

SEC Proposes Securities-Based Swap Recordkeeping, Reporting and Notification Requirements

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On May 2, 2014, the Securities and Exchange Commission (SEC) published in the Federal Register proposed regulations¹ that would implement the recordkeeping, reporting and notification requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) applicable to registered security-based swap dealers (SBSDs), major security-based swap participants (MSBSPs) and broker-dealers engaged in security-based swap activities.

The SEC proposal focuses on four basic classifications of registered entities:

- (1) Broker-dealers that are not registered as SBSDs or MSBSPs, but are engaged in security-based swap activities (stand-alone broker-dealers),
- (2) SBSDs and MSBSPs that are dually registered as broker-dealers (broker-dealer SBSDs and broker-dealer MSBSPs),
- (3) SBSDs and MSBSPs that are not dually registered as broker-dealers (stand-alone SBSDs and stand-alone MSBSPs), and
- (4) SBSDs and MSBSPs that also are banks (bank SBSDs and bank MSBSPs). Collectively, we refer to these four categories of registered entities as broker-dealers, SBSDs and MSBSPs.

This client alert summarizes the key aspects of the SEC's proposal. The SEC will accept comments on its proposal through July 1, 2014.

Proposed Recordkeeping Requirements

The SEC's proposed recordkeeping rules for stand-alone broker-dealers, SBSDs and MSBSPs are modeled on the SEC's existing recordkeeping regime for broker-dealers. Existing Rule 17a-3, which requires broker-dealers to make and keep current certain records, would be amended largely to account for the security-based swap and swap activities of stand-alone broker-dealers, broker-dealer SBSDs and broker-dealer MSBSPs.² To address the recordkeeping requirements of stand-alone SBSDs, stand-alone MSBSPs, bank SBSDs and bank MSBSPs, the SEC proposed new Rule 18a-5, which is modeled on the proposed amendments to Rule 17a-3, but would exclude recordkeeping requirements that relate to activities requiring an SBSD or MSBSP to be dually registered as a broker-dealer.

¹ 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, 79 Fed. Reg. 25194 (May 2, 2014).

² As a result of the Dodd-Frank Act, the SEC has exclusive jurisdiction over "security-based swaps," as such term is defined in Section 3(a)(68) of the Securities Exchange Act of 1934 (Exchange Act) and the CFTC has exclusive jurisdiction over "swaps," as such term is defined in Section 1a(47) of the Commodity Exchange Act and the rules promulgated thereunder. See 15 U.S.C. § 78c-3(a)(68); 7 U.S.C. § 1a(47).

Some of the specific recordkeeping requirements that the SEC's proposal would impose are:

- *Trade Blotters.* The current broker-dealer requirement to make and keep current trade blotters (or other records of original entry) containing an itemized daily record of all transactions in securities, all receipts and deliveries of securities, all receipts and disbursements of cash, and all other debits and credits would be expanded to security-based swaps (which are included within the definition of "securities" in Section 3(a)(10) of the Exchange Act) and therefore would apply to broker-dealers that register as SBSDs or MSBSPs as well as stand-alone broker-dealers. Proposed Rule 18a-5(a)(1) would impose similar trade blotter recordkeeping requirements on stand-alone SBSDs and stand-alone MSBSPs. Proposed Rule 18a-5(b)(1) would impose trade blotter recordkeeping requirements on bank SBSDs and bank MSBSPs, but only with respect to their security-based swap activities.

For each transaction in a security-based swap, the trade blotter would be required to include the contract price of the security-based swap, as well as: (1) the type of security-based swap, (2) the reference security, index or obligor, (3) the date and time of execution, (4) the effective date, (5) the termination or maturity date, (6) the notional amount, (7) the unique transaction identifier and (8) the unique counterparty identifier (collectively the SBS Trade Blotter Data).

- *Ledgers for Customer and Noncustomer Accounts.* The current broker-dealer requirement to make and keep current ledger accounts (or other records) relating to securities and commodities transactions in customer and noncustomer cash and margin accounts would be expanded to security-based swaps and therefore would apply to broker-dealers that register as SBSDs or MSBSPs as well as stand-alone broker-dealers. Proposed Rule 18a-5(a)(3) would impose a similar requirement on stand-alone SBSDs and stand-alone MSBSPs, except not with respect to records concerning cash or margin accounts (which involve activities requiring broker-dealer registration). Proposed Rule 18a-5(b)(2) would impose current ledger account requirements relating to securities and commodities transactions on bank SBSDs and bank MSBSPs, but only with respect to their security-based swap customers and noncustomers.

