Client Alert

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SEC Adopts Rule Amendments Addressing Dealing Transactions Between Non-U.S. Persons that are "Arranged, Negotiated, or Executed" in the United States

By Julian Hammar

On February 10, 2016, the U.S. Securities and Exchange Commission ("SEC") approved final rule amendments to its cross border rules that address how the security-based swap dealer definition applies to security-based swap dealing transactions between non-U.S. persons that are "arranged, negotiated, or executed" in the United States. The final rules will become effective 60 days after publication in the Federal Register, which is forthcoming. Compliance with the final rules will be required after the later of 12 months following such publication or 2 months prior to the compliance date for registration as a security-based swap dealer under the registration rules. The final rules are available here.

SECURITY-BASED SWAPS BETWEEN NON-U.S. PERSONS THAT COUNT TOWARD THE DE MINIMIS THRESHOLD

Under the final rules, a security-based swap dealing transaction that is entered into by a non-U.S. person will count toward the non-U.S. person's de minimis exception threshold from registration as a security-based swap dealer, regardless of whether the counterparty is a "U.S. person," if the transaction is "arranged, negotiated, or executed" through personnel of:

- the non-U.S. person located in a U.S. branch or office; or
- an agent (whether affiliated or unaffiliated) of such non-U.S. person located in the United States.

Accordingly, a non-U.S. person that conducts security-based swap dealing activity through personnel located in the United States will have to register with the SEC if its dealing activity in the United States – including security-based swaps with non-U.S. persons that are "arranged, negotiated, or executed" using U.S. personnel under the final rules – exceeds the relevant de minimis threshold.[1] The non-U.S. person is not required to consider under the final rules the location of its counterparty's operations or personnel (or that of the counterparty's agent) in determining whether the transaction should be considered in its own de minimis calculation.

[1] Under SEC rules, the current de minimis threshold for security-based swap dealer registration is $8 billion in aggregate gross notional amount of dealing activity over the preceding 12 months for credit default swaps and $400 million for all other security-based swaps. These phase-in thresholds are temporary and, in the absence of action by the SEC, are set to drop to $3 billion and $150 million, respectively. The threshold for security-based swaps with special entity counterparties (e.g., governments, certain pension plans, and endowments) is $25 million.

"ARRANGED, NEGOTIATED, OR EXECUTED"

Under interpretive guidance contained in the rule release, a security-based swap transaction is considered to be "arranged, negotiated, or executed" in the United States if it is "market-facing activity." In this context, "arrange" and "negotiate" means market-facing activity of sales or trading personnel in connection with a particular transaction, including interactions with counterparties or their agents.[2] "Execute" refers to the market-facing act that, in connection with a particular transaction, causes the person to become irrevocably bound under the security-based swap under applicable law. "Arranging," "negotiating," and "executing" also includes directing other personnel (including non-U.S.-based personnel) to arrange, negotiate, or execute a particular security-based swap. Personnel directing the arrangement, negotiation, or execution of security-based swaps include personnel located in a U.S. branch or office that specify the trading strategy or techniques carried out through algorithmic trading or automated electronic execution of security-based swaps (although not personnel solely engaged in coding the algorithm), even if the related server is located outside the United States.

The release also clarifies the types of activities that are *not* market-facing with respect to a specific transaction (and thus are not arranging, negotiating, or executing the transaction). These activities include:

- Designing security-based swaps (but not communicating regarding the contract in connection with a specific transaction or executing trades in the contract);
- Preparation of underlying documentation for the transaction, including the negotiation of a master agreement and related documents;
- Performing ministerial or clerical tasks in connection with the transaction (as opposed to negotiating with the counterparty the specific economic terms);
- Collateral management activities (e.g., the exchange of margin payments) that may occur in the United States;
- Submission of security-based swap transactions for clearing in the United States; and
- Reporting security-based swap transactions to U.S. security-based swap data repositories.

Involvement of U.S.-based attorneys in the negotiation of the terms for a transaction also would not, by itself, bring a transaction within "market-facing activity." The final rule also does not require persons engaged in dealing activity to consider the location of personnel booking the transaction because the ministerial task of entering transactions on a non-U.S. person's books once the transaction has been executed does not constitute market-facing activity.

[2] The SEC explains that it uses the term "arrange" rather than "solicit" in recognition of the fact that a security-based swap dealer, by virtue of being commonly known in the trade as a dealer, may respond to requests by counterparties to enter into dealing transactions, in addition to actively seeking out such counterparties.

"LOCATED IN A U.S. BRANCH OR OFFICE"

In addition, the market-facing activity of arranging, negotiating, or executing a transaction must be conducted by personnel "located in a U.S. branch or office" of the non-U.S. person or its agent in order to be counted toward the de minimis threshold. The SEC expects that a non-U.S. person will include in its de minimis calculation any transactions arranged, negotiated, or executed in the United States by personnel assigned to, on an ongoing or temporary basis, or regularly working in a U.S. branch or office. However, the non-U.S. person would not have to include transactions arranged, negotiated, or executed by personnel assigned to a foreign office if such personnel are only "incidentally" in the United States, such as to attend an education or industry conference.

"PERSONNEL"

In a footnote, the SEC states that "personnel" in this context is to be interpreted in a manner consistent with the definition of the term "associated person of a security-based swap dealer" in the Securities Exchange Act of 1934, irrespective of whether the non-U.S. person or its agent is itself a security-based swap dealer. This definition is not dependent upon whether a natural person is technically an "employee" of the non-U.S. person, and the SEC expects to consider whether the non-U.S. entity is able to control or supervise the actions of an individual when determining whether the individual is "personnel" of a U.S. branch or office or an agent of that entity.

TRANSACTIONS THAT ARE EXEMPT OR NOT EXEMPT FROM THE RULES

The final rule exempts from its requirements security-based swaps arranged, negotiated, or executed in the United States by certain international organizations (e.g., multilateral development banks) as defined in SEC rules. The final rule does *not* exempt security-based swaps that are entered into anonymously on an execution facility or national securities exchange and are cleared through a clearing agency if the transaction is arranged, negotiated, or executed in the United States. Such security-based swaps must be counted toward the de minimis total.

ISSUES NOT ADDRESSED BY THE FINAL RULES

The final rule is limited to addressing the calculation of the de minimis threshold by non-U.S. persons of security-based swap dealing activity arranged, negotiated, or executed in the United States. It does not address other issues that were contained in the April 2015 release proposing the rules, including whether external business conduct standards or security-based swap reporting requirements apply to such transactions. The SEC states that these matters will be addressed in subsequent releases.

CFTC APPROACH

The approach taken in the final rules differs from that of the Commodity Futures Trading Commission ("CFTC") in a 2013 staff advisory, in which CFTC staff took the position that, where a swap is between a non-U.S. swap dealer and another non-U.S. person, the CFTC's transaction-level requirements (e.g., mandatory clearing, trade execution, margin for uncleared swaps) would apply to the swap if it is arranged, negotiated, or executed by personnel or agents of the non-U.S. swap dealer located in the United States. However, under the CFTC's rules for determining which swaps count toward a non-U.S. person's de minimis threshold for purposes of swap dealer registration, such swaps do not count toward that threshold. The CFTC requested comment on whether it

should adopt the staff advisory, and through a series of no-action letters the CFTC staff has granted relief until September 30, 2016 (or any prior date of CFTC action) to non-U.S. swap dealers from complying with the advisory. CFTC action with respect to the staff advisory is pending at this time.

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