

ALERT MEMORANDUM

# Cross-Border Final Rule Adopted: Countdown to the SBSD Registration Compliance Date Begins

December 31, 2019

On December 18, 2019, the Securities and Exchange Commission (“SEC”) adopted supplemental guidance and rule amendments (the “**Final Rule**”)<sup>1</sup> addressing the cross-border application of certain rules regulating security-based swaps (“SBS”) pursuant to Title VII of the Dodd-Frank Act.<sup>2</sup> In particular, the Final Rule includes:

- **“Market Color” Guidance.** Guidance excluding certain “market color” provided by U.S. personnel from triggering Title VII rules applicable to SBS transactions between non-U.S. persons that are arranged, negotiated, or executed by personnel located in a U.S. branch or office of a non-U.S. SBS dealer (“**SBSD**”) or its agent (“**ANE Transactions**”);
- **De Minimis Counting Exception for Certain ANE Transactions.** A conditional exception from the requirement that a non-U.S. SBSD count ANE Transactions towards its *de minimis* registration threshold, premised on the U.S. personnel involved in the ANE Transactions being associated with an SEC-registered SBSD or broker-dealer. The conditional exception is only available if the aggregate gross notional amount of covered inter-dealer SBS positions connected with dealing activity subject to the exception over the course of the immediately preceding 12 months does not exceed \$50 billion. The Final Rule also provides a limited exemption from registration as a broker-dealer for an SBSD and its associated persons (“**APs**”) engaging in the “arranging, negotiating, or executing activity” on behalf of a non-U.S. person availing itself of the *de minimis* counting exception;
- **Guidance on Non-U.S. SBSD Certifications and Legal Opinions; Conditional Registration.** Guidance regarding the requirement that a non-U.S. SBSD, upon registration with the SEC, provide a certification and legal opinion that the SEC can promptly access the SBSD’s books and records and conduct on-site inspections and exams, as well as a conditional registration framework allowing a non-U.S. SBSD to provide the certification and opinion up to 24 months after the initial SBSD registration date (although this framework does not provide relief from corollary requirements that are triggered when parties (other than regulators) apply for substituted compliance); and

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<sup>1</sup> See “Rule Amendments and Guidance Addressing Cross-Border Application of Certain Security-Based Swap Requirements,” Release No. 34-87780; File No. S7-07-19. See also “Proposed Rule Amendments and Guidance Addressing Cross-Border Application of Certain Security-Based Swap Requirements,” Release No. 34-85823; File No. S7-07-19 (the “**Proposal**”).

<sup>2</sup> The SEC also issued a statement regarding compliance with rules for SBS data repositories and Regulation SBSR, which we address in a separate alert memorandum.



- ***Background Check Relief.*** Relief from certain rules requiring background checks for APs, including (a) an exclusion from the statutory disqualification prohibition for non-U.S. APs of an SBSB who do not effect, and are not involved in effecting, SBS transactions with U.S. counterparties, (b) an exception from the requirement that an SBSB make and keep a current questionnaire or application for employment for each AP who effects, or is involved in effecting, SBS transactions on the SBSB's behalf for any AP who is excluded from the statutory disqualification prohibition, and (c) an exception that allows certain information to be excluded in a questionnaire or application for employment for a foreign AP that effects, or is involved in effecting, SBS transactions, unless the SBSB (1) is required to obtain such information under applicable law or (2) obtains such information in conducting a customary background check.

The Final Rule starts the clock on SBSB registration and compliance with related SBSB requirements, for which the compliance date will be 18 months after the later of (1) March 1, 2020 or (2) 60 days following publication of the release for the Final Rule in the Federal Register.

Although the SEC requested comment in the Proposal on the application of Regulation SBSR and SBS business conduct requirements to ANE Transactions, the Final Rule did not address the application of these requirements to ANE Transactions. Especially given concerns that commenters raised in response to those requests for comment, as well as the decision by the Commodity Futures Trading Commission (“CFTC”) in its recent cross-border proposal<sup>3</sup> not to apply Title VII rules on the basis that U.S. personnel are involved in arranging, negotiating, or executing a swap, a fundamental question remains as to whether the SEC needs to apply Title VII rules to ANE Transactions. It accordingly remains possible that the SEC will continue to fine tune its treatment of ANE Transactions.

The following memorandum provides more details regarding the Final Rule.

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<sup>3</sup> See “Cross-Border Application of the Registration Thresholds and Certain Requirements Applicable to Swap Dealers and Major Swap Participants,” RIN 3038-AE84.

## ANE TRANSACTIONS

### (1) Background

- Under the previously adopted SEC rules, ANE Transactions are (1) included in counting towards the thresholds for the *de minimis* exception from the SBSB definition and (2) subject to certain Title VII requirements, such as business conduct standards and reporting requirements. As noted above, the Final Rule does not address the application of business conduct standards and reporting requirements to ANE Transactions.

### (2) “Market Color” Guidance

- The Final Rule provides additional guidance regarding “market color,” which would be defined to include information on pricing or market conditions with respect to a particular instrument or markets more generally and encompass information regarding current and historic pricing, volatility, or market depth and trends or predictions regarding pricing, volatility, or market depth as well as information related to risk management.

