

# SEC Proposes to Regulate Security-Based Swap Activities of Non-US Parties Conducting Dealing Activity in the United States

The US Securities and Exchange Commission ("**SEC**") has published for comments proposed rule amendments and a re-proposed rule that would clarify the application of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") to security-based swap ("**SBS**") activity between two non-US persons where at least one is conducting dealing activity within the United States (Release No. 34-74834, the "**Cross-Border Release**", available [here](#)).

In June 2014, the SEC adopted rules (Release No. 34-72472, available [here](#)) that partially address the cross-border application of the security-based swap provisions of Title VII of the Dodd Frank Act. Those rules clarify how the definitions of "Security-Based Swap Dealer" and "Major Security-Based Swap Participant" apply to cross-border SBS transactions involving:

- a US person and a non-US person, or
- two non-US persons conducting an SBS transaction that occurs in relevant part within the United States, including where the performance by either of the counterparties is guaranteed by a US person.

At that time, the SEC decided to defer proposing rules regarding the application of Title VII to cross-border SBS activities involving a transaction between two non-US persons where one or both are conducting dealing activity within the United States. The Cross-Border Release addresses this remaining category of cross-border SBS activities.

## Application of SBS dealer registration requirements and guidance for *de minimis* calculations

The Dodd-Frank Act requires security-based swap dealers ("**SBSDs**") to register with the SEC. Registered SBSBs will be subject to various regulatory obligations, including mandatory clearing, trade execution, reporting, margin and business conduct standards.

The proposed rules would impose the following requirements when personnel located in the United States arranges, negotiates, or executes a security-based swap transaction:

1. Inclusion of the transaction in the *de minimis* calculation related to security-based swap dealer registration requirements
2. Compliance with external business conduct standards
3. Compliance with certain public reporting requirements

Rule 3a71-1 under the Securities Exchange Act of 1934 (“**Exchange Act**”) specifies that an SBSB is any entity that:

- holds itself out as a dealer in security-based swaps;
- makes a market in security-based swaps;
- regularly enters into security-based swaps with counterparties as an ordinary course of business for its own account; or
- engages in any activity causing it to be commonly known in the trade as a dealer or market maker in security-based swaps.

The Dodd-Frank Act provides an exception for entities whose SBS dealing activity is below *de minimis* levels. *De minimis* thresholds for SBS dealing activity have been established by the SEC based on type of SBS. If dealing activity conducted by an entity (or any other entity controlling, controlled by or under common control with the person) in the prior rolling twelve months exceeds any of the following thresholds, the entity (or an affiliate) will be required to register with the SEC as an SBSB.

SBS Type	Threshold (Aggregate gross notional amount)
Credit default swaps (“ <b>CDS</b> ”)	\$3 Billion – subject to a phase-in level of \$8 Billion
SBS other than CDS	\$150 Million – subject to a phase-in level of \$400 Million
SBS entered into with special entities (e.g., US government entities, ERISA plans, endowments)	\$25 Million

The Cross-Border Release provides guidance on how to calculate aggregate gross notional amounts for purposes of these *de minimis* thresholds with respect to dealing transactions entered into by non-US person counterparties that involve personnel of such counterparty or its agent, located in the United States. The SEC had previously proposed rules requiring a non-US person to include in its *de minimis* calculation any transaction with another non-US person counterparty where the transaction is solicited, negotiated, executed, or booked within the United States by or on behalf of either counterparty to the transaction. The SEC has since recognized the challenges a non-US person would face if required to ascertain whether its non-US counterparty has solicited, negotiated, executed, or booked any given transaction within the United States. Accordingly, the Cross-Border Release proposes a more practical approach. Under the Cross-Border Release, whether a transaction is included in the calculation would depend on where the personnel of the non-US person or its agent is located when arranging, negotiating or executing an SBS transaction with another non-US person counterparty, irrespective of the location of personnel of the counterparty or its agent.

In the Cross-Border Release, the SEC is proposing to amend Rule 3a71-3 under the Exchange Act to require non-US persons to include in their *de minimis* calculation any SBS transaction connected with their SBS dealing activity that is arranged, negotiated, or executed by their personnel located in a US branch or office, or by personnel of an agent located in a US branch or office. The reference to trades that are “arranged, negotiated, or executed” by personnel located in the United States mirrors language used by the Commodity Futures Trading Commission (“**CFTC**”) in a staff advisory letter regarding the application of Transaction-Level Requirements (including clearing, trade execution, margin, real-time reporting and business conduct standards) to non-US swap dealers. In that letter, the CFTC stated that “a non-U.S. [swap dealer] ... regularly using personnel or agents located in the

U.S. to arrange, negotiate, or execute a swap with a non-U.S. person" would be required to comply with Transaction-Level Requirements.<sup>1</sup>

The Cross-Border Release includes the following proposed guidance on the meaning of key terms.

