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Preparing for Security-based Swap Dealer Registration: Comparing SEC & CFTC Regulatory Requirements

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Introduction

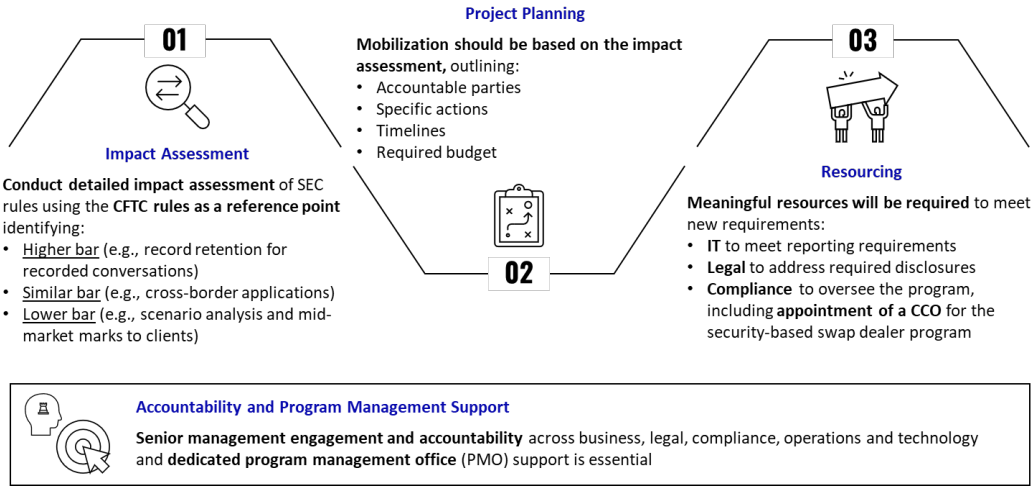
The Securities and Exchange Commission (SEC) security-based swap dealer (SBSD) rules have finally been issued, and a large amount of work will be required to comply. The good news is there is a foundation to build on, given that Commodity Futures Trading Commission (CFTC) swap dealer programs are now relatively mature at most organizations. However, there is serious risk of organizations underestimating the level of effort required to implement the SEC swap dealer rules due to a misperception that this is only a small incremental addition to the existing program. The purpose of this article is to provide guidance on how to approach the journey to implement the SEC swap dealer rules, and to serve as a catalyst for action.

At the outset, it is critical to ensure appropriate senior management engagement across business, legal, compliance, operations and information technology (IT) functions. Dodd-Frank fatigue is a real risk, and competition for scarce resources in the current environment is fierce, so appropriate resourcing for this effort likely will be a challenge. Accordingly, responsible stakeholders (i.e., compliance and legal teams) must develop a clear narrative for senior management and provide a realistic assessment of what will be necessary to implement the new rules despite these headwinds. It is important for senior management to understand this is not a “compliance only” exercise, where all that is necessary is an updated compliance manual. The effort will require business sponsorship, meaningful IT resources to meet the new reporting requirements and legal resources to address the new required disclosures. It may also require additional staff in compliance to oversee this program, including the appointment of a chief compliance officer (CCO) for the SBSD program and resources to support the CCO. As some firms learned the hard way with respect to the CFTC swap dealer rules, poor project planning and shoddy implementation can result in substantial enforcement cases and fines (e.g., numerous trade reporting cases). Firms must act now to actively avoid these mistakes with respect to implementing the SEC SBSD rules, which ultimately pose similar risks.

It is also essential that firms mobilize a project structure to accommodate the governance, people, processes and technology necessary to accomplish the broad variety of requirements of these rules in a timely fashion. In addition to appropriate representation from senior stakeholders, dedicated project management oversight is essential for a project of this breadth and complexity. The project governance must ultimately be accountable to a senior management body (e.g., an executive committee, senior change forum) for appropriate visibility, escalation paths and

funding. We observe that some firms have been slow to mobilize given the timelines provided by the SEC (e.g., registration date of October 2021), especially in comparison to the CFTC implementation timelines, which were much more aggressive. Certain key elements of many firms' compliance programs also will require planning and engagement with the SEC. For example, the internal capital model approval process can take quite a long time, and the number of firms now needing to obtain model approval is bound to test the SEC's resources. The SEC has warned prospective registrants to reach out to the SEC staff "as early as possible in advance of the registration compliance date to begin the model approval process."[1] Note that once a model is approved (or conditionally approved), firms will need time to tailor technology, recordkeeping, reporting and capital computations to the requirements of the approved model.