The Final Rule does not address activity relating to the “execution” of transactions.<sup>4</sup>

- Under the Final Rule, personnel located in the United States who provide such “market color” will not be considered to be “arranging” or “negotiating” if those U.S. personnel: (1) have not been assigned, and do not otherwise exercise, client responsibility in connection with the transaction and (2) do not receive compensation based on, or otherwise linked to, the completion of individual transactions. The SEC clarified that solely for purposes of this guidance, the SEC does

not view profit-sharing arrangements or other compensation practices that account for aggregated profits as transaction-linked compensation.

- The Final Rule also clarifies activities that will not constitute “market color”:
  - Solicitation activity by personnel located in the United States or activity to respond to requests by counterparties to enter into transactions when such requests are made directly to personnel located in the United States;
  - Providing recommendations, such as recommending particular instruments;
  - Providing predictions regarding potential merits or risks of, or providing trading ideas or strategies relating to, a proposed SBS transaction;
  - Structuring a particular SBS transaction; or
  - Finalizing or reaching agreement with respect to any pricing or non-pricing element, such as underlier, notional amount, or tenor, that must be resolved to complete an SBS transaction.

### (3) *De Minimis* Counting Exception

- The Proposal had set forth two potential alternatives for a conditional exception from counting ANE Transactions towards the *de minimis* threshold<sup>5</sup> for SBSB registration.
- Both alternatives required that, to qualify for the exception, “arranging, negotiating, or executing” activity conducted by the U.S.-located personnel of a non-U.S. entity (or its agent) (the “**Relying Entity**”) be conducted in such personnel’s capacity as an AP of a majority-owned affiliate that is registered with the SEC (the “**Registered**

<sup>4</sup> The SEC previously provided guidance that the term “execute” refers to a market-facing act that, in connection with a particular transaction, causes the person to become irrevocably bound under the relevant SBS transaction under applicable law. See “[SBS] Transactions Connected With a Non-U.S. Person’s Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S.

Branch or Office or in a U.S. Branch or Office of an Agent; [SBSB] *De Minimis* Exception,” 81 Fed. Reg. 8598, 8622 (Feb. 19, 2016).

<sup>5</sup> Such ANE Transactions also would not count towards the *de minimis* thresholds applicable to affiliates under common control.

**Entity**”). The SEC is adopting a modified version of one of the alternatives, which requires that the U.S. personnel at issue be associated with either a registered broker-dealer or a registered SBSB.

The other alternative, which was not adopted, would have only allowed the U.S. personnel to be associated with a registered SBSB in order to qualify for *de minimis* counting exception.

As adopted, the exception will not be satisfied if the “arranging, negotiating, or executing” activity is conducted by a bank that is not registered as a broker due to exceptions from bank brokerage activity in the definition of “broker” in the Securities Exchange Act of 1934 (the “**Exchange Act**”), unless the bank is registered as an SBSB.

- As in the Proposal, the SEC recognizes that the “arranging, negotiating, or executing” activity subject to the exception generally would constitute “broker” activity under the Exchange Act. The SEC thus provides a limited exemption from the broker registration requirement in Section 15(a) of the Exchange Act for “arranging, negotiating, or executing” activity that is conducted in compliance with the *de minimis* counting exception and that is with or for a counterparty that is an eligible contract participant (“**ECF**”).
- In order to avail itself of the exemption, if SEC Rule 10b-10 would apply to the “arranging, negotiating, or executing” activity (*e.g.*, if the SBS counterparty is a “customer” for SEC Rule 10b-10 purposes), the SBSB must provide the customer certain disclosures required by the rule, including disclosures regarding the capacity in which the SBSB is acting and whether the SBSB is a member of the Securities Investor Protection Corporation. However, such disclosures may be provided in accordance with the time and form requirements set forth in the SBSB trade acknowledgment rule, SEC Rule 15Fi-2(b)-(c) (*i.e.*, by T+1), or, alternatively, promptly after

discovery of any defect in the SBSB’s good faith effort to comply with such requirements.

In adopting this limited exemption, the SEC noted that, absent such an exemption, an SBSB approved to use models who serves as the Registered Entity would otherwise be subject to heightened broker-dealer capital requirements if it were required to dually register as a broker-dealer. Such a result would have limited the usefulness of the *de minimis* counting exception. Thus, the limited exemption is designed to avoid that potential outcome.

### ***Compliance with SBSB Requirements***

- The *de minimis* counting exception is conditioned on the Registered Entity’s compliance with the following Title VII requirements applicable to SBSBs as if the Registered Entity were a counterparty to its non-U.S. affiliate’s SBS transactions (and, for a Registered Entity that is a registered broker-dealer that is not registered as an SBSB, as if it were a registered SBSB).
  - **Minimum Capital Requirement.** Although not included as a condition in the Proposal, the Final Rule requires any broker-dealer that serves as the Registered Entity that is not approved to use models to compute deductions for market and credit risk to maintain minimum net capital and establish and maintain risk management control systems as if the broker-dealer were also registered as an SBSB. This would require the broker-dealer to maintain \$20 million in net capital (as opposed, for example, to the requirement to maintain \$250,000 in net capital applicable to broker-dealers that carry customer funds or securities). The SEC noted that it was imposing this requirement in order to reduce the potential for comparative disparities between firms that use a registered broker-dealer for purposes of the exception and those that make use of a registered SBSB. A broker-dealer that is approved to use models

could also serve as the Registered Entity because such a broker-dealer would already need to comply with the even higher minimum net capital requirements and tentative net capital requirements that apply to it.