For each transaction in security-based swaps, ledger accounts would be required to include the SBS Trade Blotter Data.

- *Stock Record.* The current broker-dealer requirement to make and keep current a securities record of the custody and movement of securities would be expanded to security-based swaps and therefore would apply to broker-dealers that register as SBSDs or MSBSPs as well as stand-alone broker-dealers. Proposed Rule 18a-5(a)(4) would impose a parallel requirement on stand-alone SBSDs and stand-alone MSBSPs. Proposed Rule 18a-5(b)(3) would impose a stock record requirement on bank SBSDs and bank MSBSPs, but only with respect to the positions related to their businesses as SBSDs or MSBSPs.

For each transaction in security-based swaps, a stock record would be required to include (1) the reference security, index, or obligor, (2) the unique transaction identifier, (3) the unique counterparty identifier, (4) whether it is a "long" or "short" position, (5) whether it is cleared or uncleared, and (6) if cleared, the identification of the applicable clearing agency.

- *Memoranda of Brokerage Orders.* The current broker-dealer requirement to make and keep current memoranda of each brokerage order, and of any other instruction, given or received, for the purchase or sale of a security would be expanded to security-based swaps and therefore would apply to broker-dealers that register as SBSDs or MSBSPs as well as stand-alone broker-dealers. Proposed Rule 18a-5(b)(4) would impose a parallel requirement on bank

SBSDs and bank MSBSPs. For each transaction in a security-based swap, the memoranda would be required to include the SBS Data. Stand-alone SBSDs or stand-alone MSBSPs would not be subject to a similar requirement because they would need to be registered as broker-dealers in order to engage in the business of effecting brokerage orders in security-based swaps.

- *Memoranda of Proprietary Orders.* The current broker-dealer requirement to make and keep current memoranda of each purchase and sale of each security for its own account would be expanded to security-based swaps and therefore would apply to broker-dealers that register as SBSDs or MSBSPs as well as stand-alone broker-dealers. A similar requirement, but only with respect to proprietary transactions in security-based swaps, would be imposed on stand-alone SBSDs and stand-alone MSBSPs (by proposed Rule 18a-5(a)(5)) and bank SBSDs and bank MSBSPs (by proposed Rule 18a-5(b)(5)).

For each transaction in a security-based swap, the memoranda would be required to include the SBS Trade Blotter Data.

- *Confirmations.* The current broker-dealer requirement to make and keep current confirmations of each purchase and sale of a security would be expanded to security-based swaps and therefore would apply to broker-dealers that register as SBSDs or MSBSPs as well as stand-alone broker-dealers. Proposed Rule 18a-5(a)(6) would impose a parallel requirement on stand-alone SBSDs and stand-alone MSBSPs. Proposed Rule 18a-5(b)(6) would impose a similar confirmation requirement on bank SBSDs and bank MSBSPs, but only to the extent their transactions in security-based swaps related to their business as SBSDs or MSBSPs.
- *Options Positions.* The current broker-dealer requirement to make and keep current a record of all puts, calls, spreads, straddles and other options in which the broker-dealer has any direct or indirect interest or that it has granted or guaranteed would be expanded to security-based swaps and therefore would apply to broker-dealers that register as SBSDs or MSBSPs as well as stand-alone broker-dealers. Proposed Rule 18a-5(a)(8) would impose a parallel requirement on stand-alone SBSDs and stand-alone MSBSPs. This recordkeeping requirement would not apply to bank SBSDs or bank MSBSPs.
- *Trial Balances and Computation of Net Capital.* The current broker-dealer requirement to make and keep a record of the proof of money balances of all ledger accounts in the form of trial balances and certain records relating to the computation of aggregate indebtedness and net capital under Rule 15c3-1 would not be amended. This is because the impact of security-based swaps on such computations is accounted for in the SEC's separately proposed capital rules.³ Such requirements would remain applicable to broker-dealers, including broker-dealers that register as SBSDs or MSBSPs. Proposed Rule 18a-5(a)(9) would require stand-alone SBSDs and stand-alone MSBSPs to make and keep similar records with respect to the computation of net capital under proposed Rule 18a-1 (for stand-alone SBSDs) and the computation of tangible net worth under proposed Rule 18a-2 (for stand-alone MSBSPs). This recordkeeping requirement would not apply to bank SBSDs or bank MSBSPs.
- *Liquidity Stress Test.* Pursuant to the SEC's capital proposal, broker-dealers, including broker-dealer SBSDs, that are approved to use internal models to calculate market and credit risk charges when computing net capital (ANC broker-dealers and ANC broker-dealer SBSDs)

