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THE SEC'S LONG-AWAITED SECURITY-BASED SWAPS RULES MAY BE APPROACHING

The SEC has proposed all of its major Title VII rules regulating the security-based swaps market. The authors discuss the current status of this and related rulemakings, the relief the SEC has granted, and the provisions of the rules. They then turn to the timeline for implementation in view of the new administration, preparation for required registration of security-based swap entities, and business conduct standards for registered entities. At each point, they compare the SEC's approach with that of the CFTC.

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Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") generally requires regulation of the swaps market as the Congressional response to the financial crisis of 2008.¹ Title VII splits regulation of the swaps market between the Commodity Futures Trading Commission and the Securities and Exchange Commission. While the CFTC has finalized and requires compliance with most of its rules under Title VII, very few of the SEC's rules currently require compliance, although the SEC has proposed all of its major Title VII rules and has finalized a growing number of them. With that trend toward finalization, required compliance with many of the SEC's rules, long awaited by market participants, may

be approaching. Although the recent change in administration and a new Congress have delayed the finalization trend, compliance may not be significantly slowed or altered.

In this article, we will examine the current status of SEC rulemakings under Title VII and the attendant relief that the SEC has granted, discuss the timing for registration of dealers and participants that will be subject to SEC jurisdiction when many of the SEC's rules will go "live," assess the impact of the change in administration and Congress on that timeline, which could result in dealer registration and compliance with certain other rules in February 2018, and point out some considerations in preparing for registration, including addressing requirements of the business conduct rules.

¹ Title VII of Pub. L. No. 111-203, 124 Stat. 1376 (2010).

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BACKGROUND

Under Title VII of the Dodd-Frank Act, the CFTC has jurisdiction over “swaps” and intermediaries that transact swaps, known as “swap dealers” and “major swap participants,” while the SEC has jurisdiction over “security-based swaps” and intermediaries that transact security-based swaps, known as “security-based swap dealers” and “major security-based swap participants.”² Swaps subject to CFTC regulation generally include swaps on interest rates, foreign currencies, commodities, and broad-based security indices. Security-based swaps overseen by the SEC include swaps on a single security or loan, a narrow-based security index, and certain events related to a single issuer of a security or issuers of securities in a narrow-based security index.³ The CFTC and SEC may jointly promulgate rules regarding “mixed swaps,” which are security-based swaps that also have a swap component. Regulation of the swaps markets, as divided between the two agencies, is substantively similar under Title VII, although many details are left to the agencies to address in their regulations.

The swaps market subject to CFTC regulation is much larger than the security-based swaps market regulated by the SEC. Generally, it is estimated that the CFTC regulates approximately 90 percent of the overall swaps market (in notional terms), while the SEC regulates about 10 percent of the market in the form of security-based swaps. As a consequence, it is expected

that there will be fewer security-based swap dealers than there are swap dealers. Currently, there are 104 swap dealers registered with the CFTC,⁴ while the SEC estimates in its final registration rules for security-based swap dealers and major security-based swap participants that there will be approximately 50 registered security-based swap dealers when registration is required.⁵ Nonetheless, the security-based swaps market, which includes single-name credit default swaps, is an important market segment from a regulatory perspective, as credit default swaps, then largely unregulated, were a catalyst of the 2008 financial crisis.⁶

CURRENT STATUS OF SEC TITLE VII RULEMAKINGS

Title VII of the Dodd-Frank Act requires the SEC to promulgate a number of rules to regulate the security-based swaps market, which the SEC has been in the process of completing since the law’s enactment. While developing and implementing its rules with respect to security-based swaps, the SEC has granted security-based swap market participants relief from certain Dodd-Frank Act requirements in several forms, which we will first discuss below. We will then look at the SEC’s rulemaking approach under Title VII. In general, the SEC has taken a slower, more deliberate approach to rulemaking than the CFTC, with an orderly sequencing of dependencies that focus compliance on when

² Definitions of these terms are contained in Section 1a of the Commodity Exchange Act (“CEA”) and Section 3(a) of the Securities Exchange Act of 1934 (“Exchange Act”).

³ The term “narrow-based security-index” is defined in Section 1a(35) of the CEA and Section 3(a)(55)(B) of the Exchange Act. The CFTC and SEC issued joint rules and guidance regarding narrow-based security indices in the context of derivatives in their rulemaking further defining the terms swap and security-based swap. See Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping; Final Rule, 77 Fed. Reg. 48,207 (Aug. 13, 2012).

⁴ The list of provisionally registered swap dealers is on the CFTC’s website, available at <http://www.cftc.gov/LawRegulation/DoddFrankAct/registerswapdealer>.

⁵ Registration Process for Security-Based Swap Dealers and Major Security-Based Swap Participants, Rel. No. 34-75611 at 131-32 (Aug. 5, 2015) (“Registration Release”). The SEC estimates that five entities will register as major security-based swap participants. Only two entities provisionally registered with the CFTC as major swap participants. Both entities are pending withdrawal from registration according to the website of the National Futures Association, available at: <http://www.nfa.futures.org/NFA-swaps-information/regulatory-info-sd-and-msp/SD-MSP-registry.HTML>.

⁶ Financial Crisis Inquiry Commission, Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States (2011).

security-based swap dealer and major security-based swap participant registration is required.⁷

SEC Relief Measures for Security-Based Swaps

The SEC has provided several relief measures to security-based swap market participants during its development and consideration of its Title VII rules. For example, it granted a *general exemptive order* in recognition of its well-sequenced, holistic approach to Title VII implementation (discussed further below).⁸ This order ensures that market participants are not required to prematurely comply with particular final rules upon their effectiveness as an administrative law matter while other necessary regulations or parts of the new market structure for security-based swaps are not yet in effect. Relief is aimed at particular requirements and generally expires upon the compliance date for the related rule.⁹

The SEC has also adopted several instances of *temporary* and *permanent relief* from compliance with self-executing Title VII provisions. Most notably, the

SEC adopted Interim Final Rules¹⁰ in response to foreseeable consequences from Title VII's broad amendment to the Federal securities laws to expand the definition of the term "security" to include security-based swaps.¹¹ These statutory changes became effective on July 16, 2011.¹²

Many securities laws are transactional in nature and apply to "purchases" and "sales" of "securities," or offers to "purchase" or "sell" a security, as these are key moments when investment decisions are made. The typical securities purchase or sale is effected by payment against delivery within a settlement period of a few trading days. Security-based swap transactions, however, have a different paradigm. They are usually executory contracts for an extended term and have bilateral obligations. They can also, depending on the agreement of the parties in a particular transaction, be subject to a number of life cycle events that are uncommon for traditional securities. In recognition of this, the Dodd-Frank Act broadened the definitions of "purchase" and "sale" to include the execution, early termination, assignment, exchange, or similar transfer of a security-based swap, as well as the extinguishment of rights thereunder.¹³

Because these changes were self-executing upon the effectiveness of the Dodd-Frank Act, considerable uncertainty and disruption would have resulted from full application of the Securities Act of 1933 ("Securities Act"), Exchange Act, and TIA to security-based swap transactions and their various life cycle events prior to such time as the SEC had developed the comprehensive regulatory regime for security-based swaps that was also required by Title VII of the Dodd-Frank Act. The SEC also recognized that the quality of its eventual Title VII rulemakings might be enhanced if it had more time to increase its understanding of the security-based swaps market. Consequently, the SEC adopted Interim Final Rules to address these concerns. These rules effectively

⁷ The general framework was first outlined by the SEC in a June 14, 2012 policy statement, Statement of General Policy on the Sequencing of the Compliance Dates for Final Rules Applicable to Security-Based Swaps Adopted Pursuant to the Securities Exchange Act of 1934 and the Dodd-Frank Wall Street Reform and Consumer Protection Act, Rel. No. 34-67177 (Jun. 11, 2012).