Implementation of the SEC swap dealer rules will require a detailed impact assessment at the rule provision level, boiling down the requirements to determine the policy, process and technology impacts. Firms are not working from a blank slate and can use their current CFTC swap dealer program as a reference point and drive actions based on the key differences. Some of the SEC rules will set a higher bar (e.g., record retention for recorded conversations), a similar standard (e.g., cross-border application) or a lower bar (e.g., offering scenario analysis and mid-market marks to clients) than the CFTC rules, which may be a useful way of articulating the program of work to senior stakeholders. The impact assessment then should feed a detailed action plan with accountable parties, specific actions and timelines and should enable the development of a budget for the project. This article is intended to serve as a reference tool for kicking off the gap assessment and project planning work.



I. Business Conduct Standards

a. Disclosure Requirements

CFTC Rule 23.431(a) requires swap dealers to disclose to counterparties material information concerning swap transactions at a reasonably sufficient time prior to entering the transaction and in a manner reasonably designed to allow the counterparty to assess the material risks and characteristics of the swap as well as the material incentives and conflicts of interest that the swap dealer may have in connection with the swap. For swaps that are not made available for trading, CFTC Rule 23.431(b) requires swap dealers to notify counterparties of their right to request a scenario analysis prior to entering into the swap (swap dealers are required only to notify the

[1] Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital and Segregation Requirements for Broker-Dealers, 84 Fed. Reg. 43872, 43901 (August 22, 2019).

counterparty of the right to receive the scenario analysis, but they may charge the counterparty for actually providing the scenario analysis).

Exchange Act Rule 15Fh-3(b) requires SBSDs to disclose to counterparties material information concerning security-based swap transactions at a reasonably sufficient time prior to entering into a transaction and in a manner reasonably designed to allow the counterparty to assess the material risks and characteristics and material incentives or conflicts of interest. The SEC, however, does not require SBSDs to notify counterparties of their right to receive a scenario analysis. According to the SEC, while a scenario may "prove a valuable analytical tool," it is only "one means by which information may be conveyed" and may not be appropriate or necessary in every situation to ensure proper disclosures are made.[2]

Action Item:

- SBSD policies and procedures should not require associated persons to notify customers of their right to opt-in to a scenario analysis.
- SBSDs should consider what information they will provide and how they will disclose material risks and characteristics and material incentives and conflicts of interest.

b. Daily Marks

For *uncleared swaps*, both the SEC and the CFTC rules require the dealer to provide counterparties with a daily mark. However, unlike CFTC Rule 23.431, Exchange Act Rule 15Fh-3(c)(2) requires an SBSD to disclose to the counterparty its data sources and a description of the methodology and assumptions used to prepare the daily mark for an uncleared security-based swap. Additionally, Rule 15Fh-3(c)(2) requires an SBSD to promptly disclose any material changes to the data sources, methodology or assumptions during the term of the security-based swap. An SBSD is not required to disclose the data sources or a description of the methodology and assumptions more than once unless it materially changes the data sources, methodology or assumptions used to calculate the daily mark. The SEC explained that a "material change" generally means a change that has a material impact on the daily mark provided, such as if the data sources become unreliable or unavailable.[3] In contrast, while CFTC Rule 23.431(d) generally requires swap dealers to disclose the methodology and assumptions used to prepare the daily mark, the rule expressly provides that swap dealers are not required to disclose to the counterparty confidential, proprietary information about any model they may use to prepare the daily mark.

For both *cleared and uncleared security-based swaps*, Exchange Act Rule 15Fh-3(c)(3) prohibits SBSDs from charging for providing daily marks and from placing restrictions on the internal use of the daily mark by the counterparty. CFTC Rule 23.431 does not contain similar prohibitions.

The SEC rules **do not** require SBSDs to deliver a pre-trade mid-market mark, as required by CFTC rule 23.431(a)(3).[4]

[2] Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, 81 Fed. Reg. 29960, 29985 (May 13, 2016) (SEC Business Conduct Standards).
[3] SEC Business Conduct Standards, 81 Fed. Reg. at 29987.
[4] The CFTC has brought enforcement action against swap dealers for failing to provide pre-trade mid-market marks. See *In the Matter of Cargill, Inc.*, CFTC Docket No. 18-03 (November 6, 2017).