³ See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker Dealers, 77 Fed. Reg. 70213, 70252-54 (Nov. 23, 2012) .

would be subject to liquidity stress test requirements.⁴ Anticipating the adoption of this requirement, the SEC proposes to amend current broker-dealer recordkeeping requirements to add a requirement to make and keep current a report of the results of the SEC's proposed monthly liquidity stress test, a record of the assumptions underlying the liquidity stress test, and the liquidity funding plan required under the proposed amendments to Rule 15c3-1. Proposed Rule 18a-5(a)(11) would impose a parallel recordkeeping requirement on stand-alone SBSBs that are approved to use internal models to calculate market and credit risk charges when computing net capital under proposed Rule 18a-1 (ANC stand-alone SBSBs). This recordkeeping requirement would not apply to bank SBSBs.

- *Account Equity and Margin Calculations Under Proposed Rule 18a-3.* Pursuant to the SEC's separate capital proposal, broker-dealer SBSBs, broker-dealer MSBSPs, stand-alone SBSBs and stand-alone MSBSPs would be subject to margin requirements with respect to uncleared swaps and would be required to perform two daily calculations for each security-based swap account.⁵ Anticipating the adoption of this requirement, the SEC proposes to amend current broker-dealer recordkeeping rules to require broker-dealer SBSBs and broker-dealer MSBSPs to make and keep current a record of the daily calculations that would be required under the separately-proposed equity and margin calculation requirements. Proposed Rule 18a-5(a)(12) would impose a parallel recordkeeping requirement on stand-alone SBSBs and stand-alone MSBSPs.
- *Possession or Control Requirements Under Proposed Rule 18a-4.* Pursuant to the SEC's separate capital proposal, every SBSB would be required to establish possession and control requirements with regard to excess securities collateral of security-based swap customers.⁶ Anticipating the adoption of this requirement, the SEC proposes to amend current broker-dealer recordkeeping rules to require broker-dealer SBSBs to make and keep current a record of compliance with the separately-proposed possession and control requirements. Proposed Rules 18a-5(a)(13) and 18a-5(b)(9) would impose a parallel recordkeeping requirement on stand-alone SBSBs and bank SBSBs, respectively.
- *Customer Reserve Requirements Under Proposed Rule 18a-4.* Pursuant to a the SEC's separate capital proposal, all types of SBSBs would be required to maintain a security-based swap customer reserve account at an unaffiliated bank and such account at all times would be required to have enough cash and/or qualified securities in amounts computed daily in accordance with Exhibit A to proposed Rule 18a-4. Anticipating the adoption of this requirement, the SEC proposes to amend current broker-dealer recordkeeping rules to require broker-dealer SBSBs to make and keep current a record of their customer reserve computations. Proposed Rules 18a-5(a)(14) and 18a-5(b)(10) would impose a parallel requirement on stand-alone SBSBs and bank SBSBs, respectively.
- *Unverified Transactions.* Pursuant to a separate SEC proposal regarding trade acknowledgment and verification, all SBSBs and MSBSPs would be required to promptly confirm the terms of executed OTC derivatives transactions.⁷ Anticipating the adoption of this requirement, the SEC proposes to amend current broker-dealer recordkeeping rules to require all broker-dealers, including broker-dealers that register as SBSBs or MSBSPs, to make and keep current a record of each security-based swap trade acknowledgment that is not verified

4 *Id.*

5 *Id.*

6 *Id.*

7 See Trade Acknowledgment and Verification of Security-Based Swap Transactions, 76 Fed. Reg. 3860 (Jan. 21, 2011).

within five business days of execution. Proposed Rule 18a-5(a)(15) would impose a parallel requirement on stand-alone SBSDs and stand-alone MSBSPs, and proposed Rule 18a-5(b)(11) would impose a parallel requirement on bank SBSDs and bank MSBSPs.

