# SEC PROPOSES NEW RULES FOR CROSS-BORDER SECURITY-BASED SWAPS

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**U.S. Investment Management Alert**

By: Anthony R.G. Nolan

## INTRODUCTION

On May 10, 2019, the Securities and Exchange Commission ("SEC") issued proposed rule amendments and interpretive guidance "to improve the framework for regulating cross-border security-based swaps transactions and market participants" (the "Cross-Border Proposal"). [1] The SEC's Cross-Border Proposal seeks to "improve the regulatory framework by pragmatically addressing implementation issues and efficiency concerns." [2] The Cross-Border Proposal is also intended to harmonize the SEC's security-based swaps ("SBS") regulatory regime with the swaps regulatory regime administered by the Commodity Futures Trading Commission ("CFTC"). The CFTC's cross-border regime, which was put in place in 2013, has been the subject of industry debate given its broad reach, impact on global markets, and related compliance costs. However, the CFTC is actively reviewing its own cross-border regime and rule proposals are expected in the near future. [3] The SEC's proposed regulatory framework will impact market participants that trade on a cross-border basis — in terms of outbound and inbound activity. Therefore, the SEC's Cross-Border Proposal, combined with the upcoming CFTC proposals, must be analyzed closely to assess the impact on business operations.

## THE SEC'S CROSS-BORDER PROPOSAL ADDRESSES FOUR TOPICS:

1. The use of transactions that have been "arranged, negotiated, or executed" by personnel located in the United States ("ANE Transactions") as a trigger for regulating SBS and market participants;
2. The requirement that non-U.S. resident security-based swap dealers ("SBSDs") [4] and major SBS participants certify and provide an opinion of counsel that the SEC can access their books and records and conduct onsite inspections and examinations;
3. The cross-border application of statutory disqualification provisions; and
4. The questionnaires or employment applications that SBSDs and major SBS participants must maintain with regard to their foreign associated persons.

SEC Chairman Jay Clayton indicated that: "[t]hese proposals preserve important investor and market protections, while at the same time addressing several of the practical implementation challenges that have been identified." [5]

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## TRANSACTIONS "ARRANGED, NEGOTIATED, OR EXECUTED" BY U.S. PERSONNEL NECESSITATING REGISTRATION AS A SECURITY-BASED SWAP DEALER AND REGULATORY REPORTING UNDER TITLE VII

Title VII of the Dodd-Frank Act created a framework for the SEC and the CFTC to regulate SBS and swaps, respectively. When determining whether non-U.S. persons will be deemed to be SBSDs and, therefore, subject to the Title VII requirements applicable to SBSDs, non-U.S. persons must count, against the applicable *de minimis* threshold, their SBS dealing transactions with non-U.S. counterparties that were "arranged, negotiated, or executed" ("ANE") by personnel within the U.S. [6] When adopting the *de minimis* test as a threshold for registration, the SEC stated that it was appropriate to impose Title VII requirements because of: the broad definition of swap dealing activity, the risk that non-U.S. persons engaged in SBS dealing activity in the United States could avoid regulation, concerns about competitive disparities and possible market fragmentation, and the importance of public transparency. [7]

Although the ANE test for *de minimis* counting has not yet been implemented, the SEC has decided to reconsider its approach because of ongoing concerns among market participants, potential reconsideration by the CFTC of the cross-border application provisions under Title VII, and other regulatory developments. [8] Market participants have stated that requiring a non-U.S. dealer to identify transactions that it arranges, negotiates, or executes using personnel located in the United States for purposes of compliance with the rule poses significant operational challenges and could lead to market fragmentation and lower levels of liquidity in the swaps market. [9] The Department of the Treasury weighed in on this issue by publishing a report that stated that the SEC should reconsider the implications of applying Title VII rules merely on the basis that U.S.-located personnel arrange, negotiate, or execute the swap, especially for entities in comparably regulated jurisdictions. [10] In addition, CFTC Chairman Giancarlo indicated that these transactions should be subject to U.S. requirements, but that it also may be appropriate to defer to a foreign jurisdiction if its regulatory standards are comparable to the United States. [11]

