

# Client Update

## SEC Final Cross-Border Rules on “Arranging, Negotiating, or Executing” Security-Based Swaps and the *De Minimis* Exception

### NEW YORK

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On February 10, 2016, the Securities and Exchange Commission (“SEC”) approved amendments (the “Final Rules”) to Rules 3a71-3 and 3a71-5 under the Securities Exchange Act of 1934 (the “Exchange Act”) to require a non-U.S. person to count certain security-based swaps (“SBSs”) with non-U.S. counterparties connected with its SBS dealing activity against its *de minimis* thresholds for registering as a security-based swap dealer (“SBSD”).

Under the Final Rules, an SBS of such non-U.S. person will be counted toward such thresholds if such SBS is arranged, negotiated or executed by personnel of such non-U.S. person or its agent located in the United States (such personnel or agent, “U.S. personnel”).

The Final Rules will become effective on April 19, 2016.

The text of the Final Rules and the accompanying release (the “Adopting Release”) are available at: <https://federalregister.gov/a/2016-03178>.

### COMPLIANCE DATE

The compliance date for the Final Rules is the later of (1) February 21, 2017, or (2) the date that is two months prior to the Registration Compliance Date (the “SBS Entity Counting Date”). The SBS Entity Counting Date is the date on which a person must begin calculating whether its activities meet or exceed the *de minimis* threshold for SBS registration.<sup>1</sup>

<sup>1</sup> In other words, for purposes of determining whether a person needs to register as an SBS, only SBSs entered into on and after the SBS Entity Counting Date are included in the determining person’s calculation. The SEC set the compliance date for the Final

The Registration Compliance Date (*i.e.*, the date by which an SBSB must register) is the latest of:<sup>2</sup>

- six months after the date of publication in the Federal Register of final rules establishing capital, margin and margin segregation requirements for SBSBs;
- the compliance date of final rules establishing recordkeeping and reporting requirements for SBSBs;
- the compliance date of final rules establishing business conduct requirements under the Exchange Act for SBSBs; or
- the compliance date for final rules establishing a process for a registered SBSB to make an application to the SEC to permit an associated person who is subject to a statutory disqualification to effect or be involved in effecting SBSs on its behalf.

### SECURITY-BASED SWAP DEALER *DE MINIMIS* EXCEPTION

Under Exchange Act Rule 3a71-2, a person that engages in dealing activity will qualify for the *de minimis* exception from SBSB registration if the SBS positions connected with those dealing activities entered into by such person or its affiliates over the immediately preceding 12-month period have an aggregate gross notional amount that does not exceed certain thresholds.<sup>3</sup>

Existing Exchange Act Rules<sup>4</sup> require non-U.S. persons (other than conduit affiliates of U.S. persons) to count the following SBSs against their *de minimis* thresholds:

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Rules as the later of the SBS Entity Counting Date or 12 months following publication in the Federal Register in order to provide non-U.S. persons engaged in SBS dealing activities with adequate time (*i.e.*, at least 12 months) to monitor the location of personnel engaged in the relevant SBS activities to appropriately implement the Final Rules.

<sup>2</sup> See our client memorandum, “SEC Final Rules on Registration of Security-Based Swap Entities and Proposed Rules on Statutorily Disqualified Associated Persons” (September 21, 2015), available at: <http://www.debevoise.com/insights/publications/2015/09/sec-final-rules-on-registration>.

<sup>3</sup> For credit default swaps (“CDS”) that are SBSs, the threshold is \$3 billion, subject to a phase-in level of \$8 billion. For other SBSs (non-CDS), the threshold is \$150 million, subject to a phase-in level of \$400 million. For SBSs with “special entities,” the threshold is \$25 million.

