Clients&FriendsMemo

Security-Based Swaps Meet Rule 15a-6
Potential New Exemptions for Security-Based Swaps and SBSDs

June 3, 2019

The Securities and Exchange Commission (the "**SEC**") has proposed a number of amendments to its rules and guidance governing security-based-swaps ("**SBS**") entered into by non-U.S. firms. The proposals would increase the activities that a U.S. agent could conduct without the SEC deeming the SBS to have been "arranged, negotiated or executed" in the United States and thus without triggering U.S. regulatory requirements.[1] Even when an SBS entered into by a non-U.S. SBS dealer has been arranged, negotiated or executed in the United States, the SEC proposes to reduce the regulatory requirements that would apply when the non-U.S. dealer is trading with another non-U.S. counterparty.

The Proposal represents a rethink of certain requirements adopted a few years ago (although not yet implemented, as the entire SBS regulatory regime has yet to go into effect) and, as a general matter, moves the SEC's treatment of cross-border SBS in the direction of its treatment of cross-border securities transactions under Rule 15a-6 under the Securities Exchange Act of 1934 (the "**SEA**").

I. Overview of the Proposal

The Proposal provides for four categories of changes:

- ANE Guidance. The Proposal would provide guidance (not codified as a rule) that certain sales contacts between non-U.S. customers and U.S. salespeople, acting on behalf of a non-U.S. firm "dealing" in SBS, would be considered so limited that they would not result in the SBS being deemed to have been "arranged, negotiated or executed" ("**ANE**") in the United States.[2] For purposes of this memorandum, we refer to sales contacts that would be excluded from the definition of ANE as "**Providing Market Color**."

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1 SEC Release No. 34-85823 (May 10, 2019), 84 Fed. Reg. 24206 (May 24, 2019) (the "**Proposal**").

2 Currently, SEA Rule 3a71-3 requires that, when persons in a U.S. branch or office are involved in the "arranging, negotiating or execution" of an SBS transaction effected for a non-U.S. dealing firm: (i) the non-U.S. firm must count the SBS for purposes of the *de minimis* exception under SEA Rule 3a71-2(a)(1) (which would make it more likely that the non-U.S. firm

- Exception from ANE Requirements. Where a non-U.S. SBS dealer enters into an SBS with a non-U.S. counterparty that has been "arranged, negotiated or executed" in the United States, the SEC would, subject to extensive conditions, (i) treat certain of the SEC's own regulatory requirements as wholly inapplicable and (ii) allow an SEC-registered firm to act as an agent and take responsibility for many of the customer-facing responsibilities that would continue to apply, such as suitability. For purposes of this memorandum, we refer to an SBS entered into between two non-U.S. persons, but as to which there has been ANE activity in the United States, as an "**ANE SBS**."

- Statutory Disqualifications. The SEC would lessen the obligations imposed on a non-U.S. SBSD to determine that its personnel are not subject to a "statutory disqualification."[3] In particular, the Proposal would provide that prohibition on SEC-registered SBS dealer employing an "associated person" subject to a statutory disqualification would not apply to a non-U.S. SBSD individual associated person who (i) is not a U.S. person; (ii) does not effect transactions with U.S. persons other than non-U.S. branches of U.S. persons; and (iii) is not subject to a disciplinary action either by a U.S. financial regulator or by non-U.S. financial regulator in the jurisdiction where the individual is employed or located.[4]

- Registration Opinion of Counsel Requirements. The SEC is also seeking to ease certain of the procedural requirements imposed on a non-U.S. SBSD to demonstrate that it is able to provide the required records to the SEC without violating the laws of its home jurisdiction.[5]

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would be required to register with the SEC as an SBSD); and (ii) any non-U.S., SEC-registered security-based swap dealer ("**SBSD**") must comply with all the various SEC "business conduct" requirements as to the SBS counterparty. A summary of the initial SEC adoption of the ANE requirement is available here. In addition, under Regulation SBSR Rule 908(a)(1)(v), reporting requirements would apply to ANE transactions. A summary of the SEC adoption of the reporting requirement for ANE transactions is available here.

