

## SEC Proposed Rules: Recordkeeping and Reporting for SBSDs, MSBSPs and BDs; Capital Rules for Certain SBSDs

***The SEC has proposed recordkeeping and reporting rules and capital charges for security-based swap dealers based on the current broker-dealer reporting and recordkeeping regime.***

Market participants in the derivatives markets have until July 1, 2014 to comment on the Securities Exchange Commission's (SEC's) recently proposed rules on April 17, 2014 with respect to recordkeeping and reporting obligations for security-based swap dealers (SBSDs) and major security-based swap participants (MSBSPs). At the same time, the SEC issued a proposed rule imposing a capital charge for unresolved securities differences, which would supplement the SEC's proposed capital and margin rules issued on October 18, 2012 (the SEC Proposed Capital and Margin Rules).<sup>1</sup>

The Proposed Rules are based on the current recordkeeping and reporting regime for broker-dealers and would also impose recordkeeping and reporting rules in respect of the requirements under the SEC Proposed Capital and Margin Rules. The Proposed Rules would amend the current regime to include broker-dealer SBSDs (BD SBSDs) and broker-dealer MSBSPs (BD MSBSPs) and propose new rules for stand-alone and bank SBSDs and MSBSPs. Because banks are already subject to prudential regulation, the requirements for banks are more limited in scope and would serve to complement prudential regulation and not duplicate information reporting and recordkeeping requirements under current bank regulation.

Section 764 of the Dodd-Frank Act provides that the SEC shall adopt rules governing reporting and recordkeeping for SBSDs and MSBSPs. And, while the Dodd-Frank Act amended the definition of security to include a security-based swap (SBS)<sup>2</sup>, the SEC has issued temporary exemptive relief regarding the change to the definition of "security" under the Exchange Act until the SEC finalizes the relevant rules regarding SBS. As a result, registered broker-dealers would be exempt from those provisions and rules to the extent that those provisions or rules do not apply to the broker-dealer's SBS positions or activities as of July 15, 2011 until the expiration of such relief.<sup>3</sup>

### I. Recordkeeping

The proposed recordkeeping rules are modeled after the broker-dealer recordkeeping program regime under SEC Rules 17a-3 and 17a-4 under the Exchange Act. The proposed rules would amend SEC Rules 17a-3 and 17a-4 to apply such rules to BD SBSDs/MSBSPs. Bank and stand-alone SBSDs/MSBSPs would be subject to new proposed SEC Rules 18a-5 and 18a-6.

## **Making and Keeping Records Current**

As set forth below, under the Proposed Rules, BD SBSDs/MSBSPs, stand-alone and bank SBSDs/MSBSPs would be required to make and keep current the records discussed below. The Proposed Rules would extend the broker-dealer rules to SBSDs/MSBSPs in respect of SBS as follows:

*Trade Blotters.* Stand-alone, bank and BD SBSDs/MSBSPs would be required to make and keep current trade blotters containing itemized daily records of all transactions in securities (including SBS), all receipts and deliveries of securities (including SBS), disbursements of cash and all other debits/credits.

*General Ledger.* Stand-alone SBSDs/MSBSPs would be required to keep current ledgers reflecting all assets/liabilities, income and expenses and capital accounts in respect of SBS.

*Ledgers for Customer and Non-Customer Accounts.* Stand-alone and bank SBSDs/MSBSPs would separately need to account for SBS in their ledgers of securities and commodities transactions in customer and non-customer cash and margin accounts.

*Stock Record.* All SBSDs/MSBSPs would need to make and keep current the securities record accounting for SBS in addition to the existing requirements. Bank SBSDs/MSBSPs must maintain such records only with respect to their activities as SBSDs/MSBSPs.

*Memoranda of Brokerage Orders and Proprietary Orders.* Bank and BD SBSDs/MSBSPs would need to make and keep current a memorandum of each brokerage order and proprietary order in respect of SBS in addition to the existing requirements. Stand-alone SBSDs/MSBSPs would be required to keep current such a memorandum but only with respect to proprietary orders.

*Confirmations.* All SBSDs/MSBSPs would need to make and keep current copies of confirmations of purchases and sales of securities in respect of SBS and would require firms to keep current copies of SBS trade acknowledgments and verifications. Bank SBSDs/MSBSPs confirmation requirements are limited to SBS and securities if they are related to a SBS (*i.e.*, a hedge).