- **Disclosure of Material Information.**

Consistent with the Proposal, the Registered Entity will be required to provide disclosures to the foreign counterparty regarding the material risks and characteristics of the SBS transaction and any material incentives or conflicts of interest (including those of the Relying Entity) as required under SEC Rule 15Fh-3(b). Further, the SEC clarified that the Registered Entity may delegate to the Relying Entity the tasks of delivering the required disclosures and creating (but not maintaining) books and records relating to those disclosures. However, the Registered Entity will remain responsible for compliance with the disclosure requirements.

The SEC permits these disclosures to be provided on a standardized, relationship-wide basis in many circumstances. Also, unlike the CFTC, the SEC does not require the counterparty to agree in writing to the manner of disclosure, so long as disclosure is provided in a format that is understandable but not unduly burdensome for the counterparty.

- **Suitability.** If the Registered Entity recommends an SBS or trading strategy involving an SBS to a counterparty of the Relying Entity, the Registered Entity will be required to comply with the suitability requirements of SEC Rule 15Fh-3(f), pursuant to which it must:
  - undertake reasonable diligence to understand the potential risks and rewards associated with the recommended SBS or trading strategy involving an SBS; and

- have a reasonable basis to believe that a recommended SBS or trading strategy involving an SBS is suitable for the counterparty, which will require that the Registered Entity obtain relevant information regarding the counterparty, including the counterparty's investment profile, trading objectives, and its ability to absorb potential losses associated with the recommended SBS or trading strategy involving an SBS.

However, the Registered Entity can comply with the second prong by reasonably determining that the counterparty to whom it makes a recommendation is an "institutional counterparty" as defined in SEC Rule 15Fh-3(f)(4) (e.g., a corporation with total assets of at least \$50 million) and by disclosing to the counterparty that the Registered Entity is not undertaking to assess the suitability of the SBS or trading strategy involving an SBS for the counterparty.

This alternative means of complying with the second prong is an improvement from the alternative means that were provided by the Proposal, which would have allowed compliance with the second prong with a counterparty that is an "institutional counterparty" as defined in SEC Rule 15Fh-3(f)(4) by (1) reasonably determining that the institutional counterparty, or agent to which the counterparty has delegated decision-making authority, is capable of independently evaluating investment risks with regard to the relevant SBS or trading strategy involving an SBS; (2) obtaining from the institutional counterparty or its agent affirmative written representations that it is exercising independent judgment in evaluating the recommendations with regard to the SBS or trading strategy involving an SBS; and (3) disclosing that the Registered Entity is acting in its capacity as a counterparty and is not



undertaking to assess the suitability of the SBS or trading strategy involving an SBS.

The Final Rule alleviated the burdens of complying with the second prong in a partial response to comments that the SEC reduce both prongs of the suitability condition to a disclaimer when the Registered Entity does not have primary client responsibility for the counterparty.<sup>6</sup>

- **Fair and Balanced Communications.** Consistent with the Proposal, the Registered Entity will be required to ensure its APs communicate with the counterparties in a fair and balanced manner based on principles of fair dealing and good faith as required under SEC Rule 15Fh-3(g).
- **Trade Acknowledgement and Verification.** Consistent with the Proposal, the Registered Entity will be required to provide the counterparty with a trade acknowledgment and obtain prompt verification thereof pursuant to SEC Rules 15Fi-1 and 15Fi-2. The SEC clarified that the Registered Entity may delegate to the Relying Entity the tasks of delivering the required trade acknowledgment or verification and creating (but not maintaining) books and records relating to that trade acknowledgment and verification. However, the Registered Entity will remain responsible for compliance with the trade acknowledgment and verification requirements.

If the Registered Entity is a registered broker-dealer, it will also be subject to the confirmation requirements for securities transactions under SEC Rule 10b-10 and FINRA Rule 2232, absent

exemptive relief for the inclusion of SBS in the definition of “security” under the Exchange Act.

In response to a comment that requested an exemption from SEC Rule 10b-10 for broker-dealers that serve as the Registered Entity,<sup>7</sup> the SEC adopted a limited exemption from the rule with respect to any “arranging, negotiating, or executing” activity conducted in accordance with the *de minimis* counting exception. To qualify for the exemption, the broker-dealer must (1) comply with the SBS trade acknowledgment and verification requirements and (2) include certain disclosures required by SEC Rule 10b-10, including disclosures regarding the capacity in which the broker-dealer is acting and whether the broker-dealer is a member of the Securities Investor Protection Corporation, either in the trade acknowledgment or verification or in another disclosure. The SEC clarified that such disclosures may be provided to the customer in accordance with the time and form requirements set forth in Rule 15Fi-2(b)-(c) (*i.e.*, by T+1) or, alternatively, promptly after discovery of any defect in the broker-dealer’s good faith effort to comply with such requirements.

