



SEC Issues Business Conduct Rules for Security-Based Swap Entities

In an important step in the ongoing regulation of the market for security-based swaps (both individually and in the plural, “SBS”), last month the Securities and Exchange Commission (“SEC”) issued its final business conduct rules (the “SEC Conduct Rules”) for security-based swap dealers (each, an “SBSD”) and major security-based swap participants (each, an “MSBSP”).¹ This Client Alert highlights the most significant features of those rules.

The SEC Conduct Rules are generally (though not entirely) consistent with certain of the business conduct rules that the Commodity Futures Trading Commission (“CFTC”) finalized for the swaps market in 2012.² For that reason, the substance of the SEC Conduct Rules should be generally familiar to many dealers and other market participants. Moreover, it should be possible for the industry to facilitate compliance with the SEC Conduct Rules, to the extent that those rules address dealings with counterparties, by means similar³ to the protocol by which the industry facilitated compliance with corresponding CFTC external business conduct rules.⁴

While the SEC Conduct Rules largely overlap with the CFTC external business conduct rules, they also include provisions similar to certain CFTC internal business conduct rules (with respect to, for example, supervisory requirements and the requirement that SBSDs designate a chief compliance officer). Further, unlike the CFTC’s business conduct rules, which are subject to the CFTC cross-border guidance that applies generally to the CFTC’s

¹ Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, Release No. 34-77617, File No. S7-25-11 (April 14, 2016) (the “Business Conduct Release”), available [here](#).

² See Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. 9733 (Feb. 17, 2012); Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants, 77 Fed. Reg. 20127 (April 3, 2012). Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) gives the CFTC jurisdiction over “swaps,” “swap dealers” and “major swap participants” and the SEC jurisdiction over “security-based swaps,” “security-based swap dealers” and “major security-based swap participants.”

³ The SEC Conduct Rules provide that an SBSBD or MSBSP may rely on written representations of its counterparties to satisfy its due diligence requirements “unless it has information that would cause a reasonable person to question the accuracy of the representation.” SEC Conduct Rules at Rule 15Fh-1(b). However, the SEC expressly rejected a “commenter’s suggestion that we provide that in every instance an SBS Entity that is also registered with the CFTC as a Swap Entity will be permitted to rely on a counterparty’s pre-existing written representations with respect to the CFTC’s business conduct rules to satisfy its due diligence requirements under the [SEC Conduct Rules], provided that the SBS Entity provides notice of such reliance to the counterparty and the counterparty does not object... The question of whether reliance on the representations that had been obtained with respect to the CFTC business conduct rules, including the process by which the SBS Entity makes that determination, would satisfy an SBS Entity’s obligations under our business conduct rules will depend on the facts and circumstances of the particular matter.” Business Conduct Release at 69-70. See generally Business Conduct Release at 62-70.

⁴ See ISDA August 2012 DF Protocol, available at <https://www2.isda.org/functional-areas/protocol-management/protocol/8>.

swaps rules,⁵ the SEC Conduct Rules expressly state the circumstances in which they may or may not apply to cross-border transactions.

The compliance date of the SEC Conduct Rules remains some time away, in no case earlier than the compliance date of the SEC's rules requiring SBSDs and MSBSPs to register with the SEC.⁶

Background

The Dodd-Frank Act reflects the concern that dealers might not in all cases obtain sufficient information regarding their counterparties, disclose material information to their counterparties or communicate with their counterparties in a balanced manner in relation to derivatives. It requires the SEC to adopt business conduct requirements for SBSDs and MSBSPs ("SEC Swap Entities") and the CFTC to adopt business conduct requirements for swap dealers and major swap participants ("CFTC Swap Entities" and collectively with SEC Swap Entities, "Swap Entities"). Such business conduct standards must, among other things, require Swap Entities to (i) verify that any counterparty constitutes an eligible contract participant ("ECP"), (ii) disclose to any counterparty (other than another Swap Entity) material information regarding a particular transaction and (iii) communicate in a fair and balanced manner based on principles of fair dealing and good faith.⁷

Primary Provisions of SEC Conduct Rules

The primary provisions contained in the SEC Conduct Rules can be summarized as follows.

