SEC Adopts Final Set of Rules to Start the Clock for Registration of Security-Based Swap Dealers

January 8, 2020

On December 18, 2019, the Securities and Exchange Commission (the "SEC") adopted a package of rule amendments and interpretations (the "Cross-Border Amendments")[1] to remedy certain issues that had arisen in its cross-border framework for the regulation of security-based swaps ("SBS"), security-based swap dealers ("SBSDs") and major security-based swap participants (together with SBSDs, "SBS Entities"). On the same day, the SEC also adopted rules requiring SBS Entities to execute "trading relationship documentation" and to engage in portfolio reconciliation and compression exercises for certain portfolios of uncleared SBS (the "Risk Mitigation Rules" and, together with the Cross-Border Amendments, the "Final Rules").[2] The Final Rules preserve many aspects of their respective proposals,[3] and in the case of the Risk Mitigation Rules, are intended to be consistent with rules previously adopted by the Commodity Futures Trading Commission (the "CFTC").

The Final Rules are the result of a process set into motion when Chairman Jay Clayton tasked Commissioner Hester Peirce with taking the lead in "standing up" the regime for SBS Entities. While the substance of the rules will be of significant interest to market participants, the rulemakings are perhaps even more significant as a milestone in the SEC's Dodd-Frank implementation process. The Cross-Border Amendments represent the final step deemed necessary to give market participants a fair understanding of the regulatory costs and burdens of becoming an SBS Entity. Their effective date (expected to be March 1, 2020) will set the compliance date for the SBS Entity registration rule (the "Registration Compliance Date"), as well as for a variety of other SBS Entity rules. As detailed below, that date is expected to be **September 1, 2021**.

While the SEC has provided substantial time to prepare for the implementation of its SBS Entity rules, it is not generally providing for phased implementation once those

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1 Exchange Act Release No. 87780 (Dec. 18, 2019) ("Cross-Border Amendments Adopting Release").

2 Exchange Act Release No. 87782 (Dec. 18, 2019) ("Risk Mitigation Rules Adopting Release").

3 *See* SEC, Proposed Rule Amendments and Guidance Addressing Cross-Border Application of Certain Security-Based Swap Requirements, 84 Fed. Reg. 24206 (May 24, 2019) (the "Cross-Border Amendments Proposal") and SEC, Risk Mitigation Techniques for Uncleared Security-Based Swaps, 84 Fed. Reg. 4614 (Feb. 15, 2019).

rules go into effect. Once registered, SBS Entities will be expected to comply with the bulk of the SBS Entity rules, including those implicating documentation requirements and those for which non-U.S. SBS Entities may be looking to establish "substituted compliance." Market participants should plan for effective use of the full time provided to prepare for the go-live date for the SEC's regime.

BACKGROUND AND OVERVIEW

The issues addressed by the Cross-Border Amendments arose from certain aspects of the SEC's cross-border framework for the regulation of derivative instruments under Title VII of the Dodd-Frank Act that differ from those of the CFTC. In particular:

- *Transactions Counted Toward Registration Requirements*: SEC Rule 3a71-3 specifies that non-U.S. persons engaged in SBS dealing must count toward their *de minimis* thresholds for registration those SBS transactions that are "arranged, negotiated, or executed" by U.S. personnel or agents even when they are with non-U.S. counterparties (such transactions, "ANE transactions" and such requirement, the "ANE Counting Requirement").[4] This affects non-U.S. dealers who may station personnel in the U.S. in order to serve customers in places with similar time zones, or to assist with SBS having U.S. security underliers. The SEC rule differs from both current and proposed CFTC approaches, which would not require a non-U.S. person to include ANE transactions.[5] Industry participants have raised concerns that the SEC's ANE Counting Requirement would unduly burden international services only tangentially related to the United States.

- *Assurances Regarding Access to Books and Records*: Pursuant to recently adopted requirements, a non-U.S. SBS Entity will be required to provide access to its books and records relating to all SBS and related securities activities, its relevant associated persons and, if not overseen by a prudential regulator, its financial records more broadly.[6] Rule 15Fb2-4 requires a non-resident SBS Entity to certify and provide an opinion of counsel to the SEC regarding its ability to provide such access and submit to onsite inspections (the "Certification and Opinion Requirement").[7] Many non-

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4 SEC Rule 3a71-3(b)(1)(iii)(C).

5 *See* CFTC Release No. 8097-19, Cross-Border Application of the Registration Thresholds and Certain Requirements Applicable to Swap Dealers and Major Swap Participants (Dec. 18, 2019); CFTC, Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, 77 Fed. Reg. 41213 (July 12, 2012); CFTC Staff Letter 17-36, Extension of No-Action Relief: Transaction-Level Requirements for Non-U.S. Swap Dealers (July 25, 2017).

6 *See* Exchange Act Release No. 87005 (Sept. 19, 2019) ("Books and Records Adopting Release").

