

May 6, 2015

Extraterritoriality: SEC Proposes Cross-Border Security-Based Swap Rules Regarding US-Based Activity

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

London

Barnabas W.B. Reynolds
+44.20.7655.5528
barney.reynolds@shearman.com

Thomas Donegan
+44.20.7655.5566
thomas.donegan@shearman.com

Bill Murdie
+44.20.7655.5149
bill.murdie@shearman.com

Azad Ali
+44.20.7655.5659
azad.ali@shearman.com

John Adams
+44.20.7655.5740
john.adams@shearman.com

Kolja Stehl
+44.20.7655.5864
kolja.stehl@shearman.com

Aatif Ahmad
+44.20.7655.5120
aatif.ahmad@shearman.com

Singapore

Mak Judge
+65.6230.8901
mak.judge@shearman.com

Americas

Geoffrey B. Goldman
New York
+1.212.848.4867
geoffrey.goldman@shearman.com

On April 29, 2015, the Securities and Exchange Commission (“SEC”) proposed rules that would apply certain aspects of its security-based swap regulations (when they become effective) to transactions involving non-US parties that are arranged or executed using US personnel or agents.

Overview

The proposed rules weigh in on a controversial issue concerning the scope of US regulation—the extent to which US rules apply to transactions that would otherwise be outside of US jurisdiction, but which are effected using US personnel. The SEC’s proposal follows in the wake of, and is similar in certain respects to, an advisory published by the Commodity Futures Trading Commission (“CFTC”) staff (the “CFTC Staff Advisory”).¹ That advisory, which has been the subject of substantial criticism from market participants, took the position that so-called transaction-level requirements should generally apply to a non-US swap dealer effecting a transaction through US personnel or a US agent, even where its counterparty was also a non-US person. The SEC’s proposal would broadly take a similar approach with respect to reporting and business conduct rules, but notably would not impose mandatory clearing or exchange trading requirements on such transactions.

¹ CFTC Staff Advisory No. 13-69 (Nov. 14, 2013). The CFTC subsequently sought public comment on the issues raised by the Advisory, and has delayed implementation of the Advisory until at least September 30, 2015. CFTC No-Action Letter No. 14-140 (Nov. 14, 2014).

Americas (cont.)

Donald N. Lamson
Washington DC
+1.202.508.8130
donald.lamson@shearman.com

Russell D. Sacks
New York
+1.212.848.7585
rsacks@shearman.com

Donna M. Parisi
New York
+1.212.848.7367
dparisi@shearman.com

Bradley K. Sabel
New York
+1.212.848.8410
bsabel@shearman.com

Reena Agrawal Sahni
New York
+1.212.848.7324
reena.sahni@shearman.com

Azam H. Aziz
New York
+1.212.848.8154
aaziz@shearman.com

Jason D. White
New York
+1.212.848.5259
jason.white@shearman.com

Bjorn Bjerke
New York
+1.212.848.4607
bjorn.bjerke@shearman.com

The proposal more generally marks a further evolution in the SEC's position on the extraterritorial effect of its security-based swap regulations. The proposed rules would modify the SEC's existing rules on the cross-border application of the security-based swap dealer registration requirements,² as well as recently adopted Regulation SBSR, in the context of transactions arranged, negotiated or executed by US personnel. The proposed rules also modify and re-propose rules regarding the application of external business conduct rules in that context. The comment period for the proposed rules will be 60 days after publication in the Federal Register.

General Approach to Involvement of US Personnel

The SEC's originally proposed rules on the cross-border application of its security-based swap requirements would have applied US requirements to "transactions conducted within the United States," regardless of the location of the parties.³ The new proposed rules would refine this concept by instead examining whether security-based swap activity is "arranged, negotiated, or executed by personnel located in a US branch or office or in a US branch or office of an agent" (collectively, "US personnel"). Under the SEC's "territorial" approach, engaging in activity in the United States either directly or through an agent, even if the parties are otherwise located outside the United States, justifies the application of US requirements. The SEC states in the proposing release that this approach is consistent with its approach to regulation of securities broker-dealers in the cross-border context, and complies with the extraterritorial limitations on its security-based swap authority under the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The SEC describes "arranging" and "negotiating" as encompassing any "market-facing" activities of sales and trading personnel with respect to security-based swaps, such as negotiation of the specific economic term of a particular transaction. "Executing" refers to the action that causes the party to become legally bound to the transaction. The terms also capture directing other personnel to arrange, negotiate or execute a security-based swap. Based on the proposing release, however, other activities, including designing a swap (without communicating with the counterparty in connection with a particular transaction or executing that transaction), preparing underlying documentation (including negotiation of a master agreement) and performing ministerial or clerical functions (i.e., "back-office" functions) in connection with the transaction, would not constitute arranging, negotiating or executing (and would not themselves trigger application of US requirements).

² Rule 3a71-3; *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).

³ *Cross-Border Security-Based Swap Activities*, 78 Fed. Reg. 30968 (May 23, 2013) (proposing release).

The proposed rules would apply this general approach in several contexts, including the *de minimis* exemption from security-based swap dealer registration, business conduct rules, reporting requirements and clearing and exchange trading requirements.

Registration as a Security-Based Swap Dealer and the De Minimis Exemption

Under its joint rules with the CFTC and its existing cross-border rules,⁴ a non-US person is required to register with the SEC as a security-based swap dealer (“SBSD”) if its security-based swap dealing activity with US counterparties over the past 12 months exceeds the specified notional threshold. Under the new proposed rules, a non-US person would be required to include in its *de minimis* calculation any dealing activity that it arranges, negotiates or executes using US personnel. Notably, only the party that is using US personnel would be required to count the security-based swap toward the *de minimis* threshold; its counterparty (unless it is also using US personnel) would not need to count the trade toward its own *de minimis* threshold.