To respond to these concerns, the SEC has proposed regulatory guidance and two alternative exceptions from the requirement that non-U.S. persons count SBS dealing transactions for ANE activity. Under the regulatory guidance, Title VII requirements would not be triggered merely because U.S. personnel provide "market color." While the guidance does not define "market color," it states that it consists of certain background information regarding pricing and market conditions and trends so long as those U.S. personnel do not receive transaction-based compensation or exercise client responsibility in connection with those transactions. The alternative exceptions would permit a non-U.S. person not to count the SBS dealing transactions at issue against the *de minimis* thresholds so long as all ANE activity within the United States is performed by personnel associated with an affiliated entity that is registered with the SEC as (1) a SBSD, or (2) a broker. The SEC has solicited feedback on the proposed regulatory guidance and proposed alternative exceptions. [12]

## REQUIREMENT THAT NON-U.S. RESIDENT SECURITY-BASED SWAP DEALERS AND MAJOR SECURITY-BASED SWAP PARTICIPANTS CERTIFY AND PROVIDE AN OPINION OF COUNSEL

Exchange Act Rule 15Fb2-4(c)(1) requires non-U.S. resident SBSDs and major SBS participants ("Non-Resident SBS Entities") to certify and provide an opinion of counsel that the SEC can access their books and records and conduct onsite inspections and examinations. [13]

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Because this requirement may conflict with foreign privacy laws, secrecy laws, and other legal requirements in various jurisdictions in which market participants do business, the SEC has proposed guidance to permit the certification, opinion of counsel, and submission to examinations to take into account different approaches available under such laws in order to be provided in a manner consistent with a particular applicable foreign legal requirement.

In particular, the proposed guidance would require that the certification and opinion of counsel address only the law of the jurisdiction where books and records are maintained which are related to the "U.S. business" rather than the laws of all possible jurisdictions where its customers or counterparties may be located or where it may conduct business. Additionally, it would permit the certification and opinion of counsel to be predicated, as necessary, on obtaining the consent of persons whose information will be shared. The certification and opinion also may account for whether a foreign regulatory authority has authorized the sharing of books and records.

However, the proposed guidance would not affect the separate requirement that Non-Resident SBS Entities provide the SEC with direct access to their books and records. Thus, consent is ultimately unavoidable even though it is not a timing gate for a certification or opinion. Furthermore, the proposed guidance states that it would not be consistent with the SEC's interpretation of the requirement to rely on a memorandum of understanding or other arrangement with a foreign regulatory authority if for any reason it permits the foreign regulatory authority to restrict the SEC's ability to conduct timely inspections and examinations of the books and records in the foreign office of the Non-Resident SBS Entity.

The SEC specifically requested comments on the balance it has sought to draw between its supervisory and enforcement responsibilities and the compliance needs of Non-Resident SBS Entities subject to foreign law including the European Union General Data Protection Regulation.

## CROSS-BORDER APPLICATION OF STATUTORY DISQUALIFICATION: HARMONIZATION WITH CFTC APPROACH

Exchange Act Section 15F(b)(6) makes it unlawful for SBSDs and major security-based swap participants to permit an associated person who is subject to a statutory disqualification to effect, or be involved in effecting, SBS. [14] The SEC has proposed to amend this rule to more closely harmonize with the CFTC's approach. The SEC proposes to exclude from the prohibition individuals who are natural, non-U.S. persons who do not effect and are not involved in effecting SBS transactions with or for counterparties that are U.S. persons, other than a SBS transaction conducted through a foreign branch of a counterparty that is a U.S. person.

## QUESTIONNAIRES AND EMPLOYMENT APPLICATIONS

The SEC's proposed Exchange Act Rule 18a-5 would require that standalone or bank SBS dealers and major SBS participants maintain and keep current a questionnaire or application for employment for each natural person who is an associated person. [15] In response to concerns noted by market participants, the SEC has proposed that these records need not be maintained for individuals who are not statutorily disqualified, or if the maintenance of these records would violate applicable law where the associated person is employed or located.

## CONCLUSION

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The Cross-Border Proposal described above reflects the SEC's effort to accommodate the concerns of Non-Resident SBS Entities that compliance with SEC requirements may cause them to violate foreign regulations to which they are subject. SEC Chairman Jay Clayton has stated that these "proposals reflect an important step forward in the Commission's efforts to stand up the Dodd-Frank Title VII regulatory regime." [16] Market participants should take note of the SEC's request for comments on the proposals and consider whether the SEC's effort to accommodate foreign legal requirements goes far enough to temper the extra-territorial reach of SEC regulation that could affect existing business processes or conflict with other regulatory regimes.