7 SEC Rule 15Fb2-4.

resident SBS Entities would likely be unable to satisfy the Certification and Opinion Requirement due to legal barriers imposed by various non-U.S. privacy and secrecy laws, such as the EU's General Data Protection Regulation ("GDPR").

To address these issues, the Cross-Border Amendments include:

- An exception from the ANE Counting Requirement available to non-U.S. dealers in certain jurisdictions where all relevant U.S. activity is performed by personnel associated with a majority-owned affiliate that is a registered SBSD or broker-dealer;
- Supplemental guidance on the ANE Counting Requirement relating to informational activities in the United States that would not be deemed "arranging" or "negotiating" by U.S. personnel;
- Guidance on the Certification and Opinion Requirement permitting submission of conditional certifications and opinions of counsel;
- Amendments to SEC Rule of Practice 194 (relating to statutory disqualifications) to exclude non-U.S. associated persons ("APs") who service exclusively non-U.S. counterparties; and
- Amendments to the requirement that an SBSD make and maintain employee questionnaires including personal data where the requirement would conflict with non-U.S. privacy laws.

In addition, the Risk Mitigation Rules will require SBS Entities to periodically reconcile the material terms of, and valuations for, outstanding SBS with counterparties, engage in certain forms of portfolio compression exercises and execute written trading relationship documentation prior to, or contemporaneously with, executing new SBS transactions.

TRANSACTIONS "ARRANGED, NEGOTIATED, OR EXECUTED" BY U.S. PERSONNEL

The first part of the Cross-Border Amendments seeks to strike a balance between several competing policy concerns:

- The principle that confidence in the U.S. market requires application of U.S. protections to intermediaries where a counterparty might reasonably expect those protections to apply. In the SEC's view, a counterparty reasonably expects the

protection of U.S. regulation when interacting with personnel of intermediaries who are physically located in the United States;[8]

- The focus of Dodd-Frank on systemic risk to the U.S. economy, which may not be heavily implicated in transactions between two non-U.S. entities that do not receive financial support from any U.S. entity;[9]

- A stated concern that U.S. market participants might seek to evade the SEC's rules by booking transactions offshore, and in so doing, create competitive disparities;[10] and

- A concern that over-regulation could have negative consequences in the United States by inducing financial groups to relocate U.S. jobs and causing market fragmentation.[11]

To balance these concerns, the Cross-Border Amendments reduce the regulatory burdens triggered by ANE transactions, while preserving a requirement that any ANE transactions be conducted in compliance with specified conduct rules. As described further below, they also impose additional minimum regulatory capital requirements on U.S. entities that engage in ANE activities for unregistered offshore affiliates purely to reduce the risk of evasion and competitive disparities.

Exception from Counting ANE Transactions in SBSD *De Minimis* Calculation

The SEC signaled in 2014 that it was not likely to grant a broad exemption from application of Title VII requirements for ANE transactions similar to those currently being considered by the CFTC.[12] In discussing its "territorial approach" to SBS regulation, which borrows from historical principles used for broker-dealer regulation, the SEC indicated that it would focus on activity occurring in the United States even where the risk is located offshore.[13] As SBS are also securities under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), market participants responded by arguing that arranging, negotiation and execution by a registered broker-dealer should not necessitate application of the SEC's Title VII requirements, as they would

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[8] The SEC also views this policy as founded in the statutory text of Title VII. *See* SEC, Application of "Security-Based Swap Dealer" and "Major Security-Based Swap Participant" Definitions to Cross-Border Security-Based Swap Activities, 79 Fed. Reg. 47278 (Aug. 12, 2014) (setting out initial "territorial approach" to the application of Title VII and explaining that the statutory definition of swap dealer looked to where "holding out" activity occurred and that the policy goals associated with the swap dealer definition included counterparty protection).

[9] *But see id*. at 47283-84 (discussion of high concentration of risk in the industry and channels for risk transmission that may flow back into United States, particularly where there are U.S.-based affiliates).

[10] *See* Cross-Border Amendments Adopting Release at 15.

[11] *See id*. at 26.

[12] *See, e.g.*, 79 Fed. Reg. at 47316.

[13] *See id*. at 47287-88.

trigger various parallel SEC and FINRA requirements already in effect.[14] The Cross-Border Amendments do not offer an exemption on this basis, but adopt a similar approach to a safe harbor for offshore broker-dealers (Rule 15a-6) by imposing Title VII requirements in a roughly parallel manner, albeit with more of a focus on risk regulation and competitive equality.