⁸ Order Pursuant to Sections 15F(b)(6) and 36 of the Securities Exchange Act of 1934 Granting Temporary Exemptions and Other Temporary Relief, Together With Information on Compliance Dates for New Provisions of the Securities Exchange Act of 1934 Applicable to Security-based Swaps, and Request for Comment, Rel. No. 34-64678 (June 15, 2011).

⁹ The Order, among other things, (i) delays the reporting of pre-enactment security-based swaps until six months after a security-based swap data repository has been registered with the SEC; (ii) exempts trading platforms for security-based swaps that are required to be security-based swap execution facilities from this requirement until final registration rules are effective; (iii) exempts compliance with prohibitions with respect to statutorily disqualified persons until the effectiveness of registration rules for security-based swap dealers and major security-based swap participants; (iv) exempts registered clearing agencies from the obligation to appoint a chief compliance officer until a compliance date has been established by the SEC; and (v) exempts security-based swap dealers and major security-based swap participants from initial margin segregation requirements until the effectiveness of registration rules for such entities.

¹⁰ Exemptions for Security-Based Swaps, Rel. No. 33-9231 (July 1, 2011) ("Interim Final Rules").

¹¹ Section 768 of the Dodd-Frank Act (definition of the term "security" under Section 2(a)(1) of the Securities Act) and Section 761 of the Dodd-Frank Act (the same term under the Exchange Act). The definition of the term "security" under the Trust Indenture Act of 1939 (the "TIA"), uses the Securities Act definition. The Dodd-Frank Act did not change the definition of the term "security" under the Investment Company Act of 1940.

¹² Section 774 of the Dodd-Frank Act.

¹³ Section 2(a)(18) of the Securities Act.

maintain the status quo. For example, Rule 240 under the Securities Act exempts individually negotiated security-based swap transactions that are between two Eligible Contract Participants (“ECPs”)¹⁴ from the registration requirements and other provisions (except for anti-fraud provisions) of the Securities Act.¹⁵ SEC Rules 12a-11 and 12h-1(i) under the Exchange Act exempt security-based swap transactions from the Exchange Act’s registration requirements to the extent that a security-based swap is offered or sold in reliance on Rule 240. SEC Rule 4d-12 under the TIA similarly exempts a security-based swap from the TIA to the extent that it is offered or sold in reliance on Rule 240.¹⁶ These rules after a series of extensions were set to expire on February 11, 2017, but on February 10, the SEC provided a one-year extension until February 11, 2018.¹⁷

¹⁴ An ECP, which is defined in Section 1a(18) of the CEA, generally is an entity, such as a financial institution, broker-dealer, insurance company, investment company, or commodity pool, that is classified as an ECP based on its regulated status, or a corporation, partnership, proprietorship, organization, trust, or other entity that is classified as an ECP based on its assets (e.g., total assets exceeding \$10 million or net worth exceeding \$1 million and use of derivatives for hedging purposes). ECPs also include individuals who invest certain amounts on a discretionary basis. This classification permits these entities and individuals to engage in specific transactions including bilateral over-the-counter security-based swap trades not directly available to non-ECPs (i.e., retail customers).

¹⁵ Section 768 of the Dodd-Frank Act amended Section 5 of the Securities Act to provide that the offer to sell or buy, and the purchase or sale of, a security-based swap, to or from a non-ECP is unlawful unless made through an effective registration statement under the Securities Act, without availability of the exemptions under Sections 3 (exempt securities) and 4 (exempt transactions) of the Securities Act. The SEC’s exemptive power is thus limited to such transactions by ECPs.

¹⁶ The purpose of the TIA is to protect the interests of bondholders pursuant to public debt offerings; its application to security-based swaps, which are bilateral contracts between ECPs that are capable of enforcing their rights, would not further TIA policy goals or afford counterparties additional meaningful protections.

¹⁷ Exemptions for Security-Based Swaps, Rel. No. 33-10305 (Feb. 10, 2017). In this Release the SEC said that it is still considering a 2014 rule proposal that would allow dissemination of price quotes (otherwise arguably an “offer” or a “solicitation of an offer”) on a non-restricted basis (including to non-ECPs) with respect to security-based swaps that may be purchased only by ECPs and are traded or processed through national securities exchanges. and security-based swap execution facilities. Treatment of Certain Communications

Practitioners hope that the SEC will make these changes permanent to the extent that the same concerns are not directly addressed in the SEC’s final Title VII rules.¹⁸

Additionally, the SEC adopted an Exchange Act *temporary exemptive order* that provides broad relief from application of Exchange Act provisions and related regulations to security-based swaps between certain ECPs due to the expanded scope of the definition of the term “security” (other than the registration requirement that was addressed in the Interim Final Rule).¹⁹ This order also included temporary exemptions that are specific to security-based swaps activities of registered broker-dealers.²⁰

Security-based swap market participants, through The Securities Industry and Financial Markets Association (“SIFMA”) and the International Swaps and Derivatives Association (“ISDA”), have asked the SEC to grant permanent relief under the Exchange Act.²¹ The industry associations generally prefer a comprehensive approach, as opposed to more targeted requests for exemptions and interpretive or other relief. They

footnote continued from previous column...

Involving Security-Based Swaps That May Be Purchased Only By Eligible Contract Participants, Rel. No. 33-9643 (Sep. 8, 2014).

¹⁸ The Financial Institutions Regulatory Authority (“FINRA”), the self-regulatory organization for U.S. broker-dealers, has also adopted and extended temporary relief from application of most of its rules to security-based swaps until February 12, 2018.

¹⁹ Order Granting Temporary Exemptions under the Securities Exchange Act of 1934 in Connection with the Pending Revision of the Definition of “Security” to Encompass Security-Based Swaps, and Request for Comment, Rel. No. 34-64795 (July 1, 2011).

²⁰ Additionally, the SEC adopted one permanent exemption (other than anti-fraud provisions) for security-based swap transactions between ECPs that are centrally cleared through SEC-registered security-based swap clearing agencies. This was necessary because the novation model used by the major U.S. central clearinghouses results in the creation of a new transaction by the clearing agency as “issuer,” and thus the “offer” and “sale” of a new “security” that would otherwise be subject to mandatory, but unworkable, requirements under the Securities Act, Exchange Act and TIA. Exemptions for Security-Based Swaps Issued By Certain Clearing Agencies, Rel. No. 33-9308 (Mar. 30, 2012).