<sup>4</sup> See our client memorandum, “SEC Final Rules on Cross-Border Application of Security-Based Swap Entity Definitions and Other Related Matters” (July 3, 2014), available at

- SBSs with a U.S. person (including foreign branches of U.S. banks), other than SBSs conducted through a foreign branch of a U.S. registered SBSD;<sup>5</sup> and
- SBSs for which the non-U.S. person's counterparty has rights of recourse against a U.S. person that is controlling, controlled by or under common control with the non-U.S. person (regardless of where personnel of the non-U.S. person arranges, negotiates or executes the SBSs).

The Final Rules add to the requirements imposed by existing Exchange Act Rules by requiring that non-U.S. persons (other than conduit affiliates of U.S. persons) count against their *de minimis* thresholds SBSs that are arranged, negotiated or executed by such non-U.S. person's U.S. personnel.

### PROPOSALS ADDRESSING CROSS-BORDER APPLICATION OF THE *DE MINIMIS* EXCEPTION

The SEC has twice proposed rules relating to the application of the *de minimis* calculation to non-U.S. persons' SBS transactions that involve activity in the United States. The SEC's 2013 cross-border proposal (the "2013 Proposal") required non-U.S. persons to include in their *de minimis* calculation any "transaction conducted within the United States." Thus, a non-U.S. person engaged in SBS dealing activity (the "dealing non-U.S. person") would have been required to include any dealing transaction entered into with another non-U.S. person that was conducted in the United States by the dealing non-U.S. person or its counterparty (or an agent of either such party). This would have required a dealing non-U.S. person to either monitor the location of relevant personnel acting on behalf of its counterparties or obtain a representation concerning whether its counterparty was engaging in activity within the United States on a transaction-by-transaction basis.

In response to comments received on the 2013 Proposal, the SEC proposed a modified approach in 2015 (the "2015 Proposal") that focused exclusively on the location of the U.S. personnel of the dealing non-U.S. person engaged in relevant SBS activity. Under the 2015 Proposal, a dealing non-U.S. person would be required to include an SBS with another non-U.S. person only if the SBS is arranged, negotiated, or executed by its U.S. personnel.

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<http://www.debevoise.com/insights/publications/2014/07/sec-final-rules-on-crossborder-application-of-se>.

<sup>5</sup> To allow time to submit the required registration application, there is a grace period for transactions entered into prior to 60 days following the earliest date on which the registration of SBSDs is first required under the final rules for SBSD registration.

## THE FINAL RULES

The Final Rules are generally consistent with the 2015 Proposal with respect to the cross-border application of the *de minimis* calculation.<sup>6</sup> The Final Rules require a non-U.S. person engaged in SBS dealing activities to include any SBS transactions connected with its dealing activity that are arranged, negotiated, or executed by such non-U.S. person's U.S. personnel.

The Final Rules adopt the activity-based test, rather than other tests (such as the risk-based test) by requiring all persons that engage in significant SBS dealing activity in the United States through U.S. personnel to register as SBSDs and to comply with relevant requirements applicable to SBSDs. In addition, the Adopting Release notes that the Final Rules avoid unnecessary costs and complexity because they do not require a non-U.S. person to consider the location of its counterparty's operations (or that of the counterparty's agent) in determining whether a particular SBS transaction should be included. The Adopting Release further states that the Final Rules should reduce the likelihood that a non-U.S. person's personnel who are incidentally within the United States will trigger the counting requirement.

### Meaning of “arranging, negotiating, or executing” an SBS

For purposes of the Final Rules, “arrange” and “negotiate” mean the market-facing activity of sales or trading personnel in connection with a particular transaction, including interactions with counterparties or their agents. “Execute” is the market-facing act that, in connection with a particular transaction, causes a person to become irrevocably bound under the SBS under applicable law.

### What constitutes “arranging, negotiating, or executing”

Examples of activities that we would expect to fall under the categories of “arranging, negotiating or executing” an SBS include:

- a person in a sales or marketing role who negotiates the financial terms, including the collateral terms, of an SBS;
- a trader who provides a pricing quote to a counterparty or the agent of a counterparty (e.g., a marketer for the client);

<sup>6</sup> In addition to the application of the *de minimis* exception to the dealing activity of non-U.S. persons, the 2015 Proposal also addressed the cross-border application of business conduct requirements, Regulation SBSR, and clearing and trade execution requirements. The Adopting Release notes that the Final Rules only relate to the *de minimis* exception, and that the SEC anticipates addressing the other issues addressed by the 2015 Proposal in subsequent releases.