Action Items:

- SBSDs will need to adopt new policies and procedures and disclosures regarding daily mark data sources and prompt disclosure of material changes to the data source during the term of the security-based swap.
- SBSD policies and procedures need not require associated persons to disclose the pre-trade mid-market mark.
- SBSD policies and procedures should clarify that the SBSD is prohibited from charging for providing daily marks and from placing internal restrictions on the use of the daily mark by the counterparty.

c. Clearing Rights

The requirements of Exchange Act Rule 15Fh-3(d) are not the same as the CFTC requirements in CFTC Rule 23.432 for disclosing clearing choices. SBSDs will need to develop new disclosures.

d. Recommendations

Action Item:

- SBSDs will need to adopt new policies, procedures and disclosures regarding counterparty clearing rights.

The SEC and the CFTC adopted consistent requirements regarding recommendations to counterparties. Exchange Act Rule 15Fh-3(f)(1) requires that SBSDs undertake reasonable diligence to understand the potential risk and rewards associated with recommended security-based swaps or trading strategies involving security-based swaps (i.e., product suitability) and to ensure that these recommendations are suitable for the counterparty (i.e., customer-specific suitability). This language follows the requirements of CFTC Rule 23.434.

The SEC indicated that determinations as to whether a particular communication is a recommendation will follow the Financial Industry Regulatory Authority (FINRA) approach to what constitutes a recommendation for purposes of FINRA's suitability rule.[5] Similar to the SEC and FINRA, the CFTC has not provided a bright-line test for what constitutes a recommendation. The CFTC appears to adopt FINRA's general definition that a recommendation is a communication that a counterparty would reasonably consider a "call to action" or a suggestion to enter into a swap.[6]

Both the SEC and the CFTC impose a safe harbor from the customer-specific suitability requirement; however, the requirements to claim the safe harbor differ. Exchange Act Rule 15Fh-3(f)(2) includes an institutional suitability alternative for customer-specific suitability assessments. SBSDs will be deemed to have fulfilled their customer-specific suitability obligations if they (i) reasonably determine that the counterparty or its agent is capable of independently evaluating the investment risks, (ii) the counterparty or agent affirmatively represents in writing that they are evaluating the investment independently and (iii) the SBSD discloses that it is not undertaking to assess suitability for the counterparty.

Exchange Act Rule 15Fh-3(f)(3) provides a safe harbor permitting an SBSD to satisfy its requirement under the first prong of the institutional suitability alternative in Rule 15Fh-3(f)(2) to make a reasonable determination that the counterparty (or its agent) is capable of independently evaluating investment risks with regard to the relevant security-based swap or trading strategy by receiving appropriate written representations from its counterparty.

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[5] *See* SEC Business Conduct Standards, 91 Fed. Reg. at 29997.
[6] Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. 9734, 9772 (February 17, 2012).

Exchange Act Rule 15Fh-3(f)(4), as adopted, defines the term "institutional counterparty" for these purposes to include certain categories of "eligible contract participant" defined in Section 1a(18) of the Commodity Exchange Act (CEA) or any person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least $50 million. The SEC's institutional counterparty thus aligns with the definition of "institutional account" under FINRA's institutional suitability alternative.[7]

The CFTC does not limit the availability of its safe harbor to recommendations to institutional counterparties or impose a specific asset threshold. Instead, the swap dealer must reasonably determine that the counterparty (or the counterparty's agent) is capable of independently evaluating investments risks with regard to the swap or trading strategy, obtain a representation that the counterparty is exercising independent judgment in evaluating the recommendations of the swap dealer, and disclose in writing that it is acting in its capacity as a counterparty and is not undertaking to assess the suitability of the swap or trading strategy. *See* CFTC Rule 23.434(b).

Action Item:

- For security-based swap activities, policies and procedures should limit the institutional counterparty safe harbor to entities with total assets of at least $50 million.
- To the extent SBSDs intend to rely on the safe harbor, legal and compliance should prepare policies and procedures and work with their business colleagues to obtain the requisite information and representations necessary to satisfy the SEC's institutional counterparty safe harbor.

e. Rules Applicable to Dealing With Special Entities

Employee Benefit Plans and Governmental Plans

Under Exchange Act Rule 15Fh-2(d)(4), an employee benefit plan that is "defined in" Section 3 of the Employment Retirement Income Security Act (ERISA) but not "subject to" regulation under ERISA is included within the special-entity definition, although it may elect to opt out of special-entity status by notifying an SBSD of its election to opt out prior to entering into a security-based swap. Therefore, for example, under Rule 15Fh-2(d)(4), any church plan, as defined in Section 3(33) of ERISA, would be considered a special entity unless it elected to opt out of special-entity status.