- *Records Relating to Business Conduct Standards.* Anticipating the adoption external business conduct standards for all SBSDs and MSBSPs, the SEC proposes to amend current broker-dealer recordkeeping rules to require broker-dealer SBSDs and broker-dealer MSBSPs to make and keep current a record that demonstrates compliance with the external business conduct standards.⁸ Proposed Rules 18a-5(a)(16) and (a)(17) would impose a parallel recordkeeping requirement on stand-alone SBSDs and stand-alone MSBSPs, and proposed Rules 18a-5(b)(12) and (b)(13) would impose the same recordkeeping requirements on bank SBSDs and bank MSBSPs.
- *Records of Data Reported to Security-Based Swap Data Repository.* Every broker-dealer, SBSD and MSBSP would be required to document — either in its daily trading records, ledger accounts, memoranda of brokerage orders and/or memoranda of proprietary trades⁹ as well as in its securities records¹⁰ — certain of the data that is proposed to be reported to a security-based swap data repository (SBSR).¹¹

Proposed Record Maintenance and Preservation Requirements

The SEC's proposed records maintenance and preservation requirements — like the proposed recordkeeping rules — are modeled on the existing regime for broker-dealers. Existing Rule 17a-4, which requires broker-dealers to retain records for the period and in the form prescribed by the SEC, would be amended to account for the security-based swap activities of stand-alone broker-dealers, broker-dealer SBSDs and broker-dealer MSBSPs. Proposed Rule 18a-6 would impose similar records maintenance requirements on stand-alone SBSDs, stand-alone MSBSPs, bank SBSDs and bank MSBSPs, but would exclude provisions concerning records that only would be required of a registered broker-dealer. As explained below, records would be maintained for a minimum period of six years or three years, depending on the type of record:

- *Key Records Retained for a Minimum Six-Year Period.* Consistent with current broker-dealer requirements under existing Rule 17a-4, broker-dealers, including broker-dealers that register as SBSDs or MSBSPs, would continue to be required to maintain for a period of no less than six years the following records: trade blotters, general ledgers, ledgers of customer and noncustomer accounts, stock records, records of recordkeeping personnel, records of certain principals responsible for compliance with federal requirements and self-regulatory organizations, and security future product records. These records would need to remain in a place that is easily accessible for the first two years of the six-year retention period.

⁸ See Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, 76 Fed. Reg. 42396 (July 18, 2011).

⁹ The data reported to the SBSR that the broker-dealer, SBSD or MSBSP would be required to document in its daily trading records, ledger accounts, memoranda of brokerage orders and/or memoranda of proprietary trades is: (1) the type of security-based swap, (2) the reference security, index or obligor, (3) the date and time of execution, (4) the effective date, (5) the termination or maturity date, (6) the notional amount, (7) the unique transaction identifier and (8) the unique counterparty identifier. See 79 Fed. Reg. at 25201.

¹⁰ The data reported to the SBSR that the broker-dealer, SBSD or MSBSP would be required to document in its securities record is: (1) the reference security, index or obligor, (2) the unique transaction identifier, (3) the unique counterparty identifier, (4) whether the security-based swap is cleared or uncleared, and (5) if cleared, identification of the clearing agency where the security-based swap is cleared. See *id.*

¹¹ See Regulation SBSR – Reporting and Determination of Security-Based Swap Information, 75 Fed. Reg. 75207 (Dec. 2, 2010).

Proposed Rule 18a-6(a)(1) would impose a parallel minimum six-year record maintenance and preservation period on stand-alone SBSs and stand-alone MSBSs with respect to trade blotters, general ledgers, ledgers of customer and noncustomer accounts, and stock records. Proposed Rule 18a-6(a)(2) also would require bank SBSs and bank MSBSs to preserve for not less than six years trade blotters, ledgers of security-based swap customers and noncustomers, and stock records. In each case, such records would need to remain in a place that is easily accessible for the first two years of the six-year retention period.

- *Key Records Retained for a Minimum Three-Year Period.* Consistent with current broker-dealer requirements under Rule 17a-4(b)(1), broker-dealers, including broker-dealers that register as SBSs or MSBSs, would continue to be required to maintain for a period of no less than three years the following records: ledgers of specific transactions, memoranda of each brokerage order, memoranda of each proprietary order, copies of confirmations, accountholder information, records of options positions, records of each cash and margin account, records of any internal broker-dealer system of which it is the sponsor, records of customer complaints, records concerning associated persons and records concerning promotional materials. In addition, broker-dealers, including broker-dealer SBSs and broker-dealer MSBSs, would be required to keep for at least three years the following records under amended Rule 17a-4(b)(1): results of liquidity stress tests, proposed Rule 18a-3 calculations, compliance with proposed Rule 18a-4 possession or control requirements, proposed Rule 18a-4 reserve account computations, unverified transactions, political contributions and compliance with external business conduct standards.