- **Portfolio Reconciliation.** Under the Proposal, the Registered Entity would have been required to comply with SBS portfolio reconciliation requirements as if the ANE Transactions were included in the Registered Entity’s SBS portfolio, but only the first time a transaction was reconciled.

In response to comments,<sup>8</sup> the SEC will not require the Registered Entity to comply with SBS portfolio reconciliation requirements as if

<sup>6</sup> Letter from Briget Polichene, CEO, Institute of International Bankers, and Kenneth E. Bentsen, President and CEO, Securities Industry and Financial Markets Association, dated July 23, 2019 (“**IIB/SIFMA Letter**”) at 13.

<sup>7</sup> IIB/SIFMA Letter at 13-14.

<sup>8</sup> IIB/SIFMA Letter at 14; Letter from Scott O’Malia, CEO, International Swaps and Derivatives Association, dated July 23, 2019 (“**ISDA Letter**”) at 8.

the ANE Transactions were included in the Registered Entity's SBS portfolio, noting that "in the context of transactions eligible for the exception, the costs of these requirements likely would [discourage non-U.S. counterparties from having the interactions with U.S. personnel that could trigger the condition]." <sup>9</sup>

Relatedly, in finalizing its uncleared SBS risk mitigation techniques rule, <sup>10</sup> the SEC limited the coverage of portfolio reconciliations to terms that are relevant to the ongoing rights and obligations of the parties and the valuation of the SBS. In contrast, the proposed risk mitigation rules, <sup>11</sup> which the Proposal had cross-referenced, included a separate definition for material terms with respect to the initial portfolio reconciliation to capture each term of an SBS that is required to be reported to a registered swap data repository or the SEC pursuant to Regulation SBSR without limitation.

- None of the above as-if conditions may be satisfied by substituted compliance or otherwise by compliance with home-country requirements of the Relying Entity.
- The exception is not conditioned on compliance with ECP verification requirements or "know your counterparty" requirements, although other SEC requirements will generally prevent trading with non-ECPs. <sup>12</sup> Additionally, Registered Entities will not be required to comply with certain risk mitigation rules (such as trading relationship documentation or portfolio compression requirements) or to provide foreign counterparties with disclosure on clearing rights or daily marks.

However, all ANE Transactions will still be subject to the anti-fraud provisions of the federal securities laws.

### *Additional Disclosures*

- The exception is conditioned on the Registered Entity notifying the SBS counterparty that the Relying Entity is not registered with the SEC as an SBSD and therefore certain SBS regulations would not apply to the ANE Transaction, including those affording clearing rights to counterparties. <sup>13</sup>
- These disclosures must be made by the Registered Entity concurrently with (and in the same manner as) the "arranging, negotiating, or executing" activity. However, during a period in which a counterparty is neither a customer (as defined in SEC Rule 15c3-3) of the Registered Entity nor a counterparty to an SBS with the Registered Entity, the disclosure only needs to be provided contemporaneously with, and in the same manner as, the first "arranging, negotiating, or executing" activity. Consequently, the Final Rule would require the Registered Entity to resume providing the notice contemporaneously with, and in the same manner as, each "arranging, negotiating, or executing" activity at issue if the counterparty later becomes a customer of the Registered Entity or a counterparty to an SBS with the Registered Entity.

In the Proposal, the SEC had required such disclosures to be made contemporaneously with the "arranging, negotiating, or executing" activity under *all* circumstances. Citing the difficulty of making and documenting the notice contemporaneously with every counterparty

<sup>9</sup> Final Rule at 66.

<sup>10</sup> "Risk Mitigation Techniques for Uncleared [SBS]," Release No. 34-87782; File No. S7-28-18.

<sup>11</sup> "Risk Mitigation Techniques for Uncleared [SBS]," 84 Fed. Reg. 4614, 4671-72 (Feb. 15, 2019).

<sup>12</sup> The Securities Act of 1933 prohibits offers and sales of SBS to persons who are not ECPs unless a registration statement is in effect as to the SBS. See 15 U.S.C. § 77e(e). The Exchange Act further prohibits any person from

effecting an SBS transaction with or for a person that is not an ECP, unless such transaction is effected on a registered national securities exchange. See 15 U.S.C. § 78f(l).

<sup>13</sup> This disclosure requirement would not apply in circumstances where the Registered Entity does not know the identity of the counterparty at a reasonably sufficient time prior to the execution of the relevant ANE Transaction.

contact, two commenters argued that, if the SEC adopts this condition, the Registered Entity should be able to make the required notice one time to cover the entire relationship with the counterparty.<sup>14</sup> The Final Rule thus modified the disclosure timing as described above.