CFTC Rule 23.401 similarly defines "special entity" to include an employee benefit plan defined in Section 3 of ERISA but not otherwise defined as a special entity, but it requires these entities to opt in to special-entity status. The SEC determined that inclusion of an opt-out provision will afford maximum protection to the broadest categories of special entities while still allowing them the flexibility to elect not to be special entities when they do not wish to avail themselves of those protections.[8]

"Acts as an Adviser" to a Special Entity

Section 15F(h)(4)(B) of the Exchange Act imposes a duty on SBSDs acting "as an advisor" to a special entity, requiring that these advisors make a reasonable determination that any security-based swap or trading strategy recommended by the SBSD is in the "best interests" of the special entity.[9] Exchange Act Rule 15Fh-2(a) states that an SBSD "acts as an advisor to a special entity when it recommends a security-based swap or a trading strategy that involves the use of a security-based swap to the special entity." In contrast, CFTC Rule 23.440 states that a swap dealer

[7] *See* FINRA Rule 2111 (prescribing FINRA member suitability obligations) and FINRA Rule 4512(c) (defining "institutional account").
[8] *See* SEC Business Conduct Standards, 91 Fed. Reg. at 30008.
[9] We anticipate that the SEC's interpretation of "best interest" for purposes of this rule will be informed by the SEC's since-adopted Regulation Best Interest, 84 Fed. Reg. 33318.

"acts as an advisor to a Special Entity" when the swap dealer recommends a swap or trading strategy involving a swap that is tailored to the particular needs or characteristics of the Special Entity" (emphasis added).

The SEC's definition of "acts as an advisor" is thus broader than the definition in the CFTC's parallel rule. While the SEC agreed that the more individually tailored a communication is to a specific counterparty or a targeted group of counterparties about a swap, group of swaps or trading strategy involving the use of a swap, the greater the likelihood that the communication may be viewed as a recommendation, the SEC did not agree that a security-based swap communication must be tailored to the particular needs or characteristics of the special entity to constitute a recommendation for purposes of Rule 15Fh-2(a).

Safe Harbor

CFTC Rule 23.440 provides two safe harbors from acting as an advisor to a special entity. CFTC Rule 23.440(b)(1) provides a safe harbor for communications between a swap dealer and an ERISA plan that has an ERISA fiduciary, provided the swap dealer receives certain representations from the fiduciary and the special entity in writing. CFTC Rule 23.440(b)(2) provides a safe harbor for communications between a swap dealer and any special entity (including a special entity that is an ERISA plan) provided that the swap dealer does not express an opinion as to whether the special entity should enter into a recommended swap or trading strategy that is tailored to the particular needs or characteristics of the special entity, obtains certain representations from the special entity, and discloses that it is not undertaking to act in the best interests of the special entity.

Under Rule 15Fh-2(a)(1), as adopted, an SBSD may establish that it is not acting as an advisor to a special entity that is an ERISA plan if the special entity is represented by a qualified independent representative that meets the standard for an ERISA fiduciary. Specifically, the rule provides that an SBSD is not acting as an advisor to an ERISA special entity if (i) the ERISA plan represents in writing that it has an ERISA fiduciary; (ii) the ERISA fiduciary represents in writing that it acknowledges that the SBSD is not acting as an advisor; and (iii) the ERISA plan represents in writing that (A) it will comply in good faith with written policies and procedures reasonably designed to ensure that any recommendation the special entity receives from the SBSD involving a security-based swap transaction is evaluated by an ERISA fiduciary before the transaction is entered into or (B) any recommendation the special entity receives from the SBSD involving a security-based swap transaction will be evaluated by an ERISA fiduciary before that transaction is entered into.

Although the SEC rule largely aligns with that of the CFTC, it differs in four respects:

- Rules 15Fh-2(a)(1)(ii) and 15Fh-2(a)(2)(i)(A) require the special entity or its fiduciary to represent in writing that it acknowledges the SBSD is not acting as an advisor, whereas the CFTC requires the special entity or its fiduciary to represent it will not rely on the SBSD's recommendations.
- Rules 15Fh-2(a)(1)(iii)(A) and (B) apply to any recommendation the special entity receives from the SBSD "involving" a security-based swap transaction, while the parallel CFTC rules apply to recommendations "materially affecting" a security-based swap transaction.
- Rule 15Fh-2(a)(1)(iii) requires a security-based swap transaction to be evaluated by a fiduciary before the transaction "is entered into," whereas the CFTC's safe harbor requires a swap transaction to be evaluated by fiduciary before the transaction "occurs."
- The safe harbor in Rule 15Fh-2(a) does not prohibit an SBSD acting as an advisor from expressing an opinion as to whether a special entity should enter into a recommended security-based swap or trading strategy. Instead, the determination of whether an SBSD has provided advice to a special entity turns on whether the communication is considered a "recommendation."