*Accountholder Information.* All SBSDs/MSBSPs would need to make and keep current accountholder information in respect of SBS.

*Options Positions.* Stand-alone SBSDs/MSBSPs would be required to make and keep current the same type of records broker-dealers must keep: a record of all puts, calls, spreads, straddles, and other options in which such entity has any direct or indirect interest or which the firm has granted or guaranteed. This requirement would not be applicable to banks.

*Trial Balances and Computation of Net Capital.* Stand-alone SBSDs/MSBSPs would be required to make and keep current a record of the proof of money balances of all ledger accounts in the form of trial balances and a record as of the trial balance date of the computation of net capital in accordance with the SEC Proposed Capital and Margin Rules.<sup>4</sup>

*Records Related to SEC Proposed Capital and Margin Rules.* The SEC Proposed Capital and Margin Rules would require certain computations and calculations. The Proposed Rules would create the requirement to make and keep current such calculations as follows:

- i. *Liquidity Stress Test.* Under the SEC Proposed Capital and Margin Rules, broker-dealers (including BD SBSBs) and stand-alone SBSBs (but not banks) that are approved to use internal models to calculate market and credit risk charges when computing net capital under Rule 18a-1 are subject to liquidity stress test requirements. The Proposed Rules would require firms subject to such liquidity stress test requirements to make and keep a current record of the results of the monthly liquidity stress tests, a record of the assumptions underlying the liquidity stress test and the liquidity funding plan.
- ii. *Account Equity and Margin Calculations under Proposed Rule 18a-4.* Under Rule 18a-4, non-bank SBSBs would be required to perform two daily calculations for each SBS account: the amount of equity and margin in the account. Non-bank MSBSPs must perform only the equity calculation. The Proposed Rule would require firms to make and keep current such records.
- iii. *Possession or Control Requirements under Proposed Rule 18a-4.* Under proposed Rule 18a-4, SBSBs would be required to promptly obtain and maintain physical possession or control of all excess securities collateral carried for the accounts of SBS customers. This would prohibit lending or hypothecating excess securities collateral of SBS customers and would require firms to physically hold excess securities collateral or to custody the collateral. SBSBs must determine on a daily basis the quantity of excess securities collateral that the firm had in its possession as of previous business day. SBSBs must take steps to retrieve excess securities from non-control locations. The Proposed Rule would require all SBSBs to make and keep current a record of compliance with possession and control requirements under proposed Rule 18a-4.
- iv. *Customer Reserve Requirements under Proposed Rule 18a-4.* Rule 18a-4 would require SBSBs to maintain a SBS swap customer reserve account at an unaffiliated bank in accordance with the SEC Proposed Capital and Margin Rules. The Proposed Rule would require all SBSBs/MSBSPs to make and keep current a record of their reserve computations.
- v. *Unverified Transactions.* Proposed Rule 15Fi-1 would require prompt verification of trade acknowledgments in respect of SBS. The Proposed Rules would require all SBSBs/MSBSPs to record each SBS trade acknowledgement that is not verified within five business days of execution.
- vi. *Records relating to Business Conduct Standards.* The Proposed Rules would require that SBSBs/MSBSPs make and keep current all records related to business conduct standards: *i.e.*, supporting documentation, written disclosures and representations. The SEC states in the adopting release that attestations confirming compliance with such business conduct requirements would not be enough to satisfy such recordkeeping requirements.

## **Record Maintenance and Preservation Requirements**

The Proposed Rules would require that records be maintained as follows:

- *Six-year preservation requirement:* All SBSBs/MSBSPs must keep records in respect of (1) trade blotters, (2) general ledgers, (3) ledgers of customer and non-customer accounts, and (4) stock records for six years and such records must be easily accessible the first two years.
- *Three-year preservation requirement:* All SBSBs/MSBSPs must keep records in respect of (1) memoranda of proprietary orders, (2) confirmations, (3) accountholder information, (4) options positions, (5) trial balances and computation of net capital or tangible net worth, (6) liquidity stress

tests, (7) Rule 18a-3 calculations, (8) possession and control requirements, (9) Rule 18a-4 reserve account computations, (10) unverified transactions, (11) political contributions and (12) external business conduct rules for three years, and must be easily accessible the first two years.

*Form of Preservation.* The following documentation should be maintained: originals of communications received and copies of all communications sent, including inter-office memoranda and communications relating to its business as an SBSD/MSBSP, originals or copies of all written agreements, guarantees of accounts, powers of attorney, copies of reports, supporting documentation, disclosures, communications, notices or other relevant documentation.