3 SEA Rule 15Fb6-2 and proposed SEA Rule 18a-5 would require an SBSD, including non-U.S. dealers, to determine that none of its personnel are subject to statutory disqualification.

4 This change would implemented through an amendment to SEC Rule of Practice 194 and conforming changes to (proposed) SEA Rule 18a-5 (recordkeeping requirements relating to a statutory disqualification questionnaire for associated persons).

5 SEA Rule 15Fb2-1 would be amended to provide an exception so that a non-U.S. SBSD could be conditionally registered for up to two years from the compliance date for the rules notwithstanding it has not received the certification and opinion of counsel required under Rule 15Fb2-4(c)(1). This change is *very* significant for some non-U.S. firms contemplating registration. However, given that the issues the requirement raises largely arise under non-U.S. law, and may be different for each county, we do not address it in detail in this memorandum.

II. The ANE SBS Requirement as Adopted

Under the SEC's currently adopted (even though not yet effective) rules[6] as to ANE SBS, all of the SEC's SBSD-related regulatory requirements would be applicable.[7] From a policy standpoint, the requirement is consistent with a "territorial" approach to regulation, if the regulator's focus is on sales practices.

When adopting the requirement, the SEC provided additional guidance on when it would consider a transaction entered into by a non-U.S. firm to be an ANE SBS. Among other things, the SEC said (i) it would focus on whether the "sales or trading personnel" based in the United States were performing "market-facing" functions; (ii) that "execution" referred to when parties become "irrevocably bound"; (iii) that "negotiation" referred to "specific economic terms" and not documentation; and (iv) that supervisors of U.S. personnel involved in ANE activities would bring a transaction in scope.[8]

The SEC adoption of its ANE SBS rules followed a years-long (and still ongoing) saga of the CFTC attempting to implement its own requirements for "swaps" entered into by non-U.S. swap dealers where there had been U.S. ANE activity. In a footnote to its 2013 cross-border swaps guidance, the CFTC stated that a U.S. branch of a non-U.S. swap dealer entering into a swap as to which there has been ANE activity in the United States (an "**ANE Swap**") would be subject to CFTC "transaction-level requirements" without the possibility of substituted compliance.[9] The CFTC then reiterated that position in a subsequent advisory letter.[10] That advisory turned out to be highly controversial and was subsequently effectively rescinded, along with the application of the ANE requirements more generally, in a no-action letter.[11] In the meantime, the CFTC proposed in 2016 to adopt rules to implement an ANE Swap requirement,[12] but has not acted on that proposal. CFTC Chairman J.

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6 SEC Release No. 34-77104; 81 Fed. Reg. 8597 (Feb. 19, 2016).

7 It is important to stress that the changes that the SEC would make to the ANE rules are relevant only where a non-U.S. entity transacts with another non-U.S. entity. A non-U.S. firm dealing SBS to a U.S. person generally would remain subject to the SEC SBS requirements.

8 *Id.* at 8622-23. The SEC states in the Proposal that this prior guidance as to what the term "ANE" means is not being rescinded. Instead, the new guidance is supplementary and is provided to further explain what would constitute "arranging" or "negotiating." Proposal at 24216.

9 78 Fed. Reg. 45291, 45350 & n. 513 (July 26, 2013).

10 CFTC Letter No. 13-69.

11 That no-action relief has been extended many times, most recently in 2017. CFTC Letter No. 17-36.

12 81 Fed. Reg. 71946 (Oct. 18, 2016).