We believe there will be little if any practical differences between the SEC's and the CFTC's formulations. However, firms should consider the extent to which trading documentation and the firm's policies and procedures should be tailored to the SEC's requirements.

Action Items:

- ❖ SBSD policies and procedures should reflect that employee benefit plans and governmental plans must opt out.
- ❖ SBSD policies and procedures should reflect the broad definition of acting as an advisor under SEC rules.
- ❖ SBSD policies and procedures should be tailored to the SEC's safe harbor from acting as an advisor to a special entity.

f. Antifraud Provisions

Rule 15Fh-4(a) codifies the statutory requirements of Exchange Act Section 15F(h)(4)(A) and prohibits an SBSD from (1) employing any device, scheme or artifice to defraud any special entity or prospective customer who is a special entity; (2) engaging in any transaction, practice or course of business that operates as a fraud or deceit on any special entity or prospective customer who is a special entity; or (3) engaging in any act, practice or course of business that is fraudulent, deceptive or manipulative. The first two provisions are specific to an SBSD's interactions with special entities, while the third applies more generally.

The CFTC adopted an express, affirmative defense in its parallel antifraud rules (CFTC Rule 23.431), in part in response to concerns that the statute may impose non-scienter liability for fraud in private rights of action. The SEC determined not to provide a similar safe harbor from liability for fraud on behalf of SBSDs.

II. Recordkeeping and Reporting Requirements

Exchange Act Rule 17a-4(b)(4) requires a broker-dealer, including a broker-dealer SBSD, to preserve originals of all communications received and copies of all communications sent (and any approvals thereof) by the broker-dealer relating to its business as such, including all communications subject to the rules of a self-regulatory organization (SRO) of which the broker-dealer is a member regarding communications with the public, for a period of three years. The term "communications," as used in paragraph (b)(4) of Rule 17a-4, includes all electronic communications (e.g., emails and instant messages). Communications related to security-based swap activities would be communications relating to the business as such of a broker-dealer, including a broker-dealer SBSD. The SEC, however, did not require SBSDs to make such recordings. Thus, an SBSD need maintain only telephone recordings, if recordings are made, for a period of three years.

CFTC Rule 23.202(a)(1) requires CFTC-registered swap dealers and major swap participants to "make and keep pre-execution trade information, including, at a minimum, records of all oral and written communications provided or received concerning quotes, solicitations, bids, offers, instructions, trading, and prices, that lead to the execution of a swap, whether communicated by telephone . . . ." The CFTC requires telephone calls to be retained for only one year.

Action Item:

- ❖ SBSDs will need to consider their telephone systems and arrangements. If an SBSD that is part of a swap entity can separate security-based swap and swap personnel and/or telephone systems, the security-based swap lines will not need to be recorded. If calls are recorded, the SBSD will need to retain recordings for three years instead of the one year required by the CFTC.

III. Data Reporting

Security-based swap transactions must be reported within 24 hours of execution unless reporting would fall on a day other than a business day, in which case the security-based swap must be reported at the same time on the next business day after execution.[10] This 24-hour time frame is preliminary. The SEC stated that it anticipates proposing further rulemakings relating to reporting deadlines, including whether to establish delays for block trades, after it has collected and analyzed additional data.[11] This provides greater leeway than CFTC rules for reporting swap transactions, which generally require that a reporting party that is a swap dealer must report swap data to a swap data repository as soon as technologically practicable but no later than 15 minutes after execution.[12] However, in April 2020, the CFTC proposed amendments that would conform certain CFTC swap data reporting requirements with SEC requirements. The CFTC's proposed changes include harmonizing the swap data reporting timelines with the SEC, which would result in efficiencies for firms operating under both frameworks.

The SEC also requires certain data elements to be reported by the SBSD that are not required by the CFTC. These include (i) any condition flags of the SBSDR, if applicable;[13] (ii) branch ID, broker ID, execution agent ID, trader ID and trading desk ID, as applicable, of the direct counterparty on the reporting side;[14] and (iii) for non-clearing transactions, the title and date of any agreements incorporated into the terms of the security-based swap, such as master agreements and collateral agreements.[15] Further, the SEC does not require the reporting of valuation data, while the CFTC requires daily valuation data to be reported by the derivatives clearing organization and, if the reporting counterparty for the initial transaction is a swap dealer or a major swap participant, also by that reporting counterparty. *See* CFTC Rule 45.4.