Specifically, final Rule 3a71-3(d) provides an exception from the ANE Counting Requirement where all arranging, negotiating or executing activity within the United States is conducted by U.S. personnel associated with a majority-owned affiliate[15] that is registered with the SEC as either a broker-dealer or an SBSD[16] (a "U.S. Registered Affiliate"), subject to the certain conditions. Specifically:

- The U.S. Registered Affiliate must provide a public notice to the SEC that an affiliate will conduct ANE transactions in reliance on the safe harbor and comply with certain requirements applicable to SBSDs (1) "as if" it were a counterparty to the transaction and (2) "as if" it were registered as an SBSD (if it is not so registered).[17] These requirements include:
  - Disclosure of material risks, characteristics, incentives and conflicts of interest (including its own material incentives or conflicts of interest and those associated with the non-U.S. person relying on the exception);[18]
  - Determining the suitability of recommendations made by its personnel[19] (with an alternative means of satisfying the "counterparty-specific prong" of the SEC's

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14 Rule 15a-6 provides an exemption from broker-dealer registration for a non-U.S. broker-dealer that uses a registered broker-dealer to intermediate certain transactions, including those involving U.S. counterparties.

15 The majority-owned affiliate condition appears designed to serve only a limited purpose of ensuring that other entities in the financial group (*e.g.*, a parent holding company) have sufficient "skin-in-the-game" with respect to the U.S. Registered Affiliate's compliance with the conditions. Indeed, the SEC indicates that the condition is intended to ensure that the "financial group" has a "significant interest" in the U.S. Registered Affiliate's compliance with such conditions, "in addition to the non-U.S. person's interest" in such compliance.

16 To facilitate the use of SBSDs, the Cross-Border Amendments also introduce a limited exemption from broker registration for an SBSD engaging in ANE activity in compliance with the broader exception and that is with or for a counterparty that is an eligible contract participant. Cross-Border Amendments Adopting Release at 35; Rule 3a71-3(d)(4).

17 The Cross-Border Amendments also provide that compliance with certain SBSD regulations would not be conditions of the exception, including requirements relating to verifying counterparties' eligible contract participant status, KYC requirements, clearing rights disclosure requirements, daily mark disclosure requirements, portfolio reconciliation and compression requirements and SBS trading relationship documentation requirements.

18 *See* Exchange Act section 15Fh-3(b)(B)(i) and (ii), and Rule 15Fh-3(b) thereunder.

19 *See* Rule 15Fh-3(f).

suitability rule that is intended to be less burdensome than the alternative offered in the Cross-Border Amendments Proposal);[20]

- Fair and balanced communication requirements;[21] and
- Trade acknowledgment and verification requirements[22] (with additional guidance to avoid the potential for duplicative trade acknowledgements and verifications);[23]

- The U.S. Registered Affiliate must provide the relevant counterparty a notice that the offshore affiliate is not a registered SBSD;
- The non-U.S. person must promptly provide the SEC with access to relevant books and records within its possession, custody or control, promptly make certain non-U.S. associated persons[24] available for testimony, and assist in taking evidence requested by the SEC from other persons (wherever located) related to the transaction;[25]
- The U.S. Registered Affiliate must maintain books and records related to the transaction (as would be required under relevant SEC recordkeeping rules), and provide certain disclosures to the non-U.S. person's counterparties (including that the non-U.S. person is not a registered SBSD and that certain regulatory protections do not apply);

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20 The SEC tailored the suitability condition to allow the registered entity to comply with the counterparty-specific prong by reasonably determining that the counterparty to whom it makes a recommendation is an "institutional counterparty" as defined in Rule 15Fh-3(f)(4) and by disclosing to the counterparty that it is not undertaking to assess the suitability of the SBS or trading strategy involving an SBS for the counterparty.

21 *See* Exchange Act Section 15F(h)(3)(C) and Rule 15Fh-3(g) thereunder.

22 *See* Rules 15Fi-1 and 15Fi-2.

23 SBSDs acting as U.S. Registered Affiliates will be required to satisfy certain requirements of SEC Rule 10b-10 (the broker-dealer confirmation rule) as if they were broker-dealers to avoid broker-registration requirements, while broker-dealers acting as U.S. Registered Affiliates get relief from other requirements of this rule. Cross-Border Amendments Adopting Release at 38; Rule 3a71-3(d)(4). In addition to the Specified Regulations, the antifraud provisions of the federal securities laws continue to apply to the transaction.

24 This condition applies to any non-U.S. domiciled natural person who is a partner, officer, director, branch manager or employee of the non-U.S. person relying on the exception (or any person occupying a similar status or performing similar functions), or who controls, is controlled by or is under common control with such non-U.S. person.

25 The Cross-Border Amendments provide an exception from this condition when the non-U.S. person is prohibited by applicable non-U.S. law or regulations from providing such information, documents, testimony or assistance. In that case, the non-U.S. person could continue relying on the exception until the SEC issues an order modifying or withdrawing the relevant jurisdiction as a "listed jurisdiction" (as described below), at which point the exception would no longer be available. This "continued reliance provision" would provide only temporary relief until the SEC effectively withdraws the exception for such jurisdiction.