The Proposed Rules would allow firms to preserve records on digital media (which may be the sole method of preservation), provided firms comply with the conditions and meet applicable standards and terms for use of electronic media storage.

## **II. Reporting**

Similar to the proposed recordkeeping rules, the proposed reporting regime is modeled on Rule 17a-5 under the Exchange Act, which applies to broker-dealers. Stand-alone SBSDs/MSBSPs would be subject to proposed Rule 18a-7. Bank SBSDs/MSBSPs would only be subject to the requirement to periodically file Form SBS under Rule 18a-7 (as further discussed below). Reporting requirements for bank SBSDs/MSBSPs would be limited to their SBS activities.

### **Periodic Filing of Proposed Form SBS**

Stand-alone, bank and BD SBSDs/MSBSPs would be required to periodically file Form SBS. For BD SBSDs/MSBSPs, Form SBS would replace FOCUS Report Part II or Part IIA. Stand-alone and BD SBSDs/MSBSPs would be required to file Form SBS on a monthly basis (within 17 business days after the end of the calendar month). Banks are required to file Form SBS on a quarterly basis, as the SEC expects such information would already have submitted to prudential regulators.

SBSDs authorized to use internal models would be required to submit reports of results of backtesting of all internal models and the number of days during which loss exceeded Value at Risk (VaR) within 17 days after the end of each quarter.

Form SBS would collect information regarding the firm's financial and operational conditions. Moreover, information elicited from banks would be information available from call reports and would focus on their business as SBSDs or MSBSPs.

The proposed structure of Form SBS is as follows:

- Part 1 – Applies to non-bank SBSDs/MSBSPs (similar to Part II CSE)
- Part 2 – Applies to bank SBSDs/MSBSPs and elicits financial information similar to information reported on their call reports
- Part 3 – Applies to SBSDs/MSBSPs dually registered as FCMs and elicits information as to net capital computation and segregation of customer assets
- Part 4 – Applies to non-bank SBSDs/MSBSPs and elicits information about SBS and swap positions, counterparties and exposures

- Part 5 – Applies to bank SBSBs/MSBsPs and elicits information about SBS and swap positions

## **Filing of Annual Audited Financial Reports and Other Reports**

*Annual Audited Financial Report.* The proposed rules would extend the current broker-dealer rule requiring broker-dealers to file annual audited reports and to notify the SEC in the case of a change of accountant to BD SBSBs/MSBsPs. The annual report would consist of a (1) financial report; and (2) compliance report or an exemption report as well as independent public accountant reports.

1. *Financial report* must contain financial statements as to financial condition, statement of income and a statement of cash flows and supporting schedules as to computation of net capital (Rule 15c3-1/18a-1), computation of reserve requirements (Rule 15c3-3/18a-4), and information relating to possession and control requirements (Rule 15c3-3/18a-9) (together, the Financial Reporting Rules).
2. *Compliance Report* is required to be filed if the firm carries funds and customers' securities. The report must contain statements as to the firm's internal controls and compliance with the Financial Reporting Rules and statements that any non-compliance will be prevented or detected on a timely basis.
3. *Exemption Report* is filed if such firm does not carry funds and securities of customers. The SEC does not expect that this will be the case for stand-alone/BD SBSBs/MSBsPs and as a result expects that most firms will file a compliance report instead of an exemption report.

*Liquidity Stress Test Reports.* The Proposed Rules would extend reporting requirements of broker-dealers approved to use internal models to calculate market and credit risk charges when computing net capital to SBSBs that are approved to use internal models for the same purpose. Such SBSBs would be required to file a monthly report of the results of required monthly liquidity stress tests. The reports would be required on a monthly or quarterly basis, depending on the information being reported.

*Customer Statements.* The Proposed Rules would extend the current broker-dealer rule to stand-alone SBSBs/MSBsPs requiring firms to send customers an audited statement that must include among other things, statement of financial condition with appropriate notes, net capital and any material weaknesses identified.

*Website Disclosures for SBSBs/MSBsPs.* The Proposed Rules would make disclosure of information mandatory on a website for stand-alone SBSBs/MSBsPs. Websites must also disclose unaudited financial statements as of a date six months after the date of the most recent audited annual report. SBSBs/MSBsPs would also be required to make information required to be disclosed on a website available in writing upon request and maintain a toll-free number to receive such requests.