- a person who directs other personnel to arrange, negotiate, or execute a particular SBS (even if such other personnel are not located in the United States); or
- a person who specifies the trading strategy or techniques carried out through algorithmic trading or automated electronic execution of an SBS (even if the related server is located outside the United States).

The Adopting Release notes that U.S. personnel who engage in or direct any such market-facing activity are within the scope of the Final Rules, even if such U.S. personnel are not formally designated as sales persons or traders.

### **What does not constitute “arranging, negotiating, or executing”**

Under the Final Rules, the involvement of U.S. personnel who perform non-market-facing activities (such as booking the transaction or performing internal functions, including processing trades or other back-office activities) with respect to a specific transaction does not fall within the scope of “arranging, negotiating or executing” an SBS.

Examples of activities that we would expect to not fall under the categories of “arranging, negotiating or executing” an SBS include:

- a person who designs an SBS (*e.g.*, by structuring a particular SBS) but does not communicate with a counterparty regarding such particular SBS and does not execute such SBS;
- a person who prepares documentation for the transaction, including negotiation of a master agreement and related documentation (*e.g.*, a U.S.-based attorney who is involved in the negotiations regarding the legal terms of the SBS);
- a salesperson who meets with a potential counterparty to provide a general overview of the non-U.S. person’s SBS business;
- a person who analyzes a potential counterparty’s credit at the inception of a particular SBS transaction to set the credit line for the potential counterparty;
- a person in a credit role who monitors on an ongoing basis a counterparty’s credit;
- a person who is involved in the settlement or clearing of SBSs; or
- a person who performs ministerial or clerical tasks (such as entering on the books an executed SBS).

**“Personnel Located in a U.S. branch or office”**

Only the SBS activities of personnel who are located in the United States (those who are, “for example, assigned to, on an ongoing or temporary basis, or regularly working” in a U.S. branch or office) are relevant for the purposes of the Final Rules. On the other hand, the SBS activities of personnel who are “only incidentally present in the United States” when they arrange, negotiate, or execute the transaction—for example, an employee assigned to a foreign office who happens to be traveling within the United States (e.g., while attending an educational or industry conference) when she negotiates the terms of an SBS—will generally not be required to be considered for this purpose. However, using U.S. personnel to respond to inquiries regarding SBS activities during non-business hours of a non-U.S. person must be considered by the non-U.S. person for this purpose.

The SEC acknowledges that in certain instances, a market participant may have to conduct a trade-by-trade analysis to determine the location of relevant personnel in connection with each transaction. However, a non-U.S. person can alleviate this concern by identifying the specific sales and trading personnel located in the United States who are engaged in market-facing activity for purposes of ongoing compliance or, alternatively, by adopting policies and procedures to ensure that U.S. personnel is not involved in arranging, negotiating, or executing SBSs, and that the arrangement, negotiation and execution of SBSs are solely undertaken by personnel located outside the United States.

**“Personnel of such non-U.S. person” or “personnel of an agent”**

The term “personnel” will be interpreted by the SEC in a manner consistent with the definition of “associated person of a security-based swap dealer” contained in section 3(a)(70) of the Exchange Act, regardless of whether such non-U.S. person or such non-U.S. person’s agent is itself an SBSD. This definition is substantially similar to the definition of “associated person of a broker or dealer” in section 3(a)(18) of the Exchange Act, which encompasses a broad range of relationships used by firms to engage in and effect securities transactions, and is not dependent solely on whether a natural person is an “employee” of the firm in question. The SEC will examine whether a particular entity is able to control or supervise the actions of an individual when determining whether such person is considered to be “personnel” of a U.S. branch or office, or agent of an SBSD. The SEC notes that this is particularly relevant for a financial group that engages in SBS-dealing business, where personnel of one affiliate may operate under the direction of, or in some cases, report to personnel of another affiliate within the group.