- The non-U.S. person must provide the U.S. Registered Affiliate with written consent to service of process for any civil action brought by or proceeding before the SEC; and
- The non-U.S. person must be subject to the margin and capital requirements of a "listed jurisdiction" approved by order of the SEC.[26]

In a companion order, the SEC has initially established Australia, Canada, France, Germany, Japan, Singapore, Switzerland and the United Kingdom as listed jurisdictions.

In a departure from the Cross-Border Amendments Proposal, the Final Rule also requires any broker-dealer that serves as the U.S. Registered Affiliate and that is not approved to use models to compute its net capital requirements, to maintain minimum net capital as if it were also registered as an SBSD. Thus, the broker would be required to maintain at least $20 million in net capital, rather than $250,000 or a lesser amount.[27] Such a broker-dealer would also need to maintain certain risk management and control systems as though it were an SBSD, though in practice it is unclear whether there would be any material risks to control.[28] The SEC explained that this set of requirements was added to mitigate competitive disparities between firms that make use of a registered broker-dealer for purposes of the exception and those that make use of a registered SBSD. Although the numbers are not large for most financial institutions, the minimum capital requirement, which could require trapping capital where it has no economic use, may deter use of the exemption in marginal cases.

Limit on Use of the Exception for Certain Inter-Dealer SBS

The Cross-Border Amendments also limit the availability of the ANE exception in connection with certain inter-dealer SBS, and provide for related notices and recordkeeping requirements to facilitate the SEC's implementation of this limit. The exception is conditioned on the aggregate gross notional amount of covered inter-dealer SBS positions created through ANE transactions over the course of the immediately preceding 12 months being $50 billion in notional amount or less. Covered transactions

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[26] This condition is intended to prevent dealers from booking their transactions into entities that are not subject to adequate financial responsibility standards, and to avoid creating a competitive advantage for non-U.S. persons conducting ANE activities in the United States without being subject to such standards. The SEC notes that the condition is consistent with its belief that applying capital and margin requirements to ANE transactions between two non-U.S. entities can help mitigate the potential for financial contagion to spread to U.S. markets.

[27] Similarly, a broker-dealer that is approved to use models would be required to maintain the minimum capital applicable to models-based SBSDs.

[28] *See* Cross-Border Amendments Adopting Release at 34. The adopting release notes that such a system could "entail guidelines, policies and procedures that the broker does not undertake activities that create market or credit risk."

include those that a non-U.S. entity or an unregistered affiliate has executed in reliance on the ANE transaction exemption with a non-U.S. registered SBSD or broker-dealer that has filed a notice with the SEC that it is acting as a U.S. Registered Affiliate or with any affiliate of such an entity.[29] If that threshold is exceeded, then **all** (i) new ANE transactions and (ii) interdealer transactions over the preceding 12 months that were ANE transactions (including transactions below the $50 billion threshold) would need to be counted towards the *de minimis* thresholds, which would effectively require the offshore entity to register within two months.

Consequences of Breaching a Condition

Outside of the inter-dealer SBS limit, one significant question that the Cross-Border Amendments do not directly address is the consequences of any failure to comply with the conditions to the proposed exceptions.[30] As both of the relevant entities must comply with specified conditions for the exemption to apply, the clear implication is that a breach by **either entity** would trigger the ANE Counting Requirement with respect to one or more SBS transactions, potentially resulting in a violation by the non-U.S. dealer of a registration requirement.

This would presumably include any failure by the U.S. Registered Affiliate to comply with any of its suitability or disclosure requirements or to maintain appropriate books and records related to the transaction, as well as any failure by the non-U.S. person to provide the SEC with access to relevant records in its custody or control (subject to the continued reliance provision described above). The SEC does not address whether or how such a breach could be remedied, and in particular, whether the non-U.S. person relying on the exception potentially would be forced to suspend its SBS dealing business until the breach is cured (assuming it could be).

Guidance on Application of Title VII Requirements to ANE Transactions

In addition, the preamble to the Cross-Border Amendments provides supplemental guidance regarding the types of activities by U.S. personnel that would not constitute

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[29] Cross-Border Amendments Adopting Release at 44-46; Rule 3a71-3(a)(13).

[30] There is some specific discussion around the consequences of breaching the $50 billion threshold for inter-dealer SBS transactions. There, the SEC explains that a breach would have two principal consequences: (1) as of the date the $50 billion limit is breached, the relying entity would be prohibited from relying on the exception for future SBS transactions; and (2) as of the date that the $50 billion limit is breached, the relying entity would have to begin counting certain transactions subject to the exception against the *de minimis* thresholds. The SEC notes that, as a practical matter, because each of the *de minimis* thresholds is significantly lower than $50 billion, the relying entity would generally also breach one or more of the *de minimis* thresholds and be required to register with the SEC as an SBSD (though the relying entity would be permitted an at least two-month transitional period to register).