²¹ Security-Based Swaps as Securities: Request for Permanent Exemptions, *available at* <https://www.sec.gov/comments/s7-27-11/s72711-10.pdf>.

reviewed the Exchange Act provisions and related rules in detail and considered their potential application to security-based swaps. Based on this analysis, they bucketed the pre-Dodd-Frank Act provisions in three categories: those that (i) based on their policy purpose, should fully apply to security-based swaps (in some cases with minor modification); (ii) due to their specific applicability to traditional securities, appear unworkable or inapplicable to security-based swaps; and (iii) might apply with some modification, but are unnecessary due to overlap (notably, for broker-dealers that may register with the SEC as security-based swap dealers and would want to follow the more specific security-based swap rules). These efforts are likely to be renewed in 2017 as more SEC security-based swap rules go live.

SEC and CFTC Implementation of Title VII

The CFTC and SEC approaches to Dodd-Frank Act implementation have been markedly different, with the SEC taking a much slower, more deliberate approach to its implementation of Title VII than the CFTC approach.

With the CFTC's new authority over products representing 90 percent or more of the overall market for over-the-counter derivatives, its response was characterized by aggressive timing. While some requirements were logically phased-in over time, the focus on speed while the CFTC was still learning some of the specificity of the over-the-counter market meant that some substantive requirements proved to be ill-fitted and some timing requirements became unachievable. Additionally, the OTC derivatives business is one of the most intensely global businesses in existence. Other important jurisdictions, most notably the European Union, were also implementing the Pittsburgh G-20 Summit commitments.²² Due to political, institutional, market, and other differences, the pace of reform was slower outside the United States. The CFTC was often in the position of a first-mover, without finalized (or in some cases, even proposed) comparable rules in other important markets that could be taken into account as appropriate. These factors in combination meant that when on-the-ground implementation issues arose with respect to final CFTC rules, the CFTC's only practical response was to address them by interpretations, guidance, advisories, and temporary no-action letters. This was a very iterative approach, often requiring multiple refinements or extensions. It is hoped that

where these solutions have proved to be durable and the industry has adapted to them fully that they will be made permanent or incorporated into revised rulemakings.

The SEC, regulating a much smaller segment of the overall market and also having to respond to a number of important Dodd-Frank Act mandates outside of Title VII, took a more deliberate approach. This allowed it to take account of the CFTC experience, either learning from the CFTC's growing pains, or in some cases (see below with respect to documentation and business conduct standards) crafting rulemakings that in some ways paralleled or were generally compatible with the corresponding CFTC regulations. The latter narrows the scope of additional build-outs by market participants, especially dually-registered swap dealers and security-based swap dealers. Greater commonality should logically enhance the quality of compliance by dual registrants. Additionally, because this approach and pace generally did not front-run corresponding developments in other important jurisdictions, the SEC was perceived by its foreign counterparts as less aggressive and unilateral.

Six years after Dodd-Frank's enactment, the SEC has proposed all of its major Title VII rules. The SEC website recently listed 21 finalized rulemakings and eight proposed rulemakings.²³ Of the finalized rulemakings, many have delayed compliance dates. These dates reflect both an orderly sequencing of dependencies and infrastructures, as well as paramount roles to be played by security-based swap dealers in the new regulatory landscape. Thus, the timeline for required compliance under many of the finalized rules is triggered by the finalization of the registration rules for security-based swap dealers and the related registration deadline, which we discuss in the next section.

SECURITY-BASED SWAP ENTITY REGISTRATION

The compliance date for registration of security-based swap dealers and major security-based swap participants (collectively, "Security-Based Swap Entities") under the SEC's rules generally is dependent on the finalization of four other rules governing Security-Based Swap Entities' activities, of which the SEC has finalized one and proposed three others.

Timing for Registration Compliance

Specifically, the registration compliance date will be the *latest of*:

²² In September 2009, leaders of the G-20 group of nations met in Pittsburgh and issued a statement that made commitments for reforms in OTC derivatives markets. <https://www.oecd.org/g20/summits/pittsburgh>.

²³ Implementing Dodd-Frank, <https://www.sec.gov/spotlight/implementation-of-dodd-frank-act.shtml>.

1. six months after the date of publication in the Federal Register of a final rule release adopting rules establishing capital, margin, and segregation requirements for Security-Based Swap Entities;
2. the compliance date for final rules establishing recordkeeping and reporting requirements for Security-Based Swap Entities;
3. the compliance date for final rules establishing business conduct requirements under Exchange Act Sections 15F(h) and 15F(k); or
4. the compliance date for final rules establishing a process for registered Security-Based Swap Entities to apply to the SEC for approval for an associated person subject to statutory disqualification to effect or become involved in effecting security-based swaps on the entity's behalf.²⁴

The SEC has finalized its rules establishing business conduct requirements (i.e., the third rule listed above), but the other three rules, while proposed, have not yet been finalized. We discuss each of these rules in turn below.

Capital, Margin, and Segregation Rules

The SEC issued a proposed rule in October 2012 outlining capital and margin requirements for Security-Based Swap Entities, as well as segregation requirements for security-based swap dealers and notification requirements with respect to segregation for Security-Based Swap Entities.²⁵ Subsequent to the proposal of these rules, an international consensus around the policy framework for uncleared swaps margin was developed by the Basel Committee on Banking Supervision ("BCBS") and Board of the International Organization of Securities Commissions ("IOSCO").²⁶ This framework was later revised in March 2015,²⁷ which served to delay the beginning of

the phase-in process for implementing uncleared swaps margin requirements. In response, the CFTC re-proposed its rules, originally proposed in 2011, on uncleared swaps margin requirements after consideration of the BCBS/IOSCO framework,²⁸ and a jointly issued proposal from the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency (collectively, the "Prudential Regulators") was released, amending prior proposed rules to comport with the framework.²⁹ Both the CFTC and Prudential Regulators have finalized their uncleared swaps margin rules.³⁰

The SEC to date has not finalized its 2012 proposed rules or issued re-proposed rules. Notably, in December 2016 the CFTC re-proposed its capital rules for swap dealers and major swap participants and in its release cross-referenced the SEC's proposed rules from 2012.³¹ Since the Dodd-Frank Act requires the CFTC and SEC (as well as the Prudential Regulators) to consult with each other periodically (and no less frequently than annually) on capital and margin for dealers and major

²⁴ Registration Release, *supra* n.5, at 92.

²⁵ Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Rel. No. 34-68071 (Oct. 18, 2012).

²⁶ BCBS-IOSCO, Margin Requirements for Non-Centrally Cleared Derivatives, *available at* <http://www.bis.org/publ/bcbs261.pdf>.

²⁷ BCBS-IOSCO, Margin Requirements for Non-Centrally Cleared Derivatives, *available at* <http://www.bis.org/bcbs/publ/d317.pdf>.

²⁸ Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. 59,898 (Oct. 3, 2014).