Verification of ECP and Special Entity Status

An SEC Swap Entity must, unless the relevant SBS is executed on a registered national securities exchange, verify that its counterparty constitutes an ECP⁸ before entering into such SBS with such counterparty.⁹

In addition, an SEC Swap Entity must, if it knows the identity of the counterparty at a reasonably sufficient time prior to execution of the transaction, verify whether such counterparty constitutes a "Special Entity" (a category that includes certain types of public entities, endowments and employee benefit plans)¹⁰ before entering into an SBS with that counterparty.¹¹

⁵ See Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45291, 45369 App. E (July 26, 2013).

⁶ See Business Conduct Release at 502-503. The compliance date for the SEC registration rules (and thus the SEC Conduct Rules) will occur only after the occurrence of several events that, taken together, have not yet occurred, cannot occur for a minimum of six months, and seem relatively unlikely to occur until after significantly more than six months have passed. For further detail regarding the compliance date of the SEC's rules requiring SBSDs and MSBSPs to register with the SEC, see our client alert on the SEC registration rules, available [here](#).

⁷ See Dodd-Frank Act at Sections 731, 764(a).

⁸ See SEC Conduct Rules at Rule 15Fh-2(b) for the ECP definition.

⁹ *Id.* at Rule 15Fh-3(a)(1).

¹⁰ See *id.* at Rule 15Fh-2(d) for the full definition of "Special Entity."

¹¹ *Id.* at Rule 15Fh-3(a)(2).

Disclosures to Counterparties

If an SEC Swap Entity knows the identity of its counterparty prior to the execution of an SBS, and if such counterparty is not a Swap Entity, then the SEC Swap Entity must, at a reasonably sufficient time prior to entering into such SBS, make disclosures to such counterparty.¹²

The SEC Swap Entity must disclose to such counterparty information in a manner reasonably designed to allow the counterparty to assess the material risks and characteristics of the relevant SBS. Such “material risks and characteristics” may include, with respect to a particular SBS, (i) market, credit, liquidity, foreign currency, legal, operational, and any other applicable risks, and (ii) the material economic terms of the SBS, the terms relating to the operation of the SBS, and the rights and obligations of the parties during the term of the SBS.¹³

The SEC Swap Entity must similarly disclose to its counterparty information in a manner reasonably designed to allow the counterparty to assess any material incentives or conflicts of interest that the SEC Swap Entity may have in connection with the relevant SBS. Such “material incentives or conflicts of interest” may include any material incentives or conflicts of interest that the SEC Swap Entity may have in connection with the relevant SBS, including any compensation or other incentives from any source other than the counterparty in connection with the relevant SBS.¹⁴

Daily Marks

An SEC Swap Entity must disclose an SBS’ daily mark to a counterparty that is not a Swap Entity. For an uncleared SBS, on each business day during the term of an SBS, the SEC Swap Entity must provide a daily mark equal to the midpoint between the bid and offer, or the calculated equivalent thereof, as of the close of business, unless the parties agree in writing otherwise to a different time. For a cleared SBS, upon the request of the counterparty, the SEC Swap Entity must provide the daily mark that the SEC Swap Entity receives from the relevant clearing agency.¹⁵

Disclosure of Clearing Rights

A SEC Swap Entity must disclose information relating to the potential clearing of an SBS to a counterparty that is not a Swap Entity, so long as the SEC Swap Entity knows the identity of the counterparty at a reasonably sufficient time prior to execution of the SBS.¹⁶

Before entering into an SBS that is subject to mandatory clearing, an SEC Swap Entity must (i) disclose to the counterparty the names of the clearing agencies that accept the SBS for clearing, and through which of those clearing agencies the SEC Swap Entity is authorized or permitted to clear the SBS, and (ii) notify the counterparty that it shall have the sole right to select which applicable clearing agencies shall be used to clear the relevant SBS.¹⁷

Before entering into an SBS that is not subject to mandatory clearing, an SEC Swap Entity must (i) determine whether the SBS is accepted for clearing by one or more clearing agencies, (ii) disclose to the counterparty the

¹² *Id.* at Rule 15Fh-3(b).