Proposed Rule 18a-6(b)(1) would impose a minimum three-year record maintenance and preservation period on stand-alone SBSs and stand-alone MSBSs for the following records: memoranda of proprietary orders, confirmations, accountholder information, options positions, trial balances and computation of net capital or tangible net worth, associated persons' employment applications, liquidity stress tests, account equity and margin calculations under proposed Rule 18a-3, compliance with proposed Rule 18a-4 possession or control requirements, proposed Rule 18a-4 reserve account computations, unverified transactions, political contributions and compliance with external business conduct standards. Bank SBSs and bank MSBSs would be subject to similar records maintenance and preservation requirements, except not with respect to options positions, trial balances and computation of net capital or tangible net worth, liquidity stress tests, and account equity and margin calculations under proposed Rule 18a-3.

Other of the records required to be made and kept by amended Rule 17a-3 or new Rule 18a-5, the SEC's proposal would need to be kept for not less than three years, remaining in an easily accessible place for the first two of those three years. The proposal also would require that stand-alone broker-dealers, SBSs and MSBSs preserve certain additional records — beyond those that would be required by amended Rule 17a-3 and new Rule 18a-5 — relating to security-based swap activity.

Stand-alone broker-dealers, broker-dealer SBSs and broker-dealer MSBSs may keep required records on micrographic media or by means of electronic storage media, consistent with existing Rule 17a-4. Under proposed Rule 18a-6, stand-alone SBSs, stand-alone MSBSs, bank SBSs and bank MSBSs would be permitted to use electronic storage media to maintain and preserve their required records but not micrographic media.

Stand-alone broker-dealers, broker-dealer SBSs and broker-dealer MSBSPs would be required to furnish promptly to the SEC legible, true, complete and current copies of those records that the broker-dealer is required to preserve under Rule 17a-4, or any other records subject to SEC examination that are requested by the SEC. The proposal includes a parallel requirement under Rule 18a-6 that would apply to SBSs and MSBSPs not registered as broker-dealers.

Proposed Reporting Requirements

Like the proposed recordkeeping and records retention requirements, the SEC's proposed reporting requirements also build upon existing broker-dealer requirements. The scope and frequency of the proposed reporting obligations depend on the type of SBS or MSBSP involved: broker-dealer SBSs and broker-dealer MSBSPs would face the greatest SEC reporting burden under the proposed rules (as they are dually registered) and bank SBSs and bank MSBSPs would face the least SEC reporting burden (as they already report much of the same information in their "call reports" to prudential regulators).

The SEC's proposed framework generally can be divided into three types of required reports: (1) monthly (or quarterly) Form SBS reports, (2) monthly stress test reports and (3) audited annual reports:

- *Form SBS Filings.* Proposed Form SBS would convey unaudited information to the SEC regarding an SBS's or MSBSP's financial and operational condition. This form is based on the FOCUS Reports (predominantly, FOCUS Report Part II CSE) that broker-dealers currently are required to file. All SBSs and MSBSPs would be required to file Form SBS, and broker-dealer SBSs and broker-dealer MSBSPs would file Form SBS in lieu of filing a FOCUS Report.¹² Broker-dealer SBSs, broker-dealer MSBSPs, stand-alone SBSs and stand-alone MSBSPs would be required to file Form SBS on a monthly basis, within 17 business days after the end of each month. Bank SBSs and bank MSBSPs would be required to file Form SBS only on a quarterly basis, within 17 business days after the end of each calendar quarter. The proposal would allow a self-regulatory organization (SRO) to become the official repository for the Forms SBS submitted by SBSs and MSBSPs who are members of such SRO.¹³

Proposed Form SBS is divided into the following five parts, with each part being applicable based on type of SBS or MSBSP filing the Form:

- **Part 1:** Part 1 would use the FOCUS Report Part II CSE as a baseline and would require broker-dealer SBSs, broker-dealer MSBSPs, stand-alone SBSs and stand-alone MSBSPs to provide the following information: (1) a statement of financial condition, (2) a computation of net capital (applicable to only broker-dealer SBSs, stand-alone SBSs and broker-dealer MSBSPs), (3) a computation of minimum net capital required,¹⁴ (4) a statement of income (loss), (5) a statement of capital withdrawals,

12 To ease the transition for dual registrants from FOCUS reports to Form SBS, information fields elicited by Form SBS share the same unique number and require the entry of the same type of information as the fields used on the current FOCUS reports. See 79 Fed. Reg. at 25224. Additionally, the proposed reporting rules would allow broker-dealer SBSs and broker-dealer MSBSPs to file Form SBS in lieu of FOCUS Report Part II or Part IIA in the event the firm were to terminate its membership with a national securities association or national securities exchange. See Rule 17a-5(b), as proposed to be amended.