"arranging" or "negotiating" SBS transactions for purposes of the SEC's SBSD rules.[31] Under the guidance, a person in the U.S. could provide "market color" (including pricing information for SBS) without that activity constituting "arranging" or "negotiating," so long as such person (1) has not been assigned and does not exercise client responsibility in connection with the transaction and (2) does not receive transaction-based compensation linked to the completion of transactions for which they provide such market color.[32]

The SEC also explains that, in its view, any solicitation activity by U.S. personnel or activity to respond to requests by counterparties to enter into transactions, when such requests are made directly to U.S. personnel, would not be "market color." Further, market-facing activity by U.S. personnel also would not be "market color" if such activity involved: making recommendations; providing predictions, trading ideas or strategies relating to a proposed SBS transaction; structuring; or finalizing or reaching agreement with respect to any pricing or non-pricing element that must be resolved to complete an SBS transaction.

CERTIFICATION AND OPINION OF COUNSEL REQUIREMENT

The Certification and Opinion Requirement was originally adopted on the premise that the SEC should have access to the full books and records of any person wishing to register as an SBSD, and that a non-U.S. person seeking registration should be responsible for establishing reasonable legal certainty as to such access under all relevant laws. While the SEC's final books and records rules narrowed the scope of what some non-U.S. SBSDs must produce and make available to the SEC,[33] the Cross-Border Amendments recognize that the Certification and Opinion Requirement still created an untenable barrier to registration. The Amendments also appear to reflect recognition

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[31] In addition to the SEC's test used in connection with the *de minimis* calculation, this interpretation would also apply to the application of business conduct and transaction reporting rules.

[32] Helpfully, the guidance provides that for purposes of this limitation, the SEC would not view compensation practices that account for aggregated profits at an entity as transaction-based compensation. Cross-Border Amendments Release at 21-22, n. 61.

[33] Under the SEC's final books and records rules, non-U.S. SBSDs that have a prudential regulator must primarily produce and make available to the SEC books and records relating to their SBS business and securities transactions. Non-U.S. SBSDs that are so-called "stand-alone" SBSDs or dual broker-dealer/SBSDs are subject to more fulsome books and records requirements. *See* Books and Records Adopting Release at 38. In either case, the books and records requirement covers fully offshore activities and transactions, as well as those involving counterparties in the United States.

that a non-U.S. SBSD may engage in activities outside of the United States that may not require the same certainty and level of access.[34]

The Cross-Border Amendments thus both narrow the scope of the books and records that would be covered by the Certification and Opinion Requirement and provide guidance on what legal jurisdictions would need to be addressed. In addition, they permit an SBS Entity to provide a certification and opinion of counsel conditioned on certain future events.

Covered Books and Records

The Cross-Border Amendments do not alter the language of Rule 15Fb2-4. Instead, the preamble provides formal guidance that the certification and opinion of counsel need only address (1) books and records that relate to the nonresident SBS Entity's "U.S. business" and (2) "financial records" necessary for the SEC to assess the SBS Entity's compliance with the SEC's capital and margin requirements (if applicable). The term "U.S. business" is defined to include a non-U.S. SBSD's SBS transactions that are: (1) with U.S. persons (other than those conducted through a non-U.S. branch of the U.S. person) or (2) arranged, negotiated or executed by U.S. personnel of the non-U.S. SBSD (or its agent).[35] In this manner, the Cross-Border Amendments largely carve out books and records regarding non-SBSD activities and/or non-U.S. counterparties.[36] The Cross-Border Amendments also clarify that the certification and opinion of counsel do not have to cover access to any books and records that are held in the United States, either directly or by a third-party services provider.[37] A substituted compliance determination would not alleviate the requirement to make books and records available to the SEC or provide a certification and opinion of counsel, although the precise records that would be covered could potentially change.

Covered Laws

In the Cross-Border Amendments, the SEC also provides guidance that the certification and opinion of counsel need only address the laws of one jurisdiction (or set of

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[34] The SEC does note that the guidance with respect to the Certification and Opinion Requirement does not affect the requirement (under Rule 18a-6(g)) that a nonresident SBS Entity provide the SEC with direct access to its books and records (and permit onsite inspections and examinations thereof), which is a separate and independent requirement.

[35] SEC Rule 3a71-3(a)(8).

[36] The guidance also clarifies that the Certification and Opinion Requirement need not address contracts entered into prior to the date on which a nonresident SBS Entity submits its application for registration.

[37] The SBS Entity's certification and opinion of counsel does not have to address **access** to such books and records, other than to represent that they are kept in the United States in accordance with SEC rules, but would still have to address the ability of the SBS Entity to submit to onsite inspections and examinations with respect to those books and records.

jurisdictions) in which the nonresident SBS Entity maintains a complete set of covered books and records and does not need to cover any other jurisdictions, including any jurisdiction where customers or counterparties are located or where the SBS Entity has additional offices or conducts business. In addition to excluding jurisdictions where an SBSD's counterparties may be located, the focus on a jurisdiction or jurisdictions in which the SBSD maintains its books and records is intended to provide nonresident SBS Entities subject to privacy or blocking laws in their home country with a path to comply with the requirements by maintaining a full set of relevant books and records in a different jurisdiction. If the nonresident SBS Entity maintains its covered books and records in a jurisdiction other than its home jurisdiction, the certification and opinion of counsel needs to address only the laws of the jurisdiction in which such records are maintained.[38]