### Harmonization Concerns and Substituted Compliance

The SEC recognizes that some non-U.S. persons may become required to register as SBSDs even though they are already subject to non-U.S. regulations similar to those of the U.S. SBSD regulatory framework. However, at this time, the SEC believes that it is appropriate to regulate SBS dealing activities that occur within the United States by requiring the registration of non-U.S. persons whose SBS dealing activities exceed the relevant *de minimis* thresholds by virtue of those activities involving the arrangement, negotiation or execution of SBSs on behalf of such non-U.S. person by U.S. personnel. The SEC will continue to consider substituted compliance with respect to certain SBSD requirements but is not currently considering to forgo registration entirely for non-U.S. persons subject to other regulatory regimes.

### Availability of the Exception for Cleared Anonymous Transactions

Exchange Act Rule 3a71-5 provides that a non-U.S. person (other than a conduit affiliate) need not count against the *de minimis* thresholds its dealing transactions that are entered into anonymously on an execution facility or national securities exchange and that are cleared through a clearing agency. Under the Final Rules, a non-U.S. person no longer needs the identity of its counterparties to calculate its *de minimis* thresholds. Thus, Exchange Act Rule 3a71-5 is amended to require a non-U.S. person to include all SBS dealing activities that are arranged, negotiated or executed by U.S. personnel, regardless of whether such transactions are entered into over-the-counter or on an SBS execution facility or national securities exchange.

### CFTC DSIO ADVISORY 13-69

The Division of Swap Dealer and Intermediary Oversight (the “DSIO”) of the Commodity Futures Trading Commission issued an advisory (the “DSIO Advisory”)<sup>7</sup> in response to inquiries from swap market participants regarding the applicability of the CFTC’s transaction-level requirements to swaps between non-U.S. swap dealers (“SDs”) and non-U.S. persons, where the non-U.S. SD uses personnel located in the United States to arrange, negotiate or execute the swap.

The DSIO Advisory states that a non-U.S. SD “regularly using personnel or agents located in the United States to arrange, negotiate or execute a swap with a non-U.S. person” generally would be required to comply with the CFTC’s transaction-level requirements (including with respect to its transactions with

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<sup>7</sup> CFTC Staff Advisory 13-69 (Nov. 14, 2013). Available at: <http://www.cftc.gov/ucm/groups/public/@lrllettergeneral/documents/letter/13-69.pdf>.

non-U.S. persons), since such activities are “core, front-office activities” of the non-U.S. SD’s dealing business.

While the DSIO Advisory’s interpretation of the phrase “arranged, negotiated or executed” is phrased in terms of activities of personnel located in the United States that constitute “core, front-office activities,” we believe that both the CFTC and the SEC focus on the same type of activity conducted by the relevant personnel located in the United States. While the term “front office” is not a legal term, it is understood in the financial industry to refer to a marketing or sales function, or division or desk of a banking entity that interacts with customers. Thus, the focus of the DSIO Advisory, like that of the Final Rules, is on interactions between such personnel located in the United States and non-U.S. counterparties in marketing swaps or negotiating the economic terms of a specific swap, or the execution by such personnel located in the United States of such swap (or directing any such activity).

The DSIO Advisory pertains solely to the applicability of the CFTC’s transaction-level requirements to swaps, not to whether a non-U.S. person is required to register as an SD.

The DSIO has extended no-action relief related to the DSIO Advisory to the earlier of September 30, 2016 or the effective date of any CFTC action with respect to the applicability of transaction-level requirements to such transactions.<sup>8</sup>

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Please do not hesitate to contact us with any questions.

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<sup>8</sup> See CFTC Letter 15-48 (Aug. 13, 2015).