Action Item:

- ❖ Develop new systems for reporting security-based swap data pursuant to the SEC's security-based swap data reporting rules.

IV. Cross-Border Jurisdictional Scope

The SEC and the CFTC have disagreed over the cross-border scope of the agencies' regulatory frameworks. Since July 2013, the cross-border application of the CFTC's swaps framework has been governed by published interpretive guidance and a policy statement published by the CFTC.[16] The CFTC's guidance and policy statement, unlike a formal rule, is not legally binding on the CFTC or market participants. Under the 2013 guidance, the extent to which CFTC's swaps regulations apply to a swap depends on whether the swap is entered into by a US person, a foreign branch of a US bank, a guaranteed affiliate of a US person or a conduit affiliate of a US person.[17] The 2013 guidance also defines these categories of market participants, addresses how registration

[10] *See* Exchange Act Rule 242.901(j).
[11] *See* Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information, 80 Fed. Reg. 14564, 14617 (March 19, 2015).
[12] *See* CFTC Rule 45.3(b).
[13] *See* Exchange Act Rule 242.901(c)(7).
[14] *See* Exchange Act Rule 242.901(d)(2).
[15] *See* Exchange Act Rule 242.901(d)(4).
[16] Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations, 78 Fed. Reg. 45292 (July 26, 2013) (2013 guidance).
[17] The 2013 guidance defines a "conduit affiliate" to mean a non-US person that satisfies certain factors, including whether the non-US person (1) is a majority-owned affiliate of a US person; (2) is controlling, controlled by or under common control with the US person; (3) has financial results that are included in the consolidated financial statements of the US person; and (4) in the regular course of business, engages in swaps with non-US third-parties for the purpose of hedging or mitigating risks faced by or to take positions on behalf of its US affiliates, and enters into offsetting swaps or other arrangements with its US affiliates in order to transfer the risks and benefits of such swaps with third-parties to its US affiliates. 2013 guidance, 78 Fed. Reg, at 45359.

requirements apply to swaps entered into by each category and divides most of the remaining regulatory requirements into "entity-level" or "transaction-level" requirements.

The SEC has adopted its own rules and guidance concerning the cross-border application of the security-based swap framework. Arguably, the most significant difference is the treatment of transactions that are "arranged, negotiated, or executed" by personnel within the United States. Exchange Act Rule 3a71-3(b)(1)(C)(iii) provides that for purposes of determining whether non-US persons will be deemed SBSDs, non-US persons must count, against the applicable *de minimis* threshold, their security-based swap dealing transactions with non-US counterparties that were arranged, negotiated or executed by personnel within the United States. The SEC incorporated the arranged/negotiation/executed criteria into the cross-border application of the SBSD *de minimis* counting rules, into the cross-border application of the business conduct provisions for SBSDs,[18] and into Regulation SBSR's regulatory reporting and public dissemination provisions.[19]

The CFTC has taken a less expansive view of applying US law to transactions between non-US counterparties. In December 2019, the CFTC proposed rules that except swaps between certain non-US persons from application of the CFTC's transaction-level requirements. The CFTC's proposed rule generally requires a foreign institution dealing in swaps to count only the notional value of the swaps it executes toward the CFTC's $8 billion registration threshold only in certain enumerated circumstances.

In December 2019, the CFTC proposed new cross-border rules that would represent important changes to the CFTC's cross-border swaps regulatory framework and conform to the CFTC and SEC's cross-border rules in important respects. *See* Cross-Border Application of the Registration Thresholds and Certain Requirements Applicable to Swap Dealers and Major Swap Participants, 85 Fed. Reg. 952 (January 8, 2020).

Action Item:

- ❖ Market participants will need to analyze the scope of their cross-border activities to determine the impact of the SEC's new cross-border regulatory framework.

V. Registration Requirements

The process for registering as an SBSD and a swap dealer will differ. Practically speaking, the swap dealer registration process will be carried out by the National Futures Association (NFA). On the other hand, SBSD registration will be carried out directly by the SEC. Upon submitting Form SBSE-C and completing Form SBSE, SBSE-A or SBSE-BD, as applicable, the SBSD will be considered conditionally registered.[20] The SEC may then grant or deny ongoing registration based on the application. The SEC rules do not prescribe a time frame for approval, and it is unclear how onerous this process will be.