Consents and Memoranda of Understanding

As certain jurisdictions' laws could condition lawful provision of books and records on obtaining consents from persons whose information is documented in such records, the Cross-Border Amendments permit the required certifications and opinions to be predicated on obtaining the requisite consents. The SEC notes in the preamble to the Cross-Border Amendments that an SBS Entity that intends to rely on such consents would need to obtain them prior to registering so that it would be able to actually provide the SEC with access. The inability to obtain a consent (or a withdrawn consent) may force the SBS Entity to cease conducting SBS business with that person. However, the adopting release states that it is not the SEC's intent for the withdrawal of consent by a counterparty to affect the validity of transactions entered into when the counterparty's consent was in effect.

Similarly, the Cross-Border Amendments permit certifications and opinions of counsel to take into account whether the relevant regulatory authority in a jurisdiction has (1) issued an approval, authorization, waiver or consent or (2) entered into a Memorandum of Understanding ("MOU") or other arrangement with the SEC facilitating the latter's access. Requirements for consultation or cooperation with a foreign regulator in conducting onsite inspections and examinations would be permitted, provided that such consultation or cooperation does not restrict the SEC's ability to conduct timely inspections and examinations. However, the Cross-Border Amendments do not permit reliance on an MOU that contemplates that the SBS Entity must first provide the books and records to the foreign regulator (which in turn would provide them to the SEC).

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[38] This appears to be a change from the Cross-Border Amendments Proposal, which included a condition that the law of the home country jurisdiction could not block disclosure of records located in the other jurisdiction.

Conditional Certification and Opinion of Counsel

Finally, to provide nonresident SBS Entities with a path to comply with the Certification and Opinion Requirement in jurisdictions where time may be needed to resolve local impediments, the Cross-Border Amendments revise Rule 15Fb2-1 to permit a nonresident applicant to provide a certification and opinion that identifies future actions that would provide the SEC with adequate assurances of access. Such actions could include entry into an MOU, actions by local regulators, a substituted compliance determination by the SEC, obtaining necessary consents or "any other action" that would provide the SEC with the necessary assurances.[39] A nonresident SBS Entity that submits a conditional certification and opinion of counsel, together with an otherwise complete application, would be conditionally registered and would remain so until the SEC acts to grant or deny final registration. If none of the future actions included in the conditional certification and opinion of counsel occurs within 24 months of the compliance date for Rule 15Fb2-1, then the SEC would be authorized to institute proceedings to determine whether to deny registration.[40]

This relief would presumably be useful in limited circumstances where local regulators are working out a path to disclosure to the SEC that is reasonably certain to be provided, but have not yet finalized its terms by the registration deadline. In other situations where future resolution of a barrier may be less clear, the cost of registration is likely to be prohibitive.

STATUTORY DISQUALIFICATIONS AND BACKGROUND CHECKS

Finally, the Cross-Border Amendments also address legal barriers to recording sensitive personal information about APs of an SBSD as part of the required background check to establish that they are not subject to "statutory disqualifications."[41]

Amendment to Rule of Practice 194

SEC Rule 15Fb6-2 requires an SBSD to certify that it neither knows, nor, in the exercise of reasonable care, should have known, that any of its APs who are involved in effecting

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[39] Cross-Border Amendments Adopting Release at 91-92.

[40] The Cross-Border Amendments also address Rule 3a71-6, which provides that substituted compliance applications by parties or groups of parties (other than foreign regulators) must comply with the Certification and Opinion Requirement as if such parties were subject to that requirement at the time of the request.

[41] Exchange Act section 15F(b)(6) makes it unlawful for an SBS Entity to permit an AP who is subject to statutory disqualification to effect or be involved in effecting SBS on its behalf if the SBS Entity knew, or, in the exercise of reasonable care, should have known, of the statutory disqualification, except to the extent otherwise provided by rule, regulation or order of the SEC.

SBS on its behalf are statutorily disqualified and requires the chief compliance officer or a designee to review and sign related employment questionnaires. SEC Rule of Practice 194 provides a process by which an SBS Entity may apply to the SEC to permit a statutorily disqualified individual to nonetheless be involved in effecting SBS on its behalf. The Cross-Border Amendments modify the existing rule to provide an exclusion (the "Statutory Disqualification Exclusion") for an individual who (1) is not a U.S. person (as defined in Rule 3a71-3(a)(4)) and (2) is not involved in effecting SBS transactions with or for counterparties that are U.S. persons (other than those conducted through a foreign branch of a U.S. person counterparty). This exemption is somewhat narrower than may meet the eye, as being "involved in effecting" SBS generally includes functions necessary to enter into SBS, even if they are not client-facing (*e.g.*, middle- and back-office functions).[42] This exclusion is also not available if the individual is subject to certain types of regulatory expulsions, bars or suspensions described in Exchange Act Section 3(a)(39)(A) and (B).[43]

In adopting the exclusion, the SEC seeks to more closely harmonize Rule of Practice 194 with the CFTC's statutory disqualification approach to non-U.S. APs of a swap dealer.[44] This may benefit duly-registrants who would be unable to have statutorily disqualified non-U.S. personnel effect both swaps and SBS outside of the United States.