### "Arranging, negotiating, or executing"

The Cross-Border Release indicates that "arranging" and "negotiating" refer to market-facing activity of sales or trading personnel in relation to a specific transaction, including interaction with counterparties or their agents. The term "execute" refers to a market-facing act in connection with a specific transaction that irrevocably binds the person to the SBS under applicable law.

The SEC intends to regulate personnel that engage in market-facing activity related to a specific SBS dealing transaction to the extent they are located in the United States. It would not matter whether relevant personnel are designated as salespersons or traders. If an employee engages in market-facing activity on a particular SBS dealing transaction and is located in the United States, then that transaction would be relevant to the *de minimis* calculation. This includes transactions where an employee located in the United States directs non-US personnel to arrange, negotiate, or execute SBS dealing transactions.

By contrast, personnel that perform functions that are not market-facing in regard to a particular SBS dealing transaction, even if located in the United States, would not, by themselves, cause the transaction to be relevant to the *de minimis* calculation under the proposal. One example of a non-market facing function would be structuring an SBS without communicating with the counterparty regarding the contract and without executing the trade.

### "Located in a US branch or office"

The phrase "located in a US branch or office" is meant to distinguish dealing transactions that are arranged, negotiated or executed by personnel who are assigned to a US branch or office from those where the personnel are only incidentally present in the United States at the time of arranging, negotiating, or execution. The latter activity alone would not cause the transaction to be included in the *de minimis* calculation. If personnel based outside of the United States direct personnel located in a US branch or office to respond to inquiries from a non-US counterparty outside of business hours in the counterparty's jurisdiction, the SEC would not consider the presence and assignment of such US personnel to be "incidental". Such SBS transaction should be included in the *de minimis* calculation. In addition, if personnel not located in the United States arranges, negotiates or executes an SBS dealing transaction at the direction of personnel that is located in a US branch or office, such transaction should also be included in the *de minimis* calculation.

### "Personnel of such non-US person" or "personnel of an agent"

The SEC's view is that SBS dealing transactions arranged, negotiated or executed by personnel of a non-US party located in the United States should be included in the *de minimis* calculation of the party employing such personnel, regardless of whether it is the personnel of the relevant non-US party or personnel of an agent of such party. The SEC has noted that an agent acting on behalf of a non-US person that is engaged in SBS dealing activity generally would be required to register as a broker and, with respect to the transactions that it intermediates, could be required to comply with relevant Exchange Act requirements with respect to those transactions.

## Application of the External Business Conduct Requirements

Section 15F(h) of the Exchange Act requires the SEC, by rule, to adopt certain transaction-level requirements, including, among other things, external business conduct standards for registered SBSs. The SEC has generally re-proposed the approach

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<sup>1</sup> CFTC Staff Advisory Letter No. 13-69 (Nov. 14, 2013).

originally set out in a 2013 proposing release, pursuant to which US SBSs, non-US branches of US SBSs, and non-US SBSs would be required to comply with the external business conduct requirements only with respect to their "US business" (subject to the potential availability of substituted compliance for non-US SBSs and non-US branches) and would be exempt from the external business conduct requirements (other than the duty of diligent supervision prescribed by the SEC pursuant to Section 15F(h)(1)(B) of the Exchange Act) in connection with any "foreign business", which has been proposed to mean any SBS transactions other than the "US business."

**"US business" definition.** As proposed, the term "US business" would be defined differently with respect to a US SBS and a non-US SBS.

- With respect to a US SBS, "US business" would mean any SBS transaction entered into or offered to be entered into by or on behalf of the US SBS, other than SBS transactions between a non-US branch of the US SBS and any non-US person or another non-US branch.
- With respect to a non-US SBS, "US business" is defined as any SBS transaction that is either:
  - entered into, or offered to be entered into, by or on behalf of such non-US SBS, with a U.S. person (other than a transaction conducted through a non-US branch of that person); or
  - arranged, negotiated, or executed by personnel of the non-US SBS or its agent located in a US branch or office.

As a result, the external business conduct standards would apply to SBS transactions that a non-US SBS arranges, negotiates or executes using personnel located in a US branch or office (even if the counterparty is also a non-US person).