13 Currently, broker-dealers submit BASIC reports to their SROs instead of directly to the SEC. The SEC notes that before an SRO could begin accepting Form SBS, the SRO first would need to submit an implementation plan for approval, which the SEC expects would establish reporting requirements at least as rigorous as those included under the proposed reporting rules. See 79 Fed. Reg. at 25224.

14 For net capital and minimum net capital required, a stand-alone SBS or MSBSP would be required to post the related statements on the firm's website. See proposed Rule 18a-7(b)(1)(ii).

changes in ownership equity and changes in liabilities subordinated to claims of creditors, (6) certain financial and operational data, (7) a customer reserve account computation under Rule 15c3-3, (8) information for possession or control requirements under Rule 15c3-3 and (9) a computation for the determination of reserve requirements for proprietary accounts of broker-dealers.

- **Part 2:** Part 2 would be modeled after Federal Financial Institutions Examination Council (FFIEC) Form 031 that is submitted by banks to their prudential regulators and would require bank SBSs and bank MSBSPs to duplicate the following information: (1) balance sheet information (similar to Schedule RC), (2) a statement of regulatory capital (scaled-down version of Schedule RC-R) and (3) income statement information (scaled-down version of Schedule RI).¹⁵ Similar to Part 1, Part 2 also would require bank SBSs to provide a computation of the deposit requirement for the security-based swap customer reserve account and information related to the possession or control requirements of proposed Rule 18a-4.¹⁶
- **Part 3:** Part 3 would require any SBS or MSBSP dually-registered with the Commodity Futures Trading Commission (CFTC) as a futures commission merchant (FCM) to provide the same information already required by the CFTC to be reported on Form 1-FR-FCM. The SEC explains that the information elicited in Part 3 is intended to allow the dual-registrant to submit Form SBS in lieu of CFTC Form 1-FR-FCM, subject to CFTC approval.¹⁷
- **Part 4:** Part 4 consists of four schedules modeled after various schedules to the FOCUS Report that are applicable to nonbank SBSs and nonbank MSBSPs. Generally, these schedules would elicit information regarding the firm's over-the-counter swap, security-based swap and mixed swap positions, counterparties and exposures, on both an aggregate and net basis.
- **Part 5:** Part 5 consists of a single schedule applicable to bank SBSs and bank MSBSPs. The single schedule is a truncated version of Schedule 1 to Part 4, and requires reporting aggregate long and short positions in certain swap, security-based swap and mixed swap positions.
- *Stress Test Reports.* The proposal would require ANC broker-dealers, ANC broker-dealer SBSs and ANC stand-alone SBSs each to report to the SEC on a monthly basis the results of the liquidity stress tests separately being proposed by the SEC.¹⁸
- *Audited Annual Report.* The proposal would require nonbank SBSs and nonbank MSBSPs to file an audited annual report to the SEC consisting of a statement of financial condition

15 Line items on Part 2 of Proposed Form SBS that correspond to line items on FFIEC Form 031 would require the entry of the same information. See 79 Fed. Reg. at 25231.

16 See *id.*

17 CFTC Rule 1.10(h) currently allows broker-dealers dually registered as FCMs to submit FOCUS reports in lieu of Form 1-FR-FCM. See 17 C.F.R. § 1.10(h). Part 3 of Proposed Form SBS includes a section modeled after the CFTC's recent amendments to Form 1-FR-FCM that elicits the same details regarding segregation requirements and funds in cleared swap customer accounts.

18 *Supra* at n. 3.

(and for nonbank SBSBs, also a compliance report).¹⁹ The financial report would consist of audited statements of financial condition, income and cash flows, including relevant supporting schedules and reconciliations. The compliance report would consist of representations and other information related to Rule 15c3-3 (for stand-alone broker-dealers, broker-dealer SBSBs and broker-dealer MSBSPs) or proposed Rule 18a-4 (for stand-alone SBSBs and stand-alone MSBSPs), including any finding of material weakness by the auditor.²⁰

Nonbank SBSBs and nonbank MSBSPs would be required to engage independent public accountants qualified under Rule 2-01 of Regulation S-X and registered with PCAOB to audit their annual report.²¹ During the course of performing its audit functions, the independent public accountant would be required to notify the nonbank SBSB or nonbank MSBSP if the firm is not in compliance with any rule or if any material weakness exists.