Exception to Certification of Employment Application/Questionnaire

To address potential conflicts with foreign privacy laws involving employee records, the Cross-Border Amendments also amend the requirement in SEC Rule 18a-5 to "make and keep" a questionnaire or employment application signed by each of its APs who are individuals.[45]

The Cross-Border Amendments revise this requirement in two respects:

- A non-U.S. SBS Entity (other than a broker-dealer) would not be required to "make and keep" a questionnaire or employment application with respect to a non-U.S. person for which the Statutory Disqualification Exclusion applies; and

[42] However, the SEC notes that the statutory definition of an AP generally excludes persons whose duties are solely clerical or ministerial.

[43] An order by a foreign financial regulator with respect to an AP (described in Exchange Act section 3(a)(39)(B)(i) and (ii)) would prevent the SBS Entity from relying on the proposed exclusion with respect to such AP only when the order is issued by a foreign regulator in the jurisdiction where the AP is employed or located.

[44] CFTC Regulation 23.22(b) does not require registered swap dealers to comply with the equivalent prohibition when the statutorily disqualified AP is a non-U.S. person who deals only with non-U.S. counterparties.

[45] This questionnaire or application would serve as a basis for a background check with respect to such AP, and would need to include certain personally identifiable information with respect to the AP (including name, address, social security number, date of birth, employment history and criminal history, among other information).

- A questionnaire or employment application for a non-U.S. person does not need to include certain information unless that information is required under local law or is obtained as part of a customary background check and the creation or maintenance of records reflecting that information would not result in a violation of applicable law in the jurisdiction in which the individual is employed or located. This latter exemption would apply to foreign APs involved in effecting SBS on behalf of an SBS Entity with all counterparties, including U.S. counterparties.

SBS Entities relying on these exemptions are still required under Rule 15Fb6-2(b) to gather sufficient information on foreign APs to reasonably conclude that the relevant individuals are not statutorily disqualified.[46] Therefore, in practice, an SBS Entity relying on the exemptions would need to collect relevant information and retain a record of the fact that the review was conducted, even if the materials subject to disclosure prohibitions are ultimately destroyed (or otherwise not retained). The exemptions should provide a path around GDPR and other legal barriers to information sharing, at least where such barriers are not construed so broadly as to prohibit SEC access to basic information consisting of a name and an indication that the AP was vetted.[47] However, to the extent such legal barriers prohibit the retention of even more limited records, they could still pose obstacles to an SBS Entity in demonstrating how it reached the determination that each AP was not disqualified.

RISK MITIGATION TECHNIQUES FOR UNCLEARED SBS

The separately adopted Risk Mitigation Rules will require SBS Entities to (i) execute written trading relationship documentation with each of their counterparties prior to, or contemporaneously with, executing an SBS, (ii) enter into portfolio reconciliation agreements and reconcile their SBS portfolios with other SBS Entities on a daily, weekly or quarterly basis (depending on the size of the portfolio), (iii) establish, maintain and comply with policies and procedures reasonably designed to ensure the SBS Entity engages in portfolio reconciliations with non-SBS Entities on a quarterly or annual basis and (iv) engage in certain forms of bilateral and multilateral portfolio compression exercises.

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[46] Rule 15Fb6-2(b) requires each registered SBS Entity to certify that it neither knows, nor, in the exercise of reasonable care, should have known, that any AP who effects or is involved in effecting SBS on its behalf is subject to statutory disqualification. The requirement to "make and keep" a questionnaire or employment application would support this requirement.

[47] For instance, the SBS Entity could conduct certain portions of the background check by phone or destroy any additional written records (beyond the AP's name and an indication that the AP was vetted).

These rules were not part of the core framework that the SEC originally identified as necessary to stand up its regulatory regime for SBS Entities. However, in light of the CFTC's adoption of rules on these topics, the SEC proposed parallel rules in December 2018. In doing so, the SEC recognized that any SBS Entity that is registered with the CFTC as a swap dealer has already incurred systems and documentation costs in establishing compliance with those rules. Accordingly, the SEC's rules are intended to be substantively identical to the equivalent CFTC rules, with a few exceptions. Material examples are noted below:

- Consistent with the terms of the SEC's margin rules, the new trading relationship documentation rules do not require documentation with respect to collecting initial margin until two months after breaching the $50 million dollar initial margin threshold;