### ***Limit on Use of Exception for Covered Inter-Dealer SBS***

- Under the Final Rule, the *de minimis* counting exception is only available to a Relying Entity if the aggregate gross notional amount of covered inter-dealer SBS positions connected with dealing activity subject to the exception over the course of the immediately preceding 12 months does not exceed \$50 billion.
- Covered inter-dealer SBS are those that are between the Relying Entity and a non-U.S. person that is either: (1) a Registered Entity that has filed with the SEC a notice that its AP may conduct “arranging, negotiating, or executing” activity pursuant to the exception or (2) an affiliate of such a Registered Entity. The Final Rule provides that if a Relying Entity executes an SBS with a counterparty that, at the time of execution, the Relying Entity reasonably believes is not an affiliate of another firm’s Registered Entity, the Relying Entity need not later re-characterize the SBS as a covered inter-dealer SBS, even if it later discovers that its counterparty is an affiliate of another firm’s Registered Entity.

The preamble to the Final Rule notes that it would be reasonable for financial groups to produce and share a single list of their affiliates for use in connection with this \$50 billion limit and in connection with determining eligibility for the \$50 million initial margin threshold for uncleared SBS.<sup>15</sup>

- A Relying Entity will need to count toward this \$50 billion threshold two types of covered inter-dealer SBS swaps: (1) the covered inter-dealer SBS positions connected with the Relying Entity’s dealing activity subject to the exception and (2) the covered inter-dealer SBS positions connected with dealing activity subject to the exception engaged in by non-U.S. person affiliates of the Relying Entity. However, the Relying Entity does not need to count positions of a non-U.S. person affiliate that is in the process of registering with the SEC as an SBSD or is not subject to regulation as an SBSD for a transitional period after it has breached a *de minimis* threshold, nor transactions that are not eligible for the exception (or for which reliance on the exception is not sought, such as inter-affiliate SBS).
- If a Relying Entity exceeds the \$50 billion limit, as of the date such limit is breached, (1) the Relying Entity may not rely on the exception for any future SBS and (2) the Relying Entity will have to begin to count against the *de minimis* thresholds all covered inter-dealer SBS positions connected with dealing activity subject to the exception in which the entity or certain affiliates engaged over the course of the immediately preceding twelve months. As a result, the Relying Entity will generally need to register as an SBSD no later than two months after the end of the month it exceeds the \$50 billion limit.

### ***SEC Access to Books and Records***

- The SEC largely adopts the access to books and records requirements from the Proposal, with certain modifications. Like foreign broker-dealers relying on SEC Rule 15a-6(a)(3) for an exemption from registration as a broker-dealer, the non-U.S. SBSD relying on this *de minimis* counting exception must, upon request, (1) promptly provide the SEC with any information or documents within its possession, custody, or control; (2) promptly make its foreign APs<sup>16</sup>

<sup>14</sup> IIB/SIFMA Letter at 14-15; ISDA Letter at 9.

<sup>15</sup> Final Rule at 49.

<sup>16</sup> A Foreign AP means a natural person domiciled outside of the United States who, with respect to a non-U.S. person



available for testimony; and (3) provide any requested assistance in taking the evidence of other persons, wherever located.

If the non-U.S. SBSB was, after exercising its best efforts, prohibited by applicable foreign law or regulation from providing such information, documents, testimony, or assistance, then it could continue to rely on the exception until and unless the SEC issued an order modifying or withdrawing the “listed jurisdiction” determination discussed below.

- The exception is also conditioned on the Registered Entity creating (or obtaining from its non-U.S. SBSB affiliate, as applicable) and maintaining: (1) all required books and records relating to the ANE Transactions subject to the *de minimis* counting exception; (2) documentation regarding the Relying Entity’s compliance with the \$50 billion limit for covered inter-dealer SBS; (3) all trading relationship documentation with respect to the ANE Transactions; and (4) written consent to service of process for any civil action brought by or proceeding before the SEC. With respect to prongs (2)-(4), the SEC is also adopting certain record retention requirements in order to ensure that the Registered Entity is able to make relevant records available to the SEC as needed.

#### **Regulation in a “Listed Jurisdiction”**

- Consistent with the Proposal, as a condition to the *de minimis* counting exception, the Relying Entity must be subject to the margin and capital requirements of a “listed jurisdiction,” which includes any jurisdiction designated as such by SEC order. These designations may be conditional or unconditional.

relying on the *de minimis* counting exception, is a partner, officer, director, or branch manager of such non-U.S. person (or any person occupying a similar status or performing similar functions), any person directly or indirectly

- Similar to requests for substituted compliance, both foreign regulators and parties seeking to rely on the exception may submit an application for a potential “listed jurisdiction” to the SEC. In considering whether a foreign jurisdiction should be a “listed jurisdiction,” the SEC may consider factors relevant for purposes of assessing whether such a determination would be in the public interest, including:

- applicable margin and capital requirements of the foreign financial regulatory system; and
- the effectiveness of the foreign regime’s supervisory compliance program and enforcement authority.

- As an initial matter, “listed jurisdictions” include Australia, Canada, France, Germany, Japan, Singapore, Switzerland, and the United Kingdom.

Despite comments urging the SEC to designate all G-20 jurisdictions as “listed jurisdictions,”<sup>17</sup> the SEC declined to do so, noting that the implementation of margin and capital requirements, as well as supervision and enforcement of them, varies significantly across G-20 jurisdictions. In addition, although the Proposal noted that Hong Kong may be included as a “listed jurisdiction,” the SEC did not designate Hong Kong as such at this time.