²⁹ Margin and Capital Requirements for Covered Swap Entities; Proposed Rule, 79 Fed. Reg. 57,347 (Sept. 24, 2014). The Prudential Regulators set capital and margin requirements for swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants subject to their supervision (e.g., banks). The CFTC sets capital and margin requirements for swap dealers and major swap participants for which there is no Prudential Regulator (including non-bank subsidiaries of a bank holding company), while the SEC sets capital and margin for Security-Based Swap Entities for which there is no Prudential Regulator. Section 4s(e) of the CEA.

³⁰ Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants; Final Rule, 81 Fed. Reg. 635 (Jan. 6, 2016) (CFTC's final rules); Margin and Capital Requirements for Covered Swap Entities; Final Rule, 80 Fed. Reg. 74,839 (Nov. 30, 2015) (Prudential Regulators' final rules). *See also* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants—Cross-Border Application of the Margin Requirements, 81 Fed. Reg. 34,817 (May 31, 2016) (CFTC's final rules).

³¹ Capital Requirements of Swap Dealers and Major Swap Participants, 81 Fed. Reg. 91,252 (Dec. 16, 2016).

participants,³² this cross-referencing may reflect communication between the CFTC and SEC and may suggest that the SEC intends to issue final capital, margin, and segregation rules and not re-propose them, which could delay implementation.

Recordkeeping and Reporting

The SEC issued in 2014 proposed recordkeeping and reporting rules for Security-Based Swap Entities and broker-dealers.³³ If adopted, the proposed rules will satisfy Section 15F(g) of the Exchange Act, mandating that the SEC must enforce the Security-Based Swap Entities' maintenance of daily trading records, including related e-mail, instant message, and telephone correspondence. The proposed rules would require extensive recordkeeping by broker-dealers that engage in these regulated transactions and require broker-dealers to provide timely financial disclosure of relevant material information confirming the security-based swap.³⁴ The SEC has not finalized these rules and the proposal did not include a tentative compliance date.

Business Conduct Standards

In April 2016, the SEC finalized its rules for business conduct standards for Security-Based Swap Entities.³⁵ The substantive requirements of these rules and relevant comparisons with rules promulgated by the CFTC are discussed in greater detail below. Since the SEC believes that the conduct rules should not apply until dealers and participants are required to register, the final conduct rules establish as their compliance date the compliance date for the registration rules.³⁶

Process for Persons Subject to Statutory Disqualification

The SEC proposed a new rule of practice, Rule 15Fb6-1 under the Exchange Act, in August 2015, creating a process for Security-Based Swap Entities to

apply to the SEC for permission to continue to have certain persons otherwise subject to statutory disqualifications involved in effecting their security-based swap transactions if such continuation is consistent with the public interest.³⁷ In this regard, Section 15F(b)(6) of the Exchange Act makes it unlawful for a Security-Based Swap Entity to permit an associated person who is subject to a statutory disqualification to effect or be involved in effecting security-based swaps on behalf of the Security-Based Swap Entity if the Security-Based Swap Entity knew, or in the exercise of reasonable care should have known, of the statutory disqualification, except to the extent otherwise specifically provided by a rule, regulation, or order of the SEC.

The proposed rule permits a natural or non-natural person who is statutorily disqualified under Exchange Act Sections 3(a)(39)(A) through (F) to effect or be involved in effecting security-based swaps on behalf of a Security-Based Swap Entity, provided that the disqualification occurred prior to the compliance date of the rule and that the entity identifies each such associated person in a schedule provided to the SEC.³⁸ The SEC has not finalized Rule 15Fb6-1 or proposed a compliance date.

Other Rules Dependent upon Registration Compliance

SEC rules governing documentation standards and security-based swap data reporting and public dissemination, while not themselves one of the four dependencies for the compliance date for security-based swap registration discussed above, are nonetheless linked to the Security-Based Swap Entities' registration compliance date. Both of these rules have been finalized.

Documentation Standards

On June 8, 2016, the SEC finalized rules relating to trade acknowledgment and verification of security-based

³² Section 4s(e)(3)(D) of the CEA.

³³ Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers; Capital Rule for Certain Security-Based Swap Dealers, Rel. No. 34-71958 (Apr. 17, 2014).

³⁴ *Id.*

³⁵ Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, Rel. No. 34-77617 (Apr. 14, 2016) ("Business Conduct Standards Release").

³⁶ *Id.*

³⁷ Applications by Security-Based Swap Dealers or Major Security-Based Swap Participants for Statutorily Disqualified Associated Persons to Effect or Be Involved in Effecting Security-Based Swaps, Rel. No. 34-75612 (Aug. 5, 2015) ("Statutory Disqualification Release").

³⁸ *Id.* As proposed, the SEC rules diverge from those of the CFTC applicable to statutory disqualifications for associated persons of swap dealers, which only apply to natural persons (and not non-natural persons). 17 CFR 1.3(aa). However, the SEC requested comment on whether it should adopt the CFTC's approach.

swap transactions.³⁹ The rules provide documentation standards for the timely and accurate acknowledgment and verification of security-based swaps by Security-Based Swap Entities.⁴⁰ A “trade acknowledgment” is essentially a confirmation that generally must be provided by the Security-Based Swap Entity promptly, but in any event by the end of the first business day following the day of execution. Any trade acknowledgment must disclose all of the terms of the security-based swap transaction and be provided through electronic means that provide reasonable assurance of delivery and a record of transmittal. A Security-Based Swap Entity must establish, maintain, and enforce written policies and procedures that are reasonably designed to obtain prompt verification of the terms of a trade acknowledgment.⁴¹ In addition, the final rules address the potential availability of substituted compliance in connection with these requirements.

While expressed differently, the timing requirements in these rules are compatible with the corresponding CFTC rules that are currently in effect. This should aid Security-Based Swap Entities that are also, or are affiliated with, CFTC-registered swap dealers, since the same infrastructure and procedures can be substantially leveraged. The compliance date for these rules is the same as the Security-Based Swap Entities’ registration rules.

Regulation SBSR

Regulation SBSR governs the reporting and public dissemination of security-based swap information.⁴² Issued in final form in 2015 and then amended in July 2016,⁴³ Regulation SBSR outlines the information that must be reported and publicly disseminated for each

security-based swap transaction, assigns reporting duties for security-based swaps, and requires registered security-based swap data repositories (“SBSDRs”) to establish and maintain policies and procedures for carrying out their responsibilities under Regulation SBSR. Similar to the reporting rules for swaps adopted by the CFTC, Regulation SBSR assigns reporting duties for security-based swap transactions based on a reporting hierarchy where only one side of the security-based swap transaction reports to an SBSDR. Briefly, if both sides of the security-based swap transaction are security-based swap dealers, then they must choose the reporting side. If only one side is a security-based swap dealer, then that side will be required to report. Regulation SBSR also requires a platform (i.e., a national securities exchange or security-based swap execution facility) or a registered clearing agency to report certain security-based swaps and addresses the application of Regulation SBSR to cross-border security-based swap transactions.