Christopher Giancarlo has expressed support for applying certain CFTC requirements to ANE Swaps (though he indicated that they should not count toward *de minimis* dealing thresholds).[13]

III. "Market Color" Guidance

Under the proposed guidance, the SEC will not consider an SBS transaction to have been subject to "ANE" activity in the United States transaction if:

- a U.S. sales person does not have "client responsibility" in connection with the transaction;
- a U.S. sales person does not receive compensation linked to the client's entry into the transaction (although a U.S. sales person could receive a bonus based on the overall performance of the relevant trading desk); and
- the interaction of any U.S. sales person with the customer is limited to providing "market-based information," including pricing, volatility of the underlying depth of market, and anticipated demand, and trends regarding pricing, but did not extend to ANE activities.

Subject to the conditions above, the relevant SBS would not count towards the *de minimis* exception from registration for a non-U.S. firm. Even if the non-U.S. firm were otherwise registered, the provision of market color would not subject the transaction to either business conduct or reporting requirements.

IV. Brokering Swaps between a Non-U.S. Swaps Dealer and a Non-U.S. Customer

The SEC also proposed two alternative, but relatively similar, exceptions to its existing requirements where a U.S. sales person is engaged in ANE activities on behalf of a non-U.S. firm. Each exception would provide circumstances in which a non-U.S. firm would not be required to count an ANE SBS for purposes of its *de minimis* threshold. The general concept behind these exceptions is that (i) the United States will apply its sales practice rules where there has been meaningful sales activity (not just the provision of market color) in the United States; but (ii) the United States has little policy interest in imposing margin and capital requirements on transaction where neither of the principals is a U.S. person and the relevant non-U.S. dealer in SBSD is subject to meaningful home country capital and margin requirements.

Each of the alternatives is essentially modeled on the "chaperoning" requirements in SEA Rule 15a-6(a)(3). The SEC is generally taking a policy view that a non-U.S. person can (through agents) act in

[13] *See* J. Christopher Giancarlo, *Cross-Border Swaps Regulation Version 2.0: A Risk-Based Approach with Deference to Comparable Non-U.S. Regulation* at 76. Mr. Giancarlo has since indicated his willingness to change his approach to ANE transactions and also that he intends for the CFTC to put out a number of cross-border proposals before his departure.

a "dealing" capacity for SBS in the United States without being required to register, so long as its agent is registered with the SEC and subject to certain of the SEC's SBS requirements.[14] The first approach requires agenting by an SEC-registered SBSD. The second approach requires agenting by an SEC-registered SBSD *or* an SEC-registered broker-dealer.

A. First Alternative: Agenting by a Registered SBSD

1. *Entity Requirements*

- The U.S. sales person would have to be employed by, and acting on behalf of, an SEC-registered SBSD that is a majority-owned affiliate of the non-U.S. firm. The non-U.S. firm would be required to be subject to the capital and margin requirements of a "listed jurisdiction." The SEC would determine by order which countries would qualify as "listed jurisdictions."[15]

- The non-U.S. firm would be required to consent to services of process for any civil action involving the SEC. Such service of process would be effected by serving process on the SEC-registered SBSD.

- The non-U.S. firm would be required to provide the SEC with access (upon request or pursuant to a Memorandum of Understanding with a foreign regulatory authority) with information and access to its foreign associated persons.

2. Transaction Requirements

- The registered SBSD would be required to maintain records relevant to the transaction. In this regard, the registered SBSD would be required to maintain records of all trading relationship documentation between the non-U.S. firm and the non-U.S. customer.

- The SEC *also* would be entitled to access any relevant "books, records and testimony" of the non-U.S. firm.

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[14] Unlike 15a-6, the exception does not extend to ANE transactions between a non-U.S. firm and *U.S. person* customers (whether institutional or not). For dealing transactions with U.S. customers (other than non-U.S. branches), a non-U.S. firm must count the SBS for *de minimis* purposes under SEA Rule 3a71-3(b)(1)(iii)(A).