- The SEC may, by order, after notice and opportunity for comment, modify or withdraw a jurisdiction’s status as a “listed jurisdiction.” Such modification or withdrawal may be based on the above criteria or on any law or regulation that prevents the SEC’s prompt access to documents and information, ability to obtain foreign APs’ testimony, or ability to obtain assistance in taking the evidence of other persons.

controlling, controlled by, or under common control with such non-U.S. person, or any employee of such non-U.S. person.

<sup>17</sup> IIB/SIFMA Letter at 15.

**CERTIFICATION AND OPINION GUIDANCE****(1) Background**

- The SEC previously adopted rules requiring a non-U.S. SBSD to certify and provide a legal opinion relating to the SEC’s ability to promptly access the SBSD’s books and records directly and to conduct on-site inspections and examinations.

**(2) Guidance**

- The Final Rule clarifies: (1) what laws are covered by the certification and opinion; (2) what records are covered by the certification and opinion; (3) the treatment of open contracts; (4) the relevance of counterparty or employee consents; and (5) the relevance of approvals by foreign regulators or their agreements with the SEC.

***Covered Foreign Laws***

- The Final Rule requires a non-U.S. SBSD to obtain a certification and opinion of counsel with respect to the laws where such SBSD maintains its “covered books and records” (as defined below).
- Further, if the non-U.S. SBSD maintains copies of the required records in multiple jurisdictions, it may elect to provide a certification and opinion of counsel with respect to laws of a single jurisdiction where the necessary access can be supported.

Under the Proposal, if the non-U.S. SBSD maintains its covered books and records in a different jurisdiction than the jurisdiction of incorporation or principal place business, then the non-U.S. SBSD would have needed to ensure that its jurisdiction of incorporation or principal place of business would not impose limitations on the SBSD opening its covered books and records to the SEC or allowing the SEC to conduct onsite examinations. However, in response to comments expressing concern

regarding the difficulty or costs associated with such a negative assurance,<sup>18</sup> it is not required by the Final Rule.

***Covered Books and Records***

- The Final Rule defines “**covered books and records**” to be:
  - books and records relating to the “U.S. business” (as defined in SEC Rule 3a71-3(a)(8)) of the non-U.S. SBSD, *i.e.*, records relating to SBS with U.S. persons (other than SBS conducted through foreign branches of such U.S. persons) and ANE Transactions; and
  - financial records necessary for the SEC to assess the non-U.S. SBSD’s compliance with the SEC’s margin and capital requirements, if applicable.

In response to comments,<sup>19</sup> the SEC further clarified in the Final Rule that the certification and opinion of counsel need not cover any books and records that are held in the United States, either directly or indirectly by an AP of the non-U.S. SBSD or third party. On the other hand, the SEC did not accept a comment<sup>20</sup> to exclude from the definition of covered books and records the financial records of a non-U.S. SBSD that is relying on substituted compliance with respect to the SEC’s margin and capital requirements.

Like the Proposal, the Final Rule does not provide details on what specific types of records would be captured as relating to an SBSD’s U.S. business. However, to the extent such records could encompass personal identifying information of individuals, an SBSD’s local

<sup>18</sup> Letter from Wim Mijs, CEO, European Banking Federation, dated July 23, 2019 (“**EBF Letter**”) at 3-4; IIB/SIFMA Letter at 20-21; ISDA Letter at 11.

<sup>19</sup> EBF Letter at 3; IIB/SIFMA Letter at 22; ISDA Letter at 12.

<sup>20</sup> IIB/SIFMA Letter at 22.

privacy and other laws may prohibit direct access or on-site inspection by the SEC.

### ***Relevance of Open Contracts***

- Consistent with the guidance in the Proposal, the SEC confirms in the Final Rule that the requisite certification and opinion of counsel will not need to address books and records for SBS transactions entered into prior to the date the non-U.S. SBSB submits an application for registration.
- However, open contracts will remain subject to recordkeeping requirements.

### ***Relevance of Consents***

- Consistent with the Proposal, if the non-U.S. SBSB is required to obtain the prior consent of the persons whose information is or will be included in covered books and records in order to provide the SEC with direct access to its covered books and records, including allowing on-site inspections and examinations of such covered books and records, the certification and opinion of counsel can be predicated on any such required consents.
- The SEC clarifies in the Final Rule that when an SBSB is relying on consents in providing the requisite certification and opinion of counsel, the SBSB should obtain consents in a time and manner consistent with the representations made in the certification and opinion of counsel.
- The SEC further provides that the withdrawal of consent by a counterparty should not affect the validity of transactions entered into when the counterparty's consent was in force or necessarily require amendment of an SBSB's certification and opinion of counsel.

### ***Relevance of Memoranda of Understanding ("MOU") with Foreign Regulators***

- The certification and opinion of counsel can rely on a foreign regulatory authority's approval or arrangement with the SEC (e.g., an MOU) that provides the SEC with adequate assurances of (1) prompt access to the books and records of the

non-U.S. SBSB and (2) the ability of the non-U.S. SBSB to submit to onsite inspection or examination by the SEC.