¹³ *Id.* at Rule 15Fh-3(b)(1).

¹⁴ *Id.* at Rule 15Fh-3(b)(2).

¹⁵ *Id.* at Rule 15Fh-3(c).

¹⁶ *Id.* at Rule 15Fh-3(d).

¹⁷ *Id.* at Rule 15Fh-3(d)(1).

names of the clearing agencies that accept the SBS for clearing, and whether the SEC Swap Entity is authorized or permitted to clear the SBS through such clearing agencies and (iii) notify the counterparty that the counterparty may elect to require clearing of the SBS and will have the sole right to select the clearing agency at which the SBS will be cleared, provided it is a clearing agency at which the SEC Swap Entity is authorized or permitted to clear the SBS.¹⁸

Know Your Counterparty Requirements

Each SBSB must establish, maintain and enforce written policies and procedures reasonably designed to obtain and retain a record of the essential facts concerning each counterparty whose identity is known to the SBSB that are necessary for conducting business with such counterparty. Such essential facts concerning a counterparty include (i) facts required to comply with applicable laws, regulations and rules, (ii) facts required to implement the SBSB's credit and operational risk management policies in connection with transactions entered into with such counterparty and (iii) information regarding the authority of any person acting for such counterparty.¹⁹

Recommendations of Security-Based Swaps or Trading Strategies

An SBSB that recommends an SBS or a trading strategy involving an SBS to a counterparty that is not a Swap Entity must (i) undertake reasonable diligence to understand the potential risks and rewards associated with the recommended SBS or trading strategy and (ii) have a reasonable basis to believe that a recommended SBS or trading strategy is suitable for the counterparty. To establish a reasonable basis for a recommendation, an SBSB must have or 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.²⁰

In many but not all cases, an SBSB will also be able to establish a reasonable basis for a recommendation based in part on representations provided by the counterparty or an agent to which the counterparty has delegated decision-making authority.²¹

Fair and Balanced Communications

An SEC Swap Entity must communicate with counterparties in a fair and balanced manner based on principles of fair dealing and good faith. In particular, communications must provide a sound basis for evaluating the facts with regard to any particular SBS or trading strategy involving an SBS.²²

¹⁸ *Id.* at Rule 15Fh-3(d)(2).

¹⁹ *Id.* at Rule 15Fh-3(e).

²⁰ *Id.* at Rule 15Fh-3(f)(1).

²¹ *Id.* at Rule 15Fh-3(f)(2), (4). Such rules permit SBSBs to satisfy the "reasonable basis" requirement in part by means of representations given by or on behalf of "institutional counterparties," which must, among other things, have total assets of at least \$50 million. For counterparties with less than \$50 million in assets, SBSBs will likely be required to conduct substantial due diligence to establish a reasonable basis for a recommendation. The parallel CFTC external business conduct rule regarding recommendations contains no such asset threshold determining when dealers may rely upon counterparty representations as to suitability. *See* 17 CFR 23.434.

²² *Id.* at Rule 15Fh-3(g).

Antifraud Provisions

The SEC Conduct Rules make it unlawful for an SEC Swap Entity to (i) engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative, (ii) employ any device or scheme to defraud any Special Entity or prospective customer that is a Special Entity or (iii) engage in any transaction, practice, or course of business that operates as a fraud or deceit on any Special Entity or prospective customer that is a Special Entity.²³

Requirements for SBSs Acting as Advisors to Special Entities

An SBS acting as an advisor to a Special Entity has a duty to make a reasonable determination that any SBS or trading strategy involving an SBS recommended by the SBS is in the best interests of the Special Entity.²⁴ Such an SBS must make reasonable efforts to obtain such information that the SBS considers necessary to make a reasonable determination that an SBS or such a trading strategy is in the best interests of the Special Entity, including, among other things, information as to (i) the authority of the Special Entity to enter into the SBS, (ii) the financial status of the Special Entity, as well as future funding needs, (iii) the tax status of the Special Entity, (iv) the hedging, investment, financing or other objectives of the Special Entity and (v) the experience of the Special Entity with respect to entering into SBS generally and SBS of the type and complexity being recommended.²⁵