*Nature and Form of Reports.* FOCUS Part III (Oath and Affirmation) would be amended to accommodate use by OTC derivatives dealers and stand-alone SBSBs/MSBsPs. Stand-alone SBSBs/MSBsPs would be required to attach a FOCUS Report Part III to the confidential and non-confidential portions of the annual report. Confidential treatment of annual reports for stand-alone SBSBs/MSBsPs would mirror that of the broker-dealers.

*Qualification of Independent Public Accountant.* The current broker-dealer rules requiring engagement of independent public accountants and the filing of statements and notices related thereto would apply to stand-alone and BD SBSBs/MSBsPs. Under the current broker-dealer rules:

- Public accountants must be qualified and independent in accordance with independence requirements of Rule 2-01 of Regulation S-X and registered with the Public Company Accounting Oversight Board (PCAOB) if required under Sarbanes-Oxley Act 2002 (though PCAOB's audit authority is more limited with stand-alone SBSDs/MSBSPs than with broker-dealers and issuers).
- Firms must file an annual statement of independent public accountant (by December 10).
- Firms must file a notice with SEC if their independent public accountant is replaced.

*Independent Public Accountant Reports.* The independent public accountant would provide the financial and compliance reports for stand-alone and BD SBSDs/MSBSPs. Independent public accountants would also be required to notify a broker-dealer or stand-alone SBSDs if it is not in compliance with Rules 18a-1, 18a-4 or 18a-9/15c3-1, 15c3-3 or Rule 17a-11 or if a material weakness has occurred in respect thereto. With respect to stand-alone and BD MSBSPs, the accountant must notify the firm if it is not in compliance with Rule 18a-2 (the proposed tentative net worth standard for stand-alone and BD MSBSPs).

*Material Weakness.* All SBSDs would be required to notify the SEC of a material weakness or any non-compliance and provide a copy of such notice to the accountant. The accountant must notify the SEC if the accountant disagrees with such notice or does not receive a notice.

*Other Reports.* The proposed rules would also extend certain BD requirements to SBSDs/MSBSPs as follows:

- Reports of Independent Public Accountant: Extends BD requirements to stand-alone SBSDs/MSBSPs that apply to accountants for reports (including technical requirements, required representations, opinions/conclusions to be expressed in accountant's reports and requirements related to matters to which the accountant takes exceptions).
- Extensions and Exemptions: Extends the broker-dealer rules that allow firms to apply for an extension of or exemption from the reporting rules to stand-alone and bank SBSDs/MSBSPs.
- Notification of Change of Fiscal Year: Similar to the broker-dealer rules, stand-alone SBSDs and MSBSPs must provide notice to the SEC of a change to the firm's fiscal year and changes to the filing period of the annual report must be approved by SEC.

### **III. Notification Program**

Similar to the reporting and recordkeeping rules applicable to broker-dealers, the Proposed Rules contain notification requirements that are modeled on the broker-dealer notification program (Rule 17a-11). The Proposed Rules would amend Rule 17a-11 to extend such requirements to BD SBSDs/MSBSPs and stand-alone and bank SBSDs/MSBSPs would be subject to proposed Rule 18a-8 (modeled on Rule 17a-11 but not entirely parallel, because some notifications are inapplicable as they are not part of the SEC Proposed Capital and Margin Rules to which certain notifications relate).

#### **Requirements**

The Proposed Rules would require SBSDs/MSBSPs to notify the SEC of the occurrence of certain events and/or conditions as follows:

*Capital Requirements.* Applies to all SBSBs/MSBs and would require same-day notice of a failure to meet minimum capital requirements: (i) if net capital or tentative net capital falls below the required minimum; or (ii) if the firm fails to maintain a positive tangible net worth.

*Notification of Potential Capital or Model Problem.* Applies to stand-alone and BD SBSBs/MSBs. The following events would trigger a notification requirement (within 24 hours) to the SEC:

1. For stand-alone and BD SBSBs, if: (i) aggregate indebtedness is in excess of 120 percent of net capital; or (ii) net capital is less than five percent of aggregate debit items.
2. For stand-alone and BD MSBs, if total net capital is less than 120 percent of required minimum, tangible net worth falls below US\$20 million.

*Notice of Adjustment of Reported Capital Category.* Applies to bank SBSBs/MSBs and would require banks to give notice when filing an adjustment of reported capital with a prudential regulator.