K&L Gates LLP has a global team of derivatives and securities law attorneys to assist clients in the navigation of the cross-border regimes of both the SEC and CFTC. The remainder of this year and the next year are likely to have significant cross-border legal developments.

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## NOTES

[1] *See* Securities and Exchange Commission, SEC Proposes Actions to Improve Cross-Broder Application of Security-Based Swap Requirements, May 10, 2019, available at https://www.sec.gov/news/press-release/2019-69. The full text of the proposed regulatory framework is available by clicking here and at 84 Fed. Reg. 24206 (May 24, 2019). The comment period will close on July 23, 2019.

[2] *See* Securities and Exchange Commission, SEC Proposes Actions to Improve Cross-Broder Application of Security-Based Swap Requirements, May 10, 2019, available at https://www.sec.gov/news/press-release/2019-69.

[3] *See* testimony of Chairman J. Christopher Giancarlo Before the Senate Committee on Appropriations Subcommittee on Financial Services and General Government, Washington, DC (May 8, 2019), available at https://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo71 ("Six months ago, I released a White Paper on cross-border swaps regulation that proposed updating the agency's current cross-border application of its swaps regime with a rule-based framework based on regulatory deference to third-country regulatory jurisdictions that have adopted the G-20 swaps reforms…. I believe the CFTC should move to a flexible, outcomes-based approach for cross-border equivalence and substituted compliance and operate on the basis of comity, not uniformity, with overseas regulators").

[4] The proposed rule amendment and interpretive guidance uses the term "SBS Entity" which is collectively defined as including SBS dealers and major SBS participants. This alert refers to SBS dealers as SBSDs.

[5] *See supra* note 3.

[6] *See* Exchange Act Rule 3a71-3(b)(1)(iii)(C). Rule 3a71-3(b) discusses the cross-border SBS transactions which must be counted against thresholds associated with the *de minimis* exception to the SBSD definition. Persons whose dealing activities exceed the *de minimis* thresholds will be required to register as SBSDs once a compliance date is announced. The *de minimis* threshold is: $8 billion notional amount with regard to credit default swaps that constitute SBS and $400 million notional amount with regard to other SBS. *See* Exchange Act Section 3(a)(71)(D); Exchange Act Rule 3a71-2. *See also* 17 CFR §240.3a71-2 De minimis exception, available at https://gov.ecfr.io/cgi-bin/text-idx?SID=b76037e178dbfa7b22fde2e2b17f73b9&mc=true&node=se17.4.240_13a71_62&rgn=div8.

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[7] *See* Securities and Exchange Commission, Proposed Rule Amendments and Guidance Addressing Cross-Border Application of Certain Security-Based Swap Requirements, May 10, 2019, available at https://www.sec.gov/rules/proposed/2019/34-85823.pdf.

[8] *See supra* note 7.

[9] *See supra* note 7.

[10] *See* United States Department of the Treasury, "A Financial System That Creates Economic Opportunities: Capital Markets" (Oct. 2017) at 133-36, available at https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf.

[11] Chairman J. Christopher Giancarlo, Cross-Border Swaps Regulation Version 2.0: A Risk-Based Approach with Deference to Comparable Non-U.S. Regulation (Oct. 1, 2018) at p. 76, available at https://www.cftc.gov/sites/default/files/2018-10/Whitepaper_CBSR100118_0.pdf (discussing ANE Transactions) and Keynote Address of Chairman J. Christopher Giancarlo Before the ABA Business Law Section, Derivatives & Futures Law Committee Winter Meeting, (Jan. 25, 2019) ("It is clear that the White Paper did not get everything right. Its approach to ANE transactions, for example, may need further thought and refinement.") available at https://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo63.

[12] *See supra* note 7.

[13] *See supra* note 7.

[14] *See supra* note 7.

[15] *See supra* note 7.

[16] *See supra* note 1.

## KEY CONTACTS



**ANTHONY R.G. NOLAN**
PARTNER

NEW YORK
+1.212.536.4843
ANTHONY.NOLAN@KLGATES.COM

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