The July 2016 rule amendments to Regulation SBSR among other things establish its compliance schedule. These amendments establish three compliance dates:

- Compliance Date 1 for security-based swap reporting, which is the first Monday that is the later of (i) six months after the date on which the first security-based swap data repository can accept transaction reports in that asset class registers with the SEC or (ii) one month after the Security-Based Swap Entities’ compliance date for registration;
- Compliance Date 2 for public dissemination of security-based swap transaction information, which is the first Monday that is three months after Compliance Date 1; and
- Compliance Date 3 for reporting transitional and pre-enactment security-based swaps, which is two months after Compliance Date 2.⁴⁴

³⁹ Trade Acknowledgment and Verification of Security-Based Swap Transactions, Rel. No. 34-78011 (June 17, 2016).

⁴⁰ SEC Rules 15Fi-1 and 15Fi-2 under the Exchange Act.

⁴¹ The final rules exempt certain transactions that are processed through a registered clearing agency, or executed on a security-based swap execution facility or national securities exchange. The final rules also provide an exemption from the requirements of Exchange Act Rule 10b-10 for broker-dealers who are Security-Based Swap Entities and who satisfy the trade acknowledgment and verification requirements in the final rules.

⁴² Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information, Rel. No. 34-74244 (Feb. 11, 2015).

⁴³ Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information, Rel. No. 34-78321 (Jul. 14, 2016).

⁴⁴ *Id.* at 208-246. After the compliance schedule for Regulation SBSR was established, the SEC issued an order extending the date by which SBSDRs must comply with SEC’s core principles for SBSDRs and portions of Reg. SBSR to April 1, 2017, in order to give time for the SEC’s consideration of their registration applications. Order Extending a Temporary Exemption from Compliance with Rules 13n-1 to 13n-12 under the Securities Exchange Act of 1934, Rel. No. 34-78975 (Sept. 29, 2016). Although this could have impacted reporting timing as one of the contingencies under Compliance Date 1, because we conclude, as discussed below, that security-based swap dealer registration could not commence until February

POSSIBLE IMPLEMENTATION TIMELINE FOR SECURITY-BASED SWAP ENTITY REGULATIONS

Upon Chair White's departure, Commissioner Michael Piwowar was named acting Chair of the SEC. Before becoming Acting Chair, Mr. Piwowar stated that he would not prioritize any rules required by Title VII of the Dodd-Frank Act while serving as Acting Chair.⁴⁵ Accordingly, any Title VII rules likely will have to wait for a new permanent Chair. President Trump has nominated Jay Clayton to be the permanent Chair, but as of the date of this publication Mr. Clayton has not been confirmed.

President Trump's transition website stated an intention to "dismantle the Dodd-Frank Act and replace it with new policies to encourage economic growth and job creation."⁴⁶ No further specifics were provided as to what such a dismantling and replacing might entail. Some observers have suggested that the Financial CHOICE Act, H.R. 5983, introduced by House Financial Services Committee Chairman Hensarling in September 2016 and reported out of the Committee, may serve as a possible legislative blueprint for the new Congress with Republican majorities in both houses and the Trump administration. Given that the bill was reported out of Committee with no Democratic support and likely would have faced a veto from President Obama had it been approved by the Senate, it does not represent a compromise in order to improve its chance of enactment, but rather appears to be a "wish list" for Republicans in the financial services area. While the new Congress and Trump administration may possibly have more ambitious plans regarding the Dodd-Frank Act, and Chairman Hensarling is reportedly working on a "version 2.0" of the Financial CHOICE Act,⁴⁷ the version reported out of the House Financial Services

Committee, as a Republican set of priorities not reflecting bi-partisan input, at least serves to indicate the possible direction that changes to financial services regulation may take.

While the Financial CHOICE Act would make significant changes to the Dodd-Frank Act — including repeal of the Volcker Rule, repeal of the orderly liquidation authority contained in Title II (with some amendments to the Bankruptcy Code), repeal of Title VIII governing systemically important financial market utilities, repeal of the Department of Labor's fiduciary duty rule, and repeal of the Durbin amendment (which limits the fees that may be charged to retailers for debit card processing) — it makes relatively few changes to Title VII, and none that are substantive.

Specifically with regard to Title VII, the Financial CHOICE Act would require the CFTC and the SEC to harmonize their Title VII rules.⁴⁸ However, other than directing the agencies to jointly issue new rules to resolve any "inconsistencies" found by the agencies in their Title VII rules, the bill does not require substantive revisions. The Financial CHOICE Act would also make a number of non-substantive procedural changes that would require the agencies to issue policies and guidance as if they were rules under the requirements of the Administrative Procedure Act (subjecting them to notice and comment),⁴⁹ make certain internal organizational changes at both agencies,⁵⁰ and subject their rules, along with those of other financial services regulators, to more robust cost-benefit analysis.⁵¹ Other provisions would require the SEC and CFTC to develop comprehensive internal risk controls to safeguard and govern the storage of market data,⁵² would limit the duration of subpoenas, which would be required to be renewed by the relevant commission,⁵³ and would make other changes to the SEC's enforcement authority. In addition, the bill would require the CFTC to engage in cross-border rulemaking under Title VII (as opposed to currently applicable cross-border guidance issued by the

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2018, the other contingency – one month after registration – would be the later of the two dates and thus this SEC order would not affect the timing for reporting compliance.

⁴⁵ Dave Michaels, Wall Street Journal, SEC Commissioner Says Dodd-Frank Rules Not a Priority, *available at* <https://www.wsj.com/articles/sec-commissioner-says-agency-wont-act-on-more-dodd-frank-rules-1483733463> (Jan. 6, 2017).

⁴⁶ <https://www.greatagain.gov/policy/financial-services.html>.

⁴⁷ Elizabeth Dexheimer, Bloomberg, Hensarling Says He's Willing to Tweak Dodd-Frank Overhaul Plan (Nov. 16, 2016), *available at* <https://www.bloomberg.com/news/articles/2016-11-16/hensarling-says-he-s-willing-to-tweak-dodd-frank-overhaul-plan>.

⁴⁸ Subtitle D of Title IV of the Financial CHOICE Act.

⁴⁹ Section 412 (SEC) and Section 466 (CFTC) of the Financial CHOICE Act.

⁵⁰ Sections 405-407 (SEC) and sections 461-462 (CFTC) of the Financial CHOICE Act.

⁵¹ Subtitle A of Title VI of the Financial CHOICE Act.

⁵² Section 411 (SEC) and Section 464 (CFTC) of the Financial CHOICE Act.

⁵³ Section 421 (SEC) and Section 465 (CFTC) of the Financial CHOICE Act.