*Notice of Failure to Make/Keep Current Books and Records.* Applies to all SBSBs/MSB's and would require notice on the same day failure occurs. Notice must specify books and records which have not been made or are not current, and the firm must report within 48 hours what it is doing to correct the situation.

*Notice of Material Weakness.* Applies to stand-alone and BD SBSBs/MSBs and would require such firms to submit a notification of any material weakness (as defined in Rule 17a-5/18a-7). Notice would be required within 24 hours and a report would need to be transmitted within 48 hours stating what the firm is doing to correct the situation.

*Notice of Insufficient Liquidity Reserve.* Applies to broker-dealers and BD SBSBs approved to use internal models for credit and market risk charges in their computations of net capital and would require immediate notification to the SEC if the liquidity stress test under Rule 15c3-1 indicates the liquidity reserve is insufficient.

*Notice of Failure to Make a Required Reserve Deposit.* Applies to stand-alone and BD SBSBs and would require notice to the SEC if such firm fails to make a required deposit into its SBS customer reserve account. The proposed rule mirrors Rule 15c3-3 under the Exchange Act that requires broker-dealers to maintain a reserve of funds or qualified securities in an account at a bank that is at least equal in value to the net cash owed to customers.

#### **IV. Quarterly Securities Count and Capital Charge for Unresolved Securities Differences**

The Proposed Rules also require firms to conduct a quarterly securities count and a capital charge for unresolved differences in respect thereof. The proposed capital charge would supplement the SEC Proposed Capital and Margin Rules (Rule 18a-1). The quarterly securities count rules are modeled on Rule 17a-13 under the Exchange Act. The Proposed Rules would make SBSBs, BD SBSBs and BD MSBs subject to the securities count requirements and related capital charge. Stand-alone SBSBs would be subject to proposed Rule 18a-9, and Rule 17a-13 would be amended to include BD SBSBs and BD MSBs. The rule would not apply to stand-alone MSBs. The SEC stated that it does not anticipate stand-alone MSBs to engage in securities operations involving movement of funds and securities from buyer to seller that are as complex as the operations of dealers in securities such as broker-dealers. Further, the rule would not apply to bank SBSBs and bank MSBs.

The rule would require firms to perform a securities count on a quarterly basis. Firms would need to include in their count securities that are subject of repos or reverse repos. The rule specifies that firms must account for all securities in transfer, in transit, pledged, loaned, borrowed, deposited, failed to receive, failed to deliver or otherwise subject to control and direction but not in physical possession, and verify securities not in physical possession that have been in such status longer than 30 days. Upon completion, firms would compare results of the count and verification and record unresolved differences no later than seven business days from commencement of count. A capital charge would be imposed for short securities differences outstanding seven business days or more and for long securities differences where the securities have been sold before they are resolved.

The securities count must be performed no sooner than two months from the last count and no later than four months from the last count. Examination, count and verification must be made or supervised by persons whose regular duties do not require them to have direct responsibility for the securities or the subject records.

The capital charge for a short securities difference is calculated by deducting the market value of all short securities differences (including securities positions reflected on the securities record which are not susceptible to either count or confirmation) unresolved after discovery in accordance with the following schedule:

Differences (% of market value of short securities differences)	No. of Business Days after Discovery
25%	7
50%	14
75%	21
100%	28

The capital charge for long securities differences is calculated by deducting the market value of any long securities difference, where such securities have been sold by the broker-dealer before they are adequately resolved, less any reserves.

The SEC does not clarify how this securities count would apply to SBS, as SBS are unlike traditional securities and are not “delivered,” but has requested comment as to whether extension of the securities count rule to SBS would be appropriate and/or how should the securities count rules account for SBS.



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**Endnotes**

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- <sup>1</sup> See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, 77 FR 70214 (November 23, 2012).
  - <sup>2</sup> See Section 3(a)(10) of the Securities Exchange Act of 1934 ("Exchange Act").
  - <sup>3</sup> See Order Extending Temporary Exemptions Under the Securities Exchange Act of 1934 in Connection with the Revision of the Definition of "Security" to Encompass Security-based Swaps and Request for Comment, 79 FR 7731 (February 10, 2014) (expiration of relief dependent on the finalization of relevant rules).
  - <sup>4</sup> See SEC Proposed Capital and Margin Rules 18a-1 and 18a-2.