[15] The SEC indicated that any determination would be made on a case-by-case basis; there will not be an automatic favorable determination made for G-20 countries. In addition, the SEC could take into account factors such as its access to data from the jurisdiction. That said, the SEC indicated that it was likely to make favorable determinations out of the gate as to Australia, Canada, France, Germany, Hong Kong, Japan, Singapore, Switzerland, and the United Kingdom. *See* Proposal at 24226.

- The registered SBSD would be subject to a number of SBSD requirements *as if* the counterparty to the SBS were its counterparty, including: (i) disclosures of risks, characteristics and conflicts of interest under SEA Rule 15Fh-3(b); (ii) suitability under SEA Rule 15Fh-3(f); (iii) fair and balanced communications under Rule SEA 15Fh-3(g); (iv) confirmations under SEA Rule 15Fi-1 and SEA Rule 15Fi-2; and (v) portfolio reconciliation (but only for the initial reconciliation) under SEA Rule 15Fi-3.

    - However, the registered SBSD would *not* be required to comply with (i) "eligible contract participant" verification requirements under SEA Rule 15Fh-3(a)(1) (though the statutory ECP requirement under SEA Section 6(*l*) continues to apply); (ii) KYC requirements under SEA Rule 15Fh-3(e); (iii) clearing rights disclosures under SEA Rule 15Fh-3(d); (iv) daily mark disclosures under SEA Rule 15Fh-3(c); and (v) certain risk mitigation rules (including portfolio compression and trading relationship documentation) under SEA Rule 15Fi-4 and SEA Rule 15Fi-5.

- The registered SBSD would continue to be subject to all requirements with respect to supervision and compliance, the maintenance of its own books and records, and its own financial rules.

- The registered SBSD would need to make disclosures to counterparties as to the non-registrant status of the non-U.S. firm relying on the exception.

B. Second Alternative: Agenting by a Registered SBSD or Broker-Dealer

- U.S. sales person could be employed by, and acting on behalf of, an SEC-registered broker-dealer that is not itself a registered SBSD. As in the case with the first alternative, the intermediary firm would be required to be a majority-owned common affiliate of the non-U.S. SBSD.

- Where the SEC-registered intermediary is a broker-dealer but not an SBSD, the broker-dealer would be required to comply with the various SBSD rules applicable under the first alternative *as if* it were a registered SBSD.

An SEC-registered broker-dealer would not be required to count the arranged swaps towards its own *de minimis* exception. Otherwise, Alternative 2 essentially functions as Alternative 1.

V. Summary and Policy Considerations

"Broker" Issues

This is, in general, a practical set of proposals by the SEC, certainly an improvement on what it had previously adopted. In trying to come up with a reasonable solution for dealing with cross-border swaps, the SEC is seemingly at a disadvantage because Dodd-Frank did not provide for a category of regulated entity that might be called "security-based swap **brokers,**" as opposed to SBS *dealers*.[16] The creation, whether by statute or regulation, of a category of regulated entities that could take on sales practice responsibilities for SBS without becoming subject to capital and margin requirements, would give the SEC a much more nuanced ability to draft appropriate rules for the SBS market. This would particularly be the case in transactions where a non-U.S. SBS dealer was principal to the transaction, or even where a U.S. bank was acting as an SBS dealer, but would conduct all of its sales activities through a separate affiliated agent.

Saving Jobs

The SEC likely recognized that the ANE rules, as currently contemplated, would give a strong incentive for non-U.S. firms to move certain activities (and jobs) outside of the United States. Currently, a significant amount of SBS dealing activity between European and Asian dealers, on the one hand, and Latin American and Canadian customers, on the other, takes place from sales offices within the United States. These are good jobs. It doesn't make a lot of sense to risk losing these jobs by imposing U.S. regulatory requirements that don't serve any material U.S. policy interest.

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If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

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[16] This contrasts with the Commodity Exchange Act regulatory scheme, which provides a registration category – "introducing broker" – for persons acting in a broker, but not dealer, capacity with respect to swaps.