CFTC in 2013) and pursue substituted compliance with non-U.S. regimes.⁵⁴ But while this provision is concerned with the cross-border application of Title VII, it does not alter any of its provisions and, in any event, is not applicable to security-based swaps.⁵⁵

Various other provisions in the bill applicable to the SEC address matters not associated with derivatives regulation. However, one provision applicable to the SEC that could potentially impact derivatives involves the elimination of automatic statutory disqualifications for non-natural persons from registration with the SEC, qualifying for an exemption, or undertaking activities subject to SEC regulation.⁵⁶ As discussed above, the SEC's proposed rule for associated persons of Security-Based Swap Entities addresses statutory disqualifications for non-natural persons. In effect, the Financial CHOICE Act provision would reverse the presumption of statutory disqualification for non-natural persons, requiring the SEC, after notice and an opportunity for hearing, to disqualify the non-natural person. Although the SEC's rules as proposed would not be consistent with this provision, the SEC requested comments in the proposing release about whether it should adopt the CFTC's approach (applying the statutory disqualification provision only to natural persons as associated persons and not entities), as an alternative.⁵⁷ If the SEC adopted this alternative, it would not be inconsistent with the Financial CHOICE Act provision (which only applies to non-natural persons), and would not require a re-proposal of its rules, which would delay Title VII implementation.

Accordingly, none of the changes made by the Financial CHOICE Act would alter the fundamental structure of regulation of derivatives under Title VII of the Dodd-Frank Act or indeed most of its details. The absence of substantive changes to Title VII may suggest that the SEC will proceed with Title VII implementation, since there would be no congressional direction to the contrary, and finalizing the Title VII rules has been a priority for both Republican and Democratic commissioners, and SEC staff.⁵⁸

However, there may be some delays. As noted above, Acting Chair Piwowar has indicated that he will not prioritize Title VII rulemakings while he is Acting Chair. And it may take some time for new commissioners and a chair to be nominated and confirmed, and for them to hire their personal staffs.⁵⁹ Much may depend upon the priorities of President Trump's nominee for Chair, Jay Clayton, if he is confirmed. In his March 23, 2017 confirmation hearing before the Senate Banking Committee, Clayton expressed commitment to SEC completion of all required Dodd-Frank rulemakings (not limited to Title VII), but expected to review the rulemaking calendar and priorities. Subject to that review and prioritization, a delay may not be significant, as it has been more than six years since the enactment of the Dodd-Frank Act, and it has been a priority of both Republican and Democratic commissioners at the SEC to complete the Title VII rulemakings. That the SEC extended the exemptive order discussed above by only one year to February 2018 (the last extension that expired in February 2017 having been three years), suggests the SEC may be considering February 2018 as a possible registration start date. While that would require SEC action on the capital, margin, and segregation proposal by August 2017 (i.e., 6 months before February 2018), such action is within the realm of possibility, since the final releases according to Chair White, have been drafted and may not require significant modification.⁶⁰

Market participants therefore should begin considering during 2017 what they need to do in order to prepare for Security-Based Swap Entities' registration, possibly in the first quarter of 2018, among other SEC requirements. In the next section, we discuss some considerations to prepare for registration and the SEC's business conduct rules.

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completing the Title VII rules. *Available at* <https://www.sec.gov/news/statement/gallagher-piwowar-security-based-swaps.html> (Sept. 25, 2015).

⁵⁴ Section 468 of the Financial CHOICE Act.

⁵⁵ Certain other provisions that are applicable to the CFTC only do not substantively amend Title VII or apply to security-based swaps.

⁵⁶ Section 422 of the Financial CHOICE Act.

⁵⁷ Statutory Disqualification Release, *supra* n.37, at 55.

⁵⁸ We note that Chair White in written congressional testimony cited statements of SEC commissioners in support of

⁵⁹ Currently, the SEC has only two commissioners, Acting Chair Piwowar and Commissioner Kara Stein. The SEC is a five-member commission.

⁶⁰ Letter from SEC Chair White to Sens. Shelby and Crapo, dated December 12, 2016, *available at* https://www.findknowdo.com/news/12/15/2016/sec-chair-white-presses-ahead-new-regulations?utm_campaign=Cabinet%20Newsletter&utm_source=Newsletter&utm_medium=Email.

PREPARING FOR SECURITY-BASED SWAP ENTITIES' REGISTRATION

In late 2012, when the CFTC required registration of swap dealers and major swap participants, a number of the CFTC's rules had not yet gone into effect, and the CFTC had not finalized its guidance regarding cross-border application of its regulations. As a result, swap dealers were required to become compliant with CFTC rules that were not in place when registration was required as they became finalized. By contrast, substantially all of the SEC's rules for Security-Based Swap Entities will likely be final, and compliance will be required, by the time registration commences, in what appears will be a "big bang" approach. Accordingly, Security-Based Swap Entities will face a more predictable process than swap dealers, but will face a heavier burden in demonstrating compliance with SEC rules than swap dealers did in 2012. To a significant degree, security-based swap dealers who are also registered as swap dealers should be able to model their policies, procedures, and processes after their swap dealer policies, procedures, and processes. In this section, we look at pre-registration considerations for Security-Based Swap Entities, some of the challenges Security-Based Swap Entities may face in connection with registration submission requirements, and discuss the business conduct standards for which policies and procedures need to be implemented. While there is significant overlap in the SEC's and CFTC's business conduct rules, there are differences that will need to be taken into account when drafting the policies and procedures needed for registration.

Pre-Registration Considerations

Under the SEC's registration rules, the counting date for when a market participant is required to determine whether it exceeds the security-based swap dealer de minimis or major security-based swap participant thresholds and is required to register as a Security-Based Swap Entity is two months prior to the compliance date for registration. Market participants will need to take into account the SEC's rules for counting security-based swaps toward these thresholds, which, although broadly similar to the CFTC's rules, differ in some respects.

For example, in February 2016, the SEC adopted rules requiring non-U.S. firms using personnel located in a U.S. branch or office for arranging, negotiating, or executing a security-based swap transaction to include that transaction in determining whether it is required to

register as a security-based swap dealer.⁶¹ Under the final rules, such a transaction entered into by a non-U.S. person generally will count toward the non-U.S. person's de minimis threshold for security-based swap dealer registration.⁶² This rule differs from the CFTC staff's Advisory 13-69, which provided that, where a swap is between a non-U.S. dealer and another non-U.S. person, the CFTC's transaction-level requirements 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, the advisory did not provide that such transactions should count toward the de minimis threshold.⁶³ Recently, the CFTC has proposed rules regarding the cross-border application of its Title VII rules in which the CFTC expressly states that transactions "arranged, negotiated, or executed" in the United States do not count toward the de minimis thresholds of certain non-U.S. persons.⁶⁴ This difference will need to be considered when determining whether registration is required.

Challenges Regarding Registration Submission Requirements

Once it is determined that registration is required, Security-Based Swap Entities face certain compliance issues and challenges in meeting registration submission requirements. As part of the application, a senior officer of the applicant must certify after due inquiry that such officer has reasonably determined that the applicant has developed and implemented written policies and procedures reasonably designed to prevent violation of federal securities laws and rules thereunder, and document the process by which he or she reached such determination.⁶⁵ In order to meet this certification requirement, applicants must recruit skilled supervisory

⁶¹ Security-Based Swap 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; Security-Based Swap Dealer De Minimis Exception, Rel. No. 34-77104 (Feb. 10, 2016).