The guidance contained in the Proposal provided that such foreign regulatory authority's approval or arrangement with the SEC facilitate direct access to the books and records of the non-U.S. SBSB in order for the certification and opinion of counsel to be able to take such approval or arrangement into account. The Final Rule changes the reference from "direct" to "prompt," which is a subtle yet helpful modification.

- The Final Rule further provides that the certification and opinion of counsel may also take into account an applicant's understanding of the general experience with the foreign jurisdiction's application of the relevant local law or rule as well as an SEC determination granting substituted compliance to a jurisdiction in which the non-U.S. SBSB maintains its covered books and records.

### **(3) Conditional Registration During a 24-Month Transition Period**

- The Final Rule allows a non-U.S. SBSB that is unable to provide a certification and opinion of counsel to register conditionally for up to 24 months. Such a non-U.S. SBSB shall provide a conditional certification and opinion of counsel that identifies and is conditioned upon the occurrence of a future action that would provide the SEC with adequate assurances of prompt access to the books and records of the non-U.S. SBSB and such non-U.S. SBSB's ability to submit to onsite inspection and examination by the SEC.
- Such future action could include:
  - the entry by the SEC and the relevant foreign financial regulatory authority into an MOU, agreement, protocol, or other regulatory arrangement providing the SEC with adequate assurances of (1) prompt access to the non-U.S.

SBSD's books and records and (2) the ability of the non-U.S. SBSD to submit to onsite inspection and examination by the SEC;

- the issuance of an order by the SEC granting substituted compliance in accordance with SEC Rule 3a71-6 based on adequate assurances by the relevant foreign financial authority; or
- any other action that would provide the SEC with assurances regarding prompt access to books and records and the ability to conduct onsite inspection and examination of the non-U.S. SBSD.

This aspect of the Final Rule is intended to provide time for foreign regulators to grant requisite approvals or enter into the requisite arrangements with the SEC. If a non-U.S. SBSD cannot provide the certification or opinion after 24 months, the SEC could institute proceedings to determine whether ongoing registration should be denied.

As a practical matter, it is unclear whether this conditional registration is relevant because a non-U.S. SBSD would likely not register without receiving a substituted compliance determination for the relevant jurisdiction. Substituted compliance applications in turn must include a certification and opinion of counsel or adequate assurances (as described below) relating to the SEC's ability to promptly access the SBSD's books and records directly and to conduct on-site inspections and examinations, and a substituted compliance determination is a "future action" that would make a previously conditional registration unconditional. Thus, query whether following a substituted compliance determination based on such adequate assurances, a non-U.S. SBSD could just provide a certification and opinion of counsel that is based on those assurances (and

therefore not need to rely on conditional registration).

#### (4) Substituted Compliance Applications

- SEC Rule 3a71-6 requires that an application for a substituted compliance determination by a party other than a foreign regulatory authority must be accompanied by the above described certification and opinion of counsel, without the conditional relief described above. As in the Proposal, the SEC notes in the Final Rule that it welcomes such applications prior to the submission of a certification and opinion of counsel; however, such applications would not be considered complete until a certification and opinion are filed.
- The SEC also continues to believe that the guidance outlined above regarding the scope and content of the certification and opinion of counsel requirement also should be relevant to any certification and opinion of counsel provided in connection with a substituted compliance request.

Despite comments that the SEC received noting that it should no longer need a certification and opinion of counsel in the context of substituted compliance requests given that (1) the SEC permits delay in the delivery of the certification and counsel of opinion in connection with SBSD registration,<sup>21</sup> (2) requiring delivery of the certification and counsel of opinion in the context of substituted compliance requests only serves to prevent the SEC from having to consider substituted compliance requests from a jurisdiction with legal barriers that prevent access to an SBSD's books and records,<sup>22</sup> and (3) issues that warrant delaying delivery of the certification and opinion of counsel required in connection with SBSD registration would also impede delivery in connection with substituted compliance requests,<sup>23</sup> the SEC continues to require that the certification and opinion of

<sup>21</sup> EBF Letter at 5-6.

<sup>22</sup> IIB/SIFMA Letter at 25.

<sup>23</sup> ISDA Letter at 14-15.

counsel be submitted in connection with substituted compliance requests.

This approach effectively requires substituted compliance applications with respect to jurisdictions with privacy laws that limit or prohibit firms from providing books and records access to the SEC to come from foreign regulators even if firms in those jurisdictions were to move their covered books and records outside of such jurisdictions.

- The SEC also noted that it aims to complete consideration of timely submitted substituted compliance requests in advance of the SBSB registration compliance date. In addition, should the SEC determine that it requires additional time to complete consideration of a substituted compliance application, appropriate relief tailored to specific circumstances could be considered.

Although the SEC continues to require certification and opinion of counsel to be submitted in connected with substituted compliance determinations, the SEC's statement in the Final Rule that it will consider relief tailored to specific circumstances should it not be able to consider timely submitted substituted compliance requests in advance of the SBSB registration seems to be an indication of the SEC's willingness to address challenges faced by market participants in submitting substituted compliance requests complete with the requisite certification and opinion of counsel or adequate assurances by the relevant foreign financial authority sufficiently in advance of the SBSB registration compliance date.