Such requirements do not apply if the relevant transaction is executed on an SBS execution facility or registered national securities exchange and the SBS does not know the identity of the counterparty at a reasonably sufficient time prior to execution of the transaction.²⁶

Duties for SEC Swap Entities Acting as Counterparties to Special Entities

An SEC Swap Entity that enters into an SBS with a Special Entity must have a reasonable basis to believe that the Special Entity has either a qualified independent representative or a fiduciary under the Employee Retirement Income Security Act of 1974, 29 U.S.C. 1002 (“ERISA”).²⁷

In order to constitute a qualified independent representative, a representative must, among other things, (i) have a duty to act in the best interests of the Special Entity, (ii) have sufficient knowledge to evaluate the transaction and related risks, (iii) evaluate the fair pricing and the appropriateness of the SBS and (iv) be independent of the relevant SEC Swap Entity.²⁸

The SEC Conduct Rules provide a safe harbor under which the SEC Swap Entity, based on representations or information provided to it, is deemed to have a reasonable basis to believe that a Special Entity has a qualified independent representative or ERISA fiduciary.²⁹

²³ *Id.* at Rule 15Fh-4(a).

²⁴ *Id.* at Rule 15Fh-4(b)(1).

²⁵ *Id.* at Rule 15Fh-4(b)(2).

²⁶ *Id.* at Rule 15Fh-4(b)(3).

²⁷ *Id.* at Rule 15Fh-5(a).

²⁸ *Id.* at Rule 15Fh-5(a)(1).

²⁹ *Id.* at Rule 15Fh-5(b). The requirements of Rule 15Fh-5 do not apply if the relevant transaction is executed on an SBS execution facility or registered national securities exchange and the SEC Swap Entity does not know the identity of the counterparty at a reasonably sufficient time prior to execution of the transaction.

Political Contributions

The SEC Conduct Rules limit the circumstances in which an SBSB may enter into, or offer to enter into, an SBS, or a trading strategy involving an SBS, with a municipal entity. Subject to certain exceptions, the SEC Conduct Rules generally make such transactions unlawful within two years after an SBSB, or any “covered associate” of an SBSB, makes any contribution to an official of such municipal entity.³⁰ For these purposes, the term “covered associate” includes, among other things, (i) any general partner, managing member or executive officer and (ii) any employee who solicits a municipal entity to enter into an SBS with the SBSB and any person who directly or indirectly supervises such employee.³¹

Supervision

An SEC Swap Entity must establish and maintain a system to supervise (and must diligently supervise) its business and the activities of its associated persons. Its system must be reasonably designed to prevent violations of the provisions of applicable federal securities laws and related rules and regulations relating to its business as an SEC Swap Entity.³²

Such a system must, at a minimum, include (i) the designation of at least one person with authority to carry out the supervisory responsibilities of the SEC Swap Entity for each type of business in which it engages for which registration with the SEC is required, (ii) the use of reasonable efforts to determine that all supervisors are qualified to carry out their assigned responsibilities and (iii) the establishment, maintenance and enforcement of written policies and procedures for the supervision of the types of SBS business in which the SEC Swap Entity is engaged and the activities of its associated persons that are reasonably designed to prevent violations of applicable federal securities laws and related rules and regulations.³³

Chief Compliance Officer and Annual Compliance Reports

Similar to the CFTC’s rules, an SEC Swap Entity must designate an individual to serve as its chief compliance officer (“CCO”). The CCO must report directly to the board of directors or to the senior officer of the SEC Swap Entity and take reasonable steps to ensure that the SEC Swap Entity establishes, maintains and reviews written policies and procedures reasonably designed to achieve compliance with the portions of the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*) and related rules and regulations relating to the entity’s business as an SEC Swap Entity.³⁴

The CCO must, among other things, administer each required policy and procedure, and annually prepare and sign a detailed compliance report that contains a description of the relevant written policies and procedures of the SEC Swap Entity. The compliance report must also describe the SEC Swap Entity’s assessment of the effectiveness of its policies and procedures relating to its business as an SEC Swap Entity and any material non-compliance matters identified. The annual report must be submitted to the board of directors and audit

³⁰ *Id.* at Rule 15Fh-6(b).