⁶² SEC Rule 3a71-3(b)(1)(iii)(C) under the Exchange Act.

⁶³ CFTC Staff Advisory No. 13-69, Applicability of Transaction-Level Requirements to Activity in the United States (Nov. 14, 2013).

⁶⁴ Cross-Border Application of the Registration Thresholds and External Business Conduct Standards Applicable to Swap Dealers and Major Swap Participants, 81 Fed. Reg. 71,946, 71,956 (Oct. 18, 2016).

⁶⁵ SEC Rule 15Fb2-1(b) under the Exchange Act.

personnel and a qualified chief compliance officer, who will be relied upon to certify compliance with the respective rules, and must establish and maintain a system to diligently supervise its business to prevent violations.

In addition, an applicant for Security-Based Swap Entity registration will need to be able to determine which requirements apply to which market participants in light of the SEC's rules for cross-border transactions. For example, the SEC's business conduct standards do not apply to a U.S. security-based swap dealer's "foreign business,"⁶⁶ defined as a security-based swap that is conducted through such dealer's foreign branch with either (i) a non-U.S. person or (ii) a U.S. person counterparty acting through a foreign branch.⁶⁷ The SEC conduct rules also provide that the SEC may make substituted compliance determinations if, among other things, it determines the relevant foreign requirements are comparable to its own otherwise applicable requirements, so that non-U.S. rules may apply instead of the SEC's rules.⁶⁸ Similarly under Reg. SBSR, security-based swap transactions that are "arranged, negotiated, or executed" by non-U.S. persons within a U.S. branch or office are required to be reported and publicly disseminated.⁶⁹ Reg. SBSR provides further guidelines for cross-border transactions, outlining the particular circumstances in which the participation of non-U.S. parties will impact reporting requirements.⁷⁰

Applicants (particularly dual registrants) will also need to be able to determine whether CFTC or SEC requirements apply to particular products. Specifically, they will need to demonstrate the ability to differentiate between products subject to CFTC rules (swaps on broad-based security indices) and SEC rules (security-

based swaps), including applying the tests for narrow-based security indices discussed in joint rules issued by the CFTC and SEC, in order to ensure that the correct rule set (i.e., the CFTC's rules or the SEC's rules) is applied.⁷¹

In addition to internal compliance, cross-border, and product considerations, Security-Based Swap Entities will face enhanced demands to develop intellectual property and infrastructure protocols. Registration rules and required electronic filings, subject to electronic filing requirements of Regulation S-T, will necessitate accessibility to the SEC's EDGAR system. The SEC stated that the delayed compliance date of the registration rules should provide sufficient time for registrants to adopt and incorporate all of the necessary IT protocols.⁷²

Business Conduct Standards

As noted above, the SEC issued its final business conduct rules for Security-Based Swap Entities in April 2016.⁷³ The SEC's rules are broadly consistent with the CFTC's external and internal business conduct rules, which have been implemented by the industry.⁷⁴ There are differences, however, and careful attention to these differences, some of which we highlight below, will need to be taken into consideration when drafting policies and procedures needed for Security-Based Swap Entities' registration.

Certain disclosures, for example, that are required by the SEC's final rules diverge from CFTC requirements. Whereas CFTC rules require that counterparties must agree in writing as to the manner of disclosure,⁷⁵ the SEC has no such requirement. Under SEC rules, the Security-Based Swap Entity must disclose to its

⁶⁶ SEC Rule 3a71-3(c) under the Exchange Act.

⁶⁷ SEC Rules 3a71-3(a)(8), (9). For a non-U.S. person security-based swap dealer, "foreign business" is effectively defined as a security-based swap 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 security-based swap dealer (or its agent) located in a U.S. branch or office. *Id.*

⁶⁸ SEC Rule 3a71-6(a).

⁶⁹ 17 CFR 242.908(a)(1)(v).

⁷⁰ 17 CFR 242.908. While the CFTC, in its recently proposed cross-border rules discussed above, addresses some requirements that are applicable to swap transactions that are "arranged, negotiated, or executed" in the United States, it did not address reporting requirements. *Supra* n.64.

⁷¹ *Supra* n.3. For certain security-based swaps, applicants also may need to determine whether products may be "mixed swaps" subject to joint CFTC and SEC rules.

⁷² Registration Release, *supra* n.5, at 28-29.

⁷³ Business Conduct Standards Release, *supra* n.35.

⁷⁴ 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. 20,127 (Apr. 3, 2012).

⁷⁵ 17 CFR 23.402(e).

counterparty that is not a Security-Based Swap Entity, or a swap dealer, or major swap participant (collectively, “Swaps Entities”), at a reasonably sufficient time prior to entering into a security-based swap, information in a manner reasonably designed to allow the counterparty to assess any material incentives or conflicts of interest that the Security-Based Swap Entity may have in connection with the relevant transaction, including any compensation or other incentives from any source other than the counterparty in connection with the transaction.⁷⁶

Similarly, the CFTC requires swap dealers to provide a pre-trade mid-market mark and a scenario analysis disclosure,⁷⁷ but the SEC requires Security-Based Swap Entities to disclose only material information reasonably designed to allow the counterparty to assess material risks and characteristics of the transaction. Security-Based Swap Entities may provide these disclosures through different means, but there is no requirement for a pre-trade mid-market mark or scenario analysis.⁷⁸ Other disclosure differences include that SEC rules require daily marks to be provided by Security-Based Swap Entities to non-Swap Entity counterparties free of charge and without any restrictions on internal use, while CFTC rules do not contain similar provisions.⁷⁹ SEC rules also provide that the counterparty (that is not a Swaps Entity) has the sole right to select a clearing agency but limits choice to where the Security-Based Swap Entity has a clearing relationship, while CFTC rules do not have such a limitation.⁸⁰

In addition to the specific disclosures required under the rules, the final rules include requirements addressing a number of business conduct standards that are similar to CFTC rules. SEC Rule 15Fh-3(a) mandates that a Security-Based Swap Entity must verify that its counterparty is an ECP or special entity (if known) before entering into a security-based swap with the counterparty. “Know your counterparty” requirements under SEC Rule 15Fh-3(e) require a security-based swap dealer to establish, maintain, and enforce policies and procedures that are reasonably designed to obtain and retain a record of the essential facts that are necessary for conducting business with each counterparty that is known to the security-based swap dealer. Such essential

facts include facts required to comply with rules and regulations, facts required to implement credit and operational risk management policies, and information regarding the authority of any person acting for the counterparty.⁸¹

SEC Rule 15Fh-3(f) requires security-based swap dealers that recommend a security-based swap or related trading strategy to a non-Swap Entity counterparty to have a reasonable basis for believing that the recommended security-based swap or trading strategy is suitable for the counterparty, a requirement that is generally similar to CFTC rules. To establish a reasonable basis under the SEC’s rules, dealers generally must have or obtain relevant information regarding the counterparty including the counterparty’s investment profile, trading objectives, and ability to absorb potential losses associated with the recommended security-based swap or trading strategy. A security-based swap dealer will also be able to establish a reasonable basis for such recommendations based on representations provided by a counterparty that is an “institutional counterparty,” defined to include a natural person, corporation, partnership, trust, or other entity with total assets of at least \$50 million.⁸² Significantly, the CFTC’s rules contain no such asset threshold for when swap dealers may rely upon counterparty representations as to suitability.⁸³

The final rules also provide guidelines for communications between Security-Based Swap Entities and counterparties. Specifically, a Security-Based Swap Entity must communicate with counterparties in a fair and balanced manner, based on principles of fair dealing and good faith.⁸⁴ Communications must provide a sound basis for evaluating the facts with regard to any particular security-based swap or trading strategy involving a security-based swap. The rules also prohibit any act, practice, or course of business that is fraudulent, deceptive, or manipulative by a Security-Based Swap Entity,⁸⁵ and restrict engagement by security-based swap dealers in a security-based swap or trading strategy with

⁷⁶ SEC Rule 15Fh-3(b) under the Exchange Act.