<sup>24</sup> Section 3(a)(39) defines the circumstances under which a person would become subject to a statutory disqualification with respect to membership or participation in, or

## **STATUTORY DISQUALIFICATION RELIEF**

### **(1) Background**

- SEC Rule 15Fb6-2 requires (1) an SBSB to certify that it neither knows, nor in the exercise of reasonable care should have known, that any of its APs who effect or are involved in effecting SBS transactions on behalf of the SBSB are statutorily disqualified and (2) the chief compliance officer (“CCO”) of an SBSB (or his or her designee) to review and sign employment questionnaires or applications, which are to serve as the basis for a background check.
- The SEC's Rule of Practice 194 establishes a process by which an SBSB may seek an exemption from the prohibition against APs subject to a statutory disqualification.

### **(2) Relief for Certain Non-U.S. APs**

- Consistent with the Proposal, the Final Rule amends Rule of Practice 194 to provide an exclusion for an AP of an SBSB subject to a statutory disqualification who is a natural person who (1) is not a U.S. person and (2) does not effect and is not involved in effecting SBS transactions with or for U.S. counterparties, other than through a foreign branch of such U.S. counterparties.
- The exclusion does not apply to an AP of an SBSB that is subject to an order described in subparagraphs (A) and (B) of Section 3(a)(39) of the Exchange Act,<sup>24</sup> with the limitation that an order by a foreign financial regulatory authority described in subparagraphs (B)(i) and (B)(iii) shall only apply to orders by a foreign financial regulatory authority in the jurisdiction where the AP is employed or located.

In the Final Rule, the SEC notes that an AP does not include persons performing solely clerical or ministerial functions, and clarifies that such an exclusion would apply to middle- or back-office

association with a member of, a self-regulatory organization. *See* 15 U.S.C. § 78c(a)(39).



APs of SBSDs solely performing such functions.

In declining to further narrow the scope of non-U.S. persons subject to these statutory disqualification requirements to include only non-U.S. front-office APs who solicit or accept SBS with U.S. persons or who supervise such persons,<sup>25</sup> the SEC noted that such modifications would result in competitive disparities between U.S. and non-U.S. statutorily disqualified persons in middle- and back-office functions.

### (3) **Recordkeeping Relief**

- With respect to the requirement that an SBSBD make and keep a current questionnaire or application for employment for each AP who effects, or is involved in effecting, SBS transactions on the SBSBD's behalf, the Final Rule adds an exception for any AP who is excluded from the statutory disqualification prohibition
- Certain information does not need to be included in a questionnaire or application for employment for a foreign AP that effects, or is involved in effecting, SBS transactions with both U.S. and foreign counterparties, unless the SBSBD (1) is required to obtain such information under applicable law in the jurisdiction in which the AP is employed or located or (2) obtains such information in conducting a background check that is customary for such firms in that jurisdiction, and the creation or maintenance of records reflecting that information would not violate the law of the jurisdiction in which such person is located or employed.

With respect to the second exemption, the SEC notes that the SBSBD must still have sufficient comfort that an AP is not subject to a statutory disqualification in every instance in which an

AP is not subject to an exclusion from such statutory disqualification requirement. The SEC also notes that background checks conducted using procedures that are either legally required or customary in the relevant non-U.S. jurisdictions would constitute due diligence on which an SBSBD's CCO (or his or her designee) could rely, in the absence of red flags that are in the SBSBD's possession, when signing the AP certification required by SEC Rule 15Fb6-2. In a footnote in the Final Rule, the SEC notes that such designee need not report directly to the CCO and instead could be a person in the SBSBD's human resources department or other, similar department.<sup>26</sup>

## **EFFECTIVE DATE AND COMPLIANCE DATES**

### (1) **Effective Date of the Final Rule**

- The Final Rule will be effective on the later of (1) March 1, 2020 or (2) 60 days following publication of the release in the Federal Register (the "**Effective Date**").

### (2) **Compliance Dates**

- The compliance date for SBSBD registration will be 18 months after the Effective Date (the "**Registration Compliance Date**"). Persons are not required to begin calculating whether their activities meet or exceed the registration thresholds until two months prior to the Registration Compliance Date. Therefore, the compliance date for the amendments to SEC Rule 3a71-3 (addressing cross-border SBS dealing activity) will be the same as the Registration Compliance Date.
- The compliance date for the amendments to SEC Rule 0-13 (addressing procedures to request substituted compliance) and Rule of Practice 194 (discussed above) will be the same as the Effective Date.

<sup>25</sup> EBF Letter at 6; IIB/SIFMA Letter at 5, 30; ISDA Letter at 3, 16.

<sup>26</sup> Final Rule at 130, n. 396.

- The compliance date will also be the Registration Compliance Date for rules addressing: (1) SBSD segregation requirements and nonbank SBSD capital and market requirements; (2) SBSD recordkeeping and reporting requirements; (3) SBSD business conduct standards; (4) SBSD trade acknowledgment and verification requirements; and (5) requirements related to SBSD risk mitigation techniques.

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