Exchange Act Section 3(a)(70) generally defines the term "person associated with" an SBSD to include (i) any partner, officer, director or branch manager of an SBSD (or any person occupying a similar status or performing similar functions); (ii) any person directly or indirectly controlling, controlled by or under common control with an SBSD; or (iii) any employee of an SBSD. *See* 15 U.S.C. 78c(a)(70). The definition generally excludes persons whose functions are solely clerical or ministerial. *Id.* The definition of "person" under Exchange Act Section 3(a)(9) is not limited to natural persons but extends to both entities and natural persons. *See* 15 U.S.C. 78c(a)(9). Thus, the statutory prohibition in Exchange Act Section 15F(b)(6) with respect to associated persons of an SBSD subject to a statutory disqualification extends to both natural persons and entities.

Exchange Act Section 15F(b)(6) generally prohibits an SBSD from permitting any person associated with the SBSD who is subject to a "statutory disqualification" or who in the exercise of

[18] *See* Exchange Act Rule 3a71-3(c).
[19] *See* Exchange Act Rules 908(a)(1)(v) and 908(b)(5).
[20] Exchange Act Rule 15Fb2-1(d)(1).

reasonable care should have known of the statutory disqualification to effect or be involved in effecting security-based swaps on behalf of the SBSD. As described below, the SEC adopted rules providing that SBSDs must certify and collect certain information in an effort to prevent associated persons with statutory disqualifications from effecting security-based swap transactions.

In 2019, in an effort to harmonize SEC and CFTC rules, the SEC adopted Rule 194(c), generally excluding associated person entities from the prohibition in 15F(b)(6).[21] The SEC also adopted an exclusion applicable to non-US persons. Rule 194(c)(2) excludes from the prohibition in Exchange Act Section 15F(b)(6) associated persons who are natural persons who (i) are not a US person and (ii) do not effect and are not involved in effecting security-based swap transactions with or for counterparties that are US persons, other than a security-based swap transaction conducted through a foreign branch of a counterparty that is a US person.

Senior Officer Certification Requirement

As part of the swap dealer registration, Exchange Act Rule 15Fb2-1(b) requires a senior officer to certify that "(1) [a]fter due inquiry, he or she has reasonably determined that the security-based swap dealer or major security-based swap participant has developed and implemented written policies and procedures reasonably designed to prevent violation of federal securities laws and the rules thereunder, and (2) [h]e or she has documented the process by which he or she reached such determination." The CFTC does not require a senior officer to make a comparable certification.

CCO Certification and Associated Person Questionnaire

As part of registration, the CCO of the SBSD (or the CCO's designee) must certify on Form SBSE-C that the officer neither knows nor in the exercise of reasonable care should have known that any person associated with the SBSD who effects or is involved in effecting security-based swaps on its behalf is subject to a statutory disqualification, as described in Sections 3(a)(39)(A) through (F) of the Exchange Act, unless otherwise specifically provided by rule, regulation or order of the commission. *See* Exchange Act Rule 15Fb6-2(a).

To support the certification requirement, the CCO or a designee must review and sign the questionnaire or application for employment executed by each associated person who is a natural person and who effects or is involved in effecting security-based swaps on the SBSD's behalf. *See* Exchange Act Rule 15Fb6-2(b). The contents of the required questionnaire are prescribed in Exchange Act 17a-3(a)(12) for broker-dealer SBSDs, 18a-5(a)(10)(i) for stand-alone SBSDs and 18a-5(b)(8)(i) for bank SBSDs. There are no directly comparable requirements under CFTC rules. We note, however, that NFA Form 7-R requires a firm's electronic filer to certify that no later than 90 days following the date filing, it will be and will remain in compliance with the requirement of Section 4s(b)(6) of the Commodity Exchange Act and that the applicant will not permit any person associated with it who is subject to a statutory disqualification to effect or be involved in effecting swaps on behalf of the applicant, if the applicant knows or in the exercise of reasonable care should know of the statutory disqualification.

[21] Specifically, CFTC Regulation 1.3(aa) generally defines the term "associated person." With respect to swap dealers, the definition reads, "(aa) Associated Person. This term means any natural person who is associated in any of the following capacities with: . . . (6) A swap dealer or major swap participant as a partner, officer, employee, agent (or any natural person occupying a similar status or performing similar functions), in any capacity that involves: (i) The solicitation or acceptance of swaps (other than in a clerical or ministerial capacity); or (ii) The supervision of any person or persons so engaged."

Action Item:

- SBSDs that are required to register with the SEC will need to submit applications for registration with the SEC.
- SBSDs must obtain questionnaires or applications for employment executed by the SBSD's associated persons to support the CCO's required certification.