All nonbank SBSBs and nonbank MSBSPs would be required to submit the annual report to the SEC within 60 calendar days after the end of the fiscal year. The proposal would require an oath or affirmation by the nonbank SBSB or nonbank MSBSP regarding the veracity of the annual report to be attached to the report in the form of FOCUS Report Part III, as amended. Certain self-executing exemptions from, and extensions for, the annual report filing requirement that are available to broker-dealers would continue to be available to broker-dealer SBSBs and broker-dealer MSBSPs, while the SEC would have discretion to grant relief to stand-alone SBSBs and stand-alone MSBSPs.²²

While the statement of financial condition would be required to be public, the remainder of the annual report could be separately bound and marked confidential. To that end, stand-alone SBSBs and stand-alone MSBSPs would be required to disclose on their websites the audited statement of financial condition, including appropriate notes, within 10 business days after the date the firm is required to file its audited financial reports with the SEC.²³ Furthermore, stand-alone SBSBs and stand-alone MSBSPs would be required to post on their websites unaudited financial statements as of a date that is six months after the date of the most recent audited financial report posted.²⁴

19 The proposal would require broker-dealer SBSBs and broker-dealer MSBSPs to file a compliance report if they either did not claim an exemption from Rule 15c3-3 throughout the most recent fiscal year or were subject to proposed Rule 18a-4; similarly, these firms would be required to file an exemption report if claiming to have been exempt throughout the most recent fiscal year and to have not been subject to proposed Rule 18a-4. The SEC notes that these requirements, as amended, should mean that all broker-dealer SBSBs file the compliance report, and not the exemption report. See 79 Fed. Reg. at 25239.

20 A “material weakness” is defined as “a deficiency, or a combination of deficiencies, in ‘Internal Control Over Compliance’ such that there is a reasonable possibility that noncompliance with [Rule 15c3-1 or Rule 15c3-3(e), or proposed Rules 18a-1 or 19a-4(c)] will not be prevented or detected on a timely basis or that noncompliance to a material extent with [Rule 15c3-3 or proposed Rule 18a-4], except for [Rule 17a-13(e) or proposed Rule 18a-9(c)], or any Account Statement Rule will not be prevented or detected on a timely basis.” See 79 Fed. Reg. at 25239, fn. 656.

21 The nonbank SBSB or nonbank MSBSP would need to file no later than December 10 of each year a statement to the SEC containing certain information regarding the independent public accountant engaged. See Rule 17a-5(f)(1), as proposed to be amended and proposed Rule 18a-7(e)(1).

22 For example, Proposed Rule 17a-5(e)(3)(m)(2) exempts from the requirements of Rule 17a-5 banks or insurance companies that are registered as broker-dealers to sell variable contracts and are exempt from Rule 15c3-1. By contrast, Proposed Rule 18a-7(d)(2) only provides the SEC with discretion upon its own motion or written application to grant stand-alone and bank SBSBs and stand-alone and bank MSBSPs extensions and exemptions (either unconditionally or subject to certain terms).

23 This posting would need to include the report of the independent public accountant if such report identified one or more material weaknesses. See proposed Rule 18a-7(b)(1)(iii).

24 The posting would need to be made within 30 calendar days of the date of the unaudited financial statements. See proposed Rule 18a-7(b)(2).

Proposed Notification Requirements

The SEC's proposed notification program for stand-alone broker-dealers, SBSBs and MSBSPs is modeled on the SEC's existing notification program for broker-dealers. The proposal would amend existing Rule 17a-11 to account for broker-dealers that are dually registered as SBSBs or MSBSPs and would include new Rule 18a-8 to impose substantially similar notification requirements on stand-alone SBSBs and stand-alone MSBSPs. Bank SBSBs and bank MSBSPs would also be subject to notification requirements under proposed Rule 18a-8, but such notification requirements would be narrower in scope, given their existing notification requirements to prudential regulators.

