212-558-3268	millerry@sullcrom.com
Kenneth M. Raisler	+1-212-558-4675	raislerk@sullcrom.com
Robert W. Reeder III	+1-212-558-3755	reederr@sullcrom.com
Tracey E. Russell	+1-212-558-3289	russellt@sullcrom.com
Rebecca J. Simmons	+1 212 558 3175	simmonsr@sullcrom.com
Frederick Wertheim	+1-212-558-4974	wertheimf@sullcrom.com
Washington, D.C.		
Eric J. Kadel, Jr.	+1-202-956-7640	kadelej@sullcrom.com
Robert S. Risoleo	+1-202-956-7510	risoleor@sullcrom.com
Los Angeles		
Patrick S. Brown	+1-310-712-6603	brownp@sullcrom.com
Alison S. Ressler	+1-310-712-6630	resslera@sullcrom.com
Palo Alto		
Sarah P. Payne	+1-650-461-5669	paynesa@sullcrom.com
John L. Savva	+1-650-461-5610	savvaj@sullcrom.com