VI. Capital, Margin and Segregation Rules

There are several noticeable differences between the SEC and the CFTC capital, margin and segregation rules. First, unlike CFTC Rule 23.152, Exchange Act Rule 18a-3 does not require (but permits) an SBSD to post initial margin to any counterparty. Further, Exchange Act Rule 18a-3 does not require (but permits) an SBSD to collect initial margin from counterparties that are financial intermediaries, such as SBSDs, swap dealers, future commission merchants, broker-dealers and banks. Second, Exchange Act Rule 18a-3 does not contain the concept of material swaps exposure as in CFTC Rule 23.151 and thus does not contain an exception from the requirement to collect initial margin from a financial end user counterparty that does not have material security-based swap exposure. Third, unlike the comparable CFTC rules, Exchange Act Rule 18a-4 requires initial margin to be held by a third-party custodian.

With respect to collateral eligibility requirements, unlike the CFTC rules, the Exchange Act rules do not set out a specific list of assets that are eligible collateral. Instead, the Exchange Act rules describe general categories of eligible collateral with applicable haircuts and requirements for how that collateral must be held by the SBSD (or an independent custodian). The Exchange Act rules are more flexible than the CFTC rules in permitting collateral for both initial and variation margin in the form of any cash, securities or money-market instruments that meet certain liquidity requirements. Under the CFTC rules, only cash in US dollars, another major currency or the settlement currency may be posted as collateral for variation margin for interdealer transactions.

Action Item:

- SBSDs will need to plan and prepare for compliance with the SEC's new capital, margin and segregation rules.
- SBSDs should review the capital, margin and segregation requirements across SBSD registration categories (e.g., stand-alone SBSD, broker-dealer SBSD, or a bank SBSD) to determine the most appropriate and cost-effective structuring option for the SBSD's business.

VII. Risk Mitigation

Rule 15Fi-5(c) requires each SBSD to have an independent auditor conduct periodic audits sufficient to identify any material weakness in its documentation policies and procedures required by the rule. In addition, a record of the results of each audit must be retained for a period of three years after the conclusion of the audit. This requirement differs from CFTC Rule 23.504(c), which references an independent "internal or external" auditor.

Action Item:

- SBSDs will need to adopt policies and procedures to comply with the SEC's risk mitigation requirements.

VIII. SRO Requirements

A notable difference between the CEA and the Exchange Act regarding swap and security-based swap activities is the role of self-regulatory organizations. The provisions in the CEA directly related

to swap dealers provide the CFTC with the ability to require swap dealers to become members of the NFA.[22] Under the framework established in the Dodd-Frank Act, SBSDs are not required to be members of self-regulatory organizations. Specifically, Dodd-Frank excluded from the Exchange Act definition of "dealer" persons who engage in security-based swaps with eligible contract participants.[23] The Dodd-Frank Act does not include comparable amendments for persons who act as brokers in swaps and security-based swaps. Because security-based swaps, as defined in Section 3(a)(68) of the Exchange Act, are included in the Exchange Act Section 3(a)(10) definition of security, persons who act as brokers in connection with security-based swaps, absent an exception or exemption, must register with the SEC as a broker pursuant to Exchange Act Section 15(a) and comply with the Exchange Act's requirements applicable to brokers.

The role of FINRA in security-based swap regulation is still in question. In May 2020, FINRA issued a request for comment on security-based swap activities and how FINRA rules might apply to these activities.[24] A broad application of the FINRA rules to security-based swap activities of broker-dealers acting as principals in security-based swap transactions would likely result in an unintended competitive disadvantage for SBSDs that are also registered as broker-dealers. FINRA has adopted a temporary rule excluding member security-based swap activity from certain FINRA rules.[25] This temporary exclusion is set to expire September 1, 2021.[26]

[22] CEA Section 17(b)(2) permits any CFTC registrant to become a member of a registered futures association (i.e., NFA), and CEA Section 8a(5) gives the CFTC rulemaking authority "to effectuate any of the provisions or to accomplish any of the purposes of this Act."
[23] *See* Exchange Act Section 3(a)(5) as amended by Section 761(a)(1) of the Dodd-Frank Act.
[24] Views and Information on Activity Related to Security-Based Swaps, FINRA (May 21, 2020), *available at* https://www.finra.org/rules-guidance/requests-for-comments/security-based-swaps.
[25] FINRA Rule 0180.
[26] *Id.*

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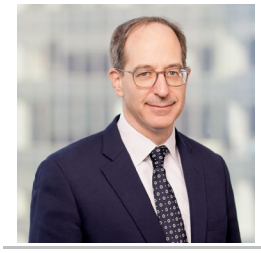

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