⁷⁷ 17 CFR 23.431(a)(3) ad 23.431(b).

⁷⁸ SEC Rule 15Fh-3(b).

⁷⁹ SEC Rule 15Fh-3(c)(3); 17 CFR 23.431(d).

⁸⁰ SEC Rule 15Fh-3(d); 17 CFR 23.432.

⁸¹ SEC Rule 15Fh-3(e)(1)-(3).

⁸² SEC Rule 15Fh-3(f)(4). This exception aligns closely with suitability requirements under FINRA rules, which have similar limitations for investor protections.

⁸³ 17 CFR 23.434.

⁸⁴ SEC Rule 15Fh-3(g). A parallel requirement is contained in CFTC rules, *see* 17 CFR 23.433.

⁸⁵ SEC Rule 15Fh-4(a).

a municipal entity following a political contribution.⁸⁶ Specific regulations regarding “special entities” (defined to include federal agencies, states and political subdivisions, employee benefit plans, and endowments)⁸⁷ provide further checks on dealer’s communications and actions with and on behalf of the special entity.⁸⁸

All told, the SEC’s business conduct rules contain approximately 20 status, informational, and other documentation requirements that will affect the client on-boarding and transactional process. This is in addition to an almost equal number of documentation requirements under other rulemakings. The required undertaking to meet these requirements across a large existing counterparty base is substantial. The rules permit a Security-Based Swap Entity to reasonably rely on written counterparty representations in satisfying a number of due diligence requirements. This standard is consistent with the CFTC’s, which should afford dual registrants some efficiencies. However, in response to a comment from SIFMA, the SEC rejected a request to permit, upon notice and counterparty non-objection, more categorical reliance on equivalent pre-existing counterparty representations pursuant to the CFTC business conduct rules. Instead, the SEC responded that the possibility of such dual reliance would depend on the facts and circumstances of the individual matter.⁸⁹ Through ISDA, the industry is discussing whether an efficient common documentation solution (such as a protocol, supplement to an existing protocol or alternate technique) would be feasible.

Lastly, the rules require extensive oversight of the supervisory and compliance systems within Security-Based Swap Entities.⁹⁰ Consistent with CFTC rules, the SEC’s rules require a designated CCO to report directly to the board of directors or senior officer of the entity,

and take reasonable steps to ensure that the entity establishes, maintains, and reviews written policies and procedures designed to comply with the Exchange Act and the related rules thereunder.⁹¹ The CCO must ensure that any non-compliance is remediated, through compliance office review, look-back, internal or external audit, or self-reporting to the SEC or other authority.⁹² The CCO must take reasonable steps to resolve any material conflicts of interest, in consultation with the board of directors and senior officers. The CCO is also required to prepare and certify an annual compliance report that must be submitted to the SEC within 30 days following the deadline for filing the entity’s annual financial report.⁹³ It should be noted that the CFTC has more detailed requirements for the CCO’s annual report than the SEC. For example, the CFTC requires that a CCO review each applicable requirement, and identify the policy and procedure reasonably designed to ensure compliance,⁹⁴ while the SEC only requires a description of the policies and procedures in the annual report.⁹⁵

CONCLUSION

Even if our prediction that Security-Based Swap Entities registration will not be significantly delayed by the new administration and Congress, and possibly will take place in February 2018, is inaccurate, it appears likely that these requirements are not going to be repealed or amended significantly. Market participants should therefore familiarize themselves with the SEC’s rules and begin preparations for registration in 2017 in case our prognostication is correct or nearly correct. Dual registrants, while certainly able to use much of their CFTC-based policies and systems, will need to ensure that differences between the CFTC’s and the SEC’s rules, some of which we have highlighted above, are taken into account. ■

⁸⁶ SEC Rule 15Fh-6(b)(1).

⁸⁷ SEC Rule 15Fh-2(d) for the full definition of the term “Special Entity.”

⁸⁸ SEC Rules 15Fh-4 and 15Fh-5.

⁸⁹ Business Conduct Standards Release, *supra* n.35, at 66-70.

⁹⁰ SEC Rule 15Fh-3(h).

⁹¹ SEC Rule 15Fk-1.

⁹² *Id.*

⁹³ *Id.*

⁹⁴ See 17 CFR 3.3(e)(2).

⁹⁵ See SEC Rule 15Fk-1(c)(1).

CLE QUESTIONS on Hammar et al., *The SEC's Long-Awaited Security-Based Swaps Rule May Be Approaching*. Circle the correct answer to each of the questions below. If at least four questions are answered correctly, there is one ethics credit for New York lawyers (nontransitional) for this article. Complete the affirmation and evaluation and return it by e-mail attachment to rscrpubs@yahoo.com. The cost is \$40, which will be billed to your firm. To request financial aid, contact us by e-mail or fax, as provided above.

1. The Dodd-Frank Act broadened the definition of “purchase” and “sale” of a security to include the execution, early termination, assignment, exchange, or similar transfer of a security-based swap, as well as the extinguishment of rights thereunder. **True** **False**
2. SEC Rule 240 under the Securities Act temporarily exempts individually negotiated security-based swap transactions that are between two Eligible Contract Participants from the registration requirements and certain other provisions of the Securities Act. **True** **False**
3. The SEC has proposed rules for security-based swap entities governing the timing for registration; capital, margin, and segregation; recordkeeping and reporting; and business conduct standards. None of these rules have been finalized. **True** **False**
4. For security-based swap entities required to register under SEC rules, a senior officer must certify after due inquiry that such officer has reasonably determined that the applicant has developed and implemented written policies and procedures designed to prevent violation of federal securities’ laws. **True** **False**
5. Under the SEC’s business conduct rules, security-based swap entities are required to provide counterparties with a pre-trade mid-market mark and a scenario analysis disclosure similar to the CFTC’s requirement in that regard. **True** **False**

A F F I R M A T I O N

_____, Esq., an attorney at law, affirms pursuant to CPLR

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2106 and under penalty of perjury that I have read the above article and have answered the above questions without the assistance of any person.

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