- The new SEC rules require periodic audits of trading relationship documentation policies and procedures by an auditor that is "independent" under its rules, which would not typically be an internal auditor.[48] By contrast, the parallel CFTC rule refers to audits by an independent "internal or external" auditor;

- The "material terms" subject to reconciliation include all SBS terms relevant to the rights and obligations of the parties and/or to valuations that must be reported to a data repository under Rule 901 of Regulation SBSR. In contrast to the proposed rule, non-contractual data required to be reported under Rule 901 will not need to be included in an initial reconciliation. However, the final Risk Mitigation Rules still differ from CFTC requirements insofar as the underlying reporting requirements may differ and the SEC rule does not include an explicit list of data fields that may be excluded similar to the list provided in CFTC Rule 23.500(g);[49]

- Although the numerical thresholds are the same as those used by the CFTC, the required frequency of portfolio reconciliations will depend on the number of SBS in a portfolio held with a counterparty rather than swaps. This means that SBS Entities that are also swap dealers may have requirements to reconcile their SBS portfolios with greater or lesser frequency than their swap portfolios.

- A "Business day" for purposes of portfolio reconciliation is any day other than a Saturday, Sunday or legal holiday, whereas the parallel CFTC rule does not exclude

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48 Risk Mitigation Rules Adopting Release at 66-67.

49 In the preamble to the rulemaking, the SEC does note that it would not consider information that corresponds to the CFTC's excluded fields as being relevant to the ongoing rights and obligations of the parties and valuations for purposes of its requirements. *Id*. at 27.

Saturdays. This means that the periods for resolving discrepancies under the SEC rules will be one day longer in many cases;

- Unlike the analogous CFTC rule, the SEC's rule on bilateral portfolio compressions on the request of a counterparty only requires conducting such exercises "when appropriate."

- The differences noted above are sufficiently material that SBS Entities will need to consider whether to execute documentation covering SEC requirements that is separate from the portfolio reconciliation agreements that they may already have in place as swap dealers, or alternatively, to consolidate the two sets of agreements.

The compliance date for these new requirements will be the same as the compliance date for registration of SBS Entities (see below).

COMPLIANCE DEADLINES

As previously established by the SEC, the Registration Compliance Date for SBS Entities will be 18 month after the effective date of the Cross-Border Amendments. In order to establish reasonable certainty as to that date, the SEC established the later of March 1, 2020 and 60 days following publication in the Federal Register as the effective date. Accordingly, assuming a March 1 effective date:

- Market participants that engage in SBS dealing activities deemed to be within U.S. jurisdiction will be required to begin calculating whether their current dealing activities meet or exceed the *de minimis* threshold for registration as an SBSD on July 1, 2021. The compliance date for amendments to Rule 3a71-3 (the new ANE transactions safe harbor) will be the same date;

- The Registration Compliance Date will technically be September 1, 2021;

- Given that SBSDs are required to submit a complete application for registration and become conditionally registered not later than two months after the end of the month on which they exceed a *de minimis* threshold, the practical deadline for registration (for active dealers that immediately exceed a threshold) would appear to be September 30 or October 1, 2021; and

- As of the same date, SBS Entities subject to registration would also generally be subject to the full set of applicable rules and requirements, including as to duties to counterparties, margin and capital requirements (for SBSDs without a prudential

regulator), collateral segregation, internal risk management, chief compliance officers and their duties, trading documentation, portfolio reconciliation and compression exercises, and books and records.

Importantly, while the SEC notes that the compliance deadline for trade reporting under Regulation SBSR has not yet been set (as an SBS data repository has yet to become registered),[50] the Cross-Border Amendments also provide **a four-year deferral for requirements to report SBS transactions in a manner that would be inconsistent with the CFTC's reporting requirements for swaps**. Specifically, the preamble to the Cross-Border Amendments articulates a "no-action" position, that it will not be a basis for enforcement for a market participant to: (i) fail to report an SBS, when under CFTC rules a different person or no person would be required to report a comparable swap, (ii) fail to report data elements in Rules 901(c)(2)-(7) and 901(d)[51] that are not required under analogous swap reporting rules or (iii) report life-cycle events in a manner consistent with CFTC rules rather than Regulation SBSR.[52] This relief includes so-called "secondary information" like broker, desk and trader IDs required under Regulation SBSR, as well as product-specific information. While the SEC's decision to require SBS data reporting under an essentially interim set of rules is questionable on cost/benefit grounds, this deferral at least promises to ameliorate coordination burdens and suggests that the SEC may reconsider Regulation SBSR as the CFTC continues to work on the data requirements for its own rule.

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Please do not hesitate to contact us with any questions.

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[50] Under Regulation SBSR, the first compliance date for affected persons to report SBS in a reportable asset class is the first Monday that is the later of: (1) six months after the date on which the first SBS data repository that can accept reports in that asset class is registered and (2) one month after the compliance date for registration of SBS Entities.

[51] Cross-Border Amendments Adopting Release at 282.

[52] *Id*. at 282-83.

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