The proposed rules would also modify the current exclusion in SEC Rule 3a71-5 from the *de minimis* test for transactions entered into anonymously on an execution facility and cleared through a clearing agency. Under the proposed revision, such transactions would count toward the *de minimis* test if arranged, negotiated or executed using US personnel.

Application of the External Business Conduct Requirements

The release re-proposes rules that would subject the “US business” of a registered SBSB to the external business conduct standards under Section 15F(h) of the Exchange Act. The “foreign business” of a registered SBSB would be exempt from the external business conduct standards. As revised, the proposal would define US business as the following:

1. For non-US persons, any transaction entered into or offered to be entered into by or on behalf of the foreign SBSB with a US person (other than a transaction conducted through a foreign branch of that US person), or any transaction arranged, negotiated or executed by personnel of the foreign SBSB, or of its agent, located in a US branch or office.
2. For US persons, any transaction by or on behalf of the US-person SBSB, wherever it occurs, except for transactions conducted through a foreign branch of the US person with a non-US person or with another US person that is itself engaged in a transaction conducted through a foreign branch.

Thus, the proposal would apply the SEC’s external business conduct rules, when they become effective, to transactions of a non-US SBSB that is arranging, negotiating or executing the transaction through US personnel, even with a non-US person counterparty. The result is similar to that under the CFTC Staff Advisory, and follows the SEC’s view expressed in the release that such sales practice activity, when conducted in the United States, is appropriately subject to US requirements.

Reporting Requirements

Additionally, the proposed rules would amend recently adopted Regulation SBSR to provide that a security-based swap would be subject to regulatory reporting and public dissemination requirements if it is connected with a non-US person’s security-based swap dealing activity and is arranged, negotiated or executed by US personnel.

⁴ Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant”, 77 Fed. Reg. 30596 (May 23, 2012); Rule 3a71-3.

Reporting would also be required if the security-based swap is executed on a platform having its principal place of business in the United States or is effected by or through a registered broker-dealer (including a registered security-based swap execution facility), even if neither party to the transaction is a US person.

Furthermore, the proposed amendments to Regulation SBSR would amend the reporting rules to specify which party has the reporting duty for transactions between two non-registered counterparties where one or both parties may be a non-US person.

Clearing and Exchange Trading Requirements

Significantly, the SEC's proposal would not subject a security-based swap between two non-US persons that was arranged, negotiated or executed by US personnel to the mandatory clearing or exchange trading requirement (if otherwise applicable). In this regard, the proposed rules differ from the approach taken in the CFTC Staff Advisory. In taking this position, the SEC noted that the financial risks of such transactions remain with the two non-US parties outside the United States, and stated that such risks were better addressed through other tools, such as margin and capital requirements. The SEC also noted that imposing the clearing and mandatory trading requirements could impose a significant burden on some market participants. The SEC did state that it intends to monitor developments in the area, including changes in liquidity or market fragmentation, that might warrant revision of its proposed approach.

Implications and Further Developments

The SEC's proposed rules, consistent with its other proposals and prior statements, clearly assert jurisdiction over security-based swap transactions between non-US persons that are arranged, negotiated or executed by US personnel. This may raise some of the same concerns expressed by many market participants with respect to the CFTC Staff Advisory. Nonetheless, the SEC's proposal takes a more measured approach to certain issues than the CFTC Staff Advisory. This is particularly so with respect to the mandatory clearing and trading requirements, which would not apply. The proposal also provides useful clarity as to what activities count, or do not count, as arranging, negotiating or executing a transaction. The SEC's approach could mitigate some significant objections that have been raised about having to comply with potentially inconsistent or conflicting clearing or trading requirements. It remains to be seen whether the CFTC will consider a similar approach as it continues to evaluate the issues in the CFTC Staff Advisory.

Links

SEC:

The re-proposed rule and amendments are available at:

<http://www.sec.gov/rules/proposed/2015/34-74834.pdf>.

The SEC media release is available at:

<http://www.sec.gov/news/pressrelease/2015-77.html>.

Chair White Statement available at:

<http://www.sec.gov/news/statement/statement-at-open-meeting-april-29-2015.html>.

Commissioner Aguilar Statement available at:

<http://www.sec.gov/news/statement/improving-transparency-for-executive-pay-practices.html>.

Commissioner Gallagher Dissenting Statement available at:

<http://www.sec.gov/news/statement/dissent-proposing-mandated-pay-versus-performance-disclosures.html>.

Commissioner Stein Statement available at:

<http://www.sec.gov/news/statement/stein-statement-on-proposed-security-based-swaps-dealing.html>.

Commissioner Piwowar Statement available at:

<http://www.sec.gov/news/statement/statement-cross-border-security-based-swap-rules.html>.

CFTC:

CFTC Staff Advisory No. 13-69 is available at available at:

<http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/13-69.pdf>.

CFTC No-Action Letter No. 14-140 is available at available at:

<http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-140.pdf>.

ABU DHABI | BEIJING | BRUSSELS | FRANKFURT | HONG KONG | LONDON | MENLO PARK | MILAN | NEW YORK
PARIS | ROME | SAN FRANCISCO | SÃO PAULO | SHANGHAI | SINGAPORE | TOKYO | TORONTO | WASHINGTON, DC

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

599 LEXINGTON AVENUE | NEW YORK | NY | 10022-6069

Copyright © 2015 Shearman & Sterling LLP. Shearman & Sterling LLP is a limited liability partnership organized under the laws of the State of Delaware, with an affiliated limited liability partnership organized for the practice of law in the United Kingdom and Italy and an affiliated partnership organized for the practice of law in Hong Kong.