³¹ *Id.* at Rule 15Fh-6(a)(2).

³² *Id.* at Rule 15Fh-3(h)(1).

³³ *Id.* at Rule 15Fh-3(h)(2). The SEC rule regarding the supervisory system is substantially more prescriptive than is the CFTC’s parallel rule. Compare SEC Conduct Rules at 15Fh-3(h)(2) and 17 CFR 23.602. The SEC supervision rule is generally based on current FINRA standards and would likely not be especially burdensome for SBSBs that are registered broker-dealers. See generally Business Conduct Release at 182-97. However, for non-broker-dealer SBSBs, the SEC rule could present implementation challenges.

³⁴ SEC Conduct Rules at Rule 15Fk-1(a), (b).

committee (or equivalent bodies), to the senior officer of the SEC Swap Entity and to the SEC itself. The compliance report must include a certification by the chief compliance officer or senior officer that, to the best of his or her knowledge and reasonable belief and under penalty of law, the information contained in the compliance report is accurate and complete in all material respects.³⁵

Cross-border Application of SEC Conduct Rules

For registered SBSDs, the SEC Conduct Rules will generally not apply to “foreign business.”³⁶ For SBSDs that are U.S. persons,³⁷ “foreign business” is effectively defined as an SBS that is conducted through such SBSD’s foreign branch with either (i) a non-U.S. person or (ii) a U.S.-person counterparty acting through a foreign branch. For SBSDs that are not U.S. persons, “foreign business” is effectively defined as an SBS transaction that is not (i) with a U.S. person (other than a transaction conducted through a foreign branch of that person) or (ii) arranged, negotiated, or executed by personnel of the foreign SBSD swap dealer (or its agent) located in a U.S. branch or office.³⁸

The SEC Conduct Rules also state the circumstances in which the SEC may make substituted compliance determinations, to the effect that compliance with particular requirements under a foreign financial regulatory system may satisfy the corresponding requirements under the SEC Conduct Rules. In order to make such a determination, the SEC must, among other things, determine that the relevant foreign requirements are comparable to its own otherwise applicable requirements and enter into a memorandum of understanding or other arrangement with the relevant foreign financial regulatory authority.³⁹

Conclusion

With the finalization of the SEC Conduct Rules, the number of rulemakings that the SEC must complete before implementing its SBS regulatory regime continues to diminish. There are still significant hurdles – for example, it seems likely that the SEC will re-propose its margin rules for SEC Swap Entities before finalizing them.⁴⁰ But while the timing for compliance remains uncertain, it is clear that the SEC’s progress on its rulemakings is bringing the compliance date for the regulation of SBS steadily nearer. A registration and compliance date for SEC Swap Entities occurring in 2017 seems ever more likely.

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³⁵ *Id.* at Rule 15Fk-1(b), (c).

³⁶ *Id.* at Rule 3a71-3(c).

³⁷ The SEC has defined “U.S. person” in previous final rules. *See* Application of “Security-Based Swap Dealer” and “Major Security-Based Swap Participant” Definitions to Cross-Border Security-Based Swap Activities, 79 Fed. Reg. 47277, 47371 (August 12, 2014).

³⁸ SEC Conduct Rules at Rule 3a71-3(a)(8), (9).

³⁹ *Id.* at Rule 3a71-6(a).

⁴⁰ The SEC originally proposed those rules in 2012, before the Basel Committee on Banking Supervision and the International Organization of Securities Commissions jointly published a final framework establishing consistent global standards for margin requirements. *See* Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, 77 Fed. Reg. 70213 (Nov. 23, 2012).

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