Below are some of the notification requirements that the SEC's proposal would impose on broker-dealers, SBSBs and MSBSPs:

- *Failure to Meet Minimum Capital Requirements.* Broker-dealers, including broker-dealers that register as SBSBs or MSBSPs, would continue to be required to notify the SEC of any deficiency in minimum net capital (or minimum tentative net capital, as applicable) required to be maintained under Rule 15c3-1. Proposed Rule 18a-8 would impose a parallel notification requirement (except with respect to Rule 18a-1 instead of Rule 15c3-1) on stand-alone SBSBs and stand-alone MSBSPs. This notification requirement would not apply to bank SBSBs or bank MSBSPs.
- *Early Warning of Potential Capital or Model Problem.* Broker-dealers, including broker-dealers that register as SBSBs or MSBSPs, would continue to be required to notify the SEC of the occurrence of any of several prescribed triggering events relating to the broker-dealer's amount of capital. Additionally, the proposal would require a broker-dealer MSBSP to notify the SEC whenever the broker-dealer MSBSP's level of tangible net worth falls below \$20 million. Proposed Rule 18a-8(b) would impose a parallel notification requirement on stand-alone SBSBs and stand-alone MSBSPs. This notification requirement would not apply to bank SBSBs or bank MSBSPs.
- *Notice of Adjustment of Reported Capital Category.* Proposed Rule 18a-8 would require bank SBSBs and bank MSBSPs to provide the SEC with a copy of any filing notifying a prudential regulator of an adjustment to the bank's reported capital category.
- *Failure to Make and Keep Current Books and Records.* Broker-dealers, including broker-dealers that register as SBSBs or MSBSPs, would continue to be required to notify the SEC on the same day of discovering a failure to make and keep current required books and records, specifying which books and records were not made or kept current. Within 48 hours of such notice, the broker-dealer would continue to be required to report to the SEC what steps have been taken to correct the situation. Proposed Rule 18a-7 would impose parallel notification requirements on stand-alone SBSBs, stand-alone MSBSPs, bank SBSBs and bank MSBSPs.
- *Material Weakness.* Broker-dealers, including broker-dealers that register as SBSBs or MSBSPs, would continue to be required to notify the SEC within 24 hours of discovering or being notified by an independent public accountant of a material weakness in internal controls, and within 48 hours of such notice, would continue to be required to report to the SEC what steps have been taken to correct the situation. Proposed Rule 18a-7 would impose a parallel notification requirement on stand-alone SBSBs. This notification requirement would not apply to stand-alone MSBSPs, bank SBSBs or bank MSBSPs.

- *Insufficient Liquidity Reserves.* ANC broker-dealers, ANC broker-dealer SBSBs and ANC stand-alone SBSBs would be required to notify the SEC immediately (in writing) if a liquidity stress test conducted pursuant to Rule 15c3-1 (for ANC broker-dealers and ANC broker-dealer SBSBs) or Rule 18a-8 (for ANC stand-alone SBSBs) indicated insufficient liquidity reserves. Bank SBSBs would not be subject to this notification requirement.
- *Failure to Make a Required Reserve Deposit.* Stand-alone broker-dealers would continue to be required to notify the SEC and their applicable designated examining authority of any failure to make a deposit into its customer reserve accounts. The proposal would amend Rule 17a-11 to impose a parallel notification requirement on broker-dealer SBSBs for any failure to make a deposit into its security-based swap customer reserve accounts. Proposed Rule 18a-8 would impose a parallel notification requirement on stand-alone SBSBs and bank SBSBs.

Every notice required by these requirements would be required to be delivered by facsimile transmission to the SEC's principal office in Washington, D.C., the appropriate SEC regional office, the designated examining authority of which the broker-dealer is a member and the CFTC (if the registrant also is registered as an FCM).

Proposed Securities Count Requirements

The SEC also proposed to establish a securities count program for nonbank SBSBs modeled on the securities count program for broker-dealers under existing Rule 17a-13. Broker-dealers, including broker-dealers that register as SBSBs or MSBSPs, would continue to be subject to Rule 17a-13. Stand-alone SBSB would be required to perform a securities count each quarter pursuant to proposed Rule 18a-9. The securities count requirement would not apply to stand-alone MSBSPs.

Proposed Capital Charge

Finally, the SEC proposed to require stand-alone SBSBs to include a capital charge for short securities differences that are unresolved for seven days or longer and for long securities differences where securities have been sold before they are adequately resolved. These capital charges were inadvertently omitted from the SEC's earlier proposed capital requirements for stand-alone SBSBs.²⁵

²⁵ *Supra* at n. 3.