Thus, the Cross-Border Release would clarify that for the purposes of determining whether an SBS transaction would constitute "US business" with respect to a non-US SBS, only the location of personnel of the non-US SBS or its agent, and not that of persons acting on behalf of the counterparty, would be relevant. For example, the external business conduct standards would not apply to an SBS transaction between a non-US fund managed by a US manager and a non-US SBS, as long as the non-US SBS is not using personnel or an agent located in the United States to arrange, negotiate, or execute the SBS transaction.

## Application of the Clearing, Trade Execution, Regulatory and Public Dissemination Requirements

### Mandatory clearing and trade execution

The Dodd-Frank Act requires clearing of any SBS transaction designated as being subject to mandatory clearing by the SEC, subject to a commercial end-user exception. Any such SBS transaction must also be traded on a securities exchange or security-based swap execution facility, unless no such market makes the SBS transaction "available to trade." The SEC has reconsidered its previous position with respect to SBS transactions entered into between two non-US persons, including where at least one party is a registered non-US SBS. As now proposed, an SBS transaction would not be subject to the mandatory clearing and trade execution requirements if it is entered between two non-US persons not guaranteed by a US person, even where the transaction was arranged, negotiated, or executed by personnel located in the United States or one of the parties is a registered non-US SBS.

### Regulatory reporting and public dissemination

**Reportable SBS transactions.** In the Cross-Border Release, the SEC proposes to amend Rule 908(a)(1) of Regulation SBSR - Reporting and Dissemination of Security-Based Swap Information to include a provision that would require any SBS transaction connected with a non-US SBS's dealing activity that is arranged, negotiated, or executed by personnel of such non-US SBS located in the United States to be reported to a registered SDR and publically disseminated pursuant to Regulation SBSR. The

proposed rule amendments would expand the scope of Regulation SBSR by requiring SBS transactions negotiated, arranged or executed by an SEC-registered non-US SBSD using personnel located in the United States to be publically disseminated even if the counterparty to such transaction is another non-US person not guaranteed by a US person. In addition, the Cross-Border Release includes proposed amendments that would require that a transaction of a non-US person that is not registered as an SBSD be subject to both regulatory reporting and public dissemination under Regulation SBSR if that non-US person would be required to include the transaction in its *de minimis* threshold calculations.

In addition, the SEC would require reporting to an SDR and public dissemination of any SBS transaction which is:

- executed on a US platform; or
- intermediated by a registered broker-dealer.

**Reporting parties.** Rule 908(b) of Regulation SBSR specifies the types of entities that are subject to the reporting and public dissemination requirements with respect to SBS transactions. In the Cross-Border Release, the SEC proposes to amend Rule 908(b) to extend the reporting and public dissemination obligations to any non-US person that uses personnel located in the United States in connection with its SBS dealing activities, but is not registered as an SBSD because it does not meet the *de minimis* threshold ("**Unregistered Non-US SBSD**"). In addition, the Cross-Border Release includes a proposed amendment to Rule 901(a)(2)(ii) of Regulation SBSR to provide that with respect to SBS transactions between two non-US persons where one party is an Unregistered Non-US SBSD that uses personnel located in the United States in connection with the dealing activities, the Unregistered Non-US SBSD has the duty to report the transaction to an SDR. Similarly, a registered broker-dealer (including a registered SB SEF) would have the obligation to report any transaction it intermediates between two unregistered non-US persons.

**Substituted compliance available.** Consistent with the SEC's existing approach, substituted compliance would be available with respect to the amended reporting and public dissemination requirements provided that such compliance is with the rules of a non-US jurisdiction that is subject to an SEC substituted compliance order.

## Conclusion

The Cross-Border Release reflects the SEC's intent to regulate personnel that engage in market-facing activity related to a specific SBS dealing transaction to the extent they are located in the United States. The proposed rule changes may create incentives for the relocation of US-based personnel to non-US branches or offices, and such incentives may increase to the extent that there is a substantial disparity in non-US regulatory requirements applicable to SBS transactions. As an alternative to relocating personnel, the SEC has acknowledged that participants may implement or adapt existing controls or conventions that restrict communication between non-US trading personnel and persons located in the United States to avoid triggering certain Title VII requirements. The SEC is seeking public comments on numerous aspects of the Cross-Border Release and requests commenters to provide empirical data and other factual support for their views to the extent possible. The comment deadline is July 13, 2015.

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