

## SEC Proposes Rule on the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants

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On October 12, 2011, the Securities and Exchange Commission (the “**SEC**” or the “**Commission**”) proposed, by a 3-1 vote, rules under the Dodd-Frank Act to provide for the registration of security-based swap dealers and major security-based swap participants (“**SBS Entities**”).<sup>1</sup> The SEC’s proposal (the “**Proposal**”) draws heavily upon existing SEC registration regimes and has taken into account the Commodity Futures Trading Commission’s registration requirements for swap dealers and major swap participants. Under the Proposal, market participants registered as both an SBS Entity and a broker-dealer are subject to a “similar and complementary registration regime.” To avoid unnecessary duplication, the Proposal would permit SBS Entities that are otherwise registered or registering as intermediaries with either the SEC or the Commodity Futures Trading Commission (the “**CFTC**”) to complete streamlined application forms.

The Proposal departs from the broker-dealer registration regime in what is likely to be its most controversial provision, requiring a “Senior Officer Certification” of the SBS Entity’s financial, operational, and compliance capabilities as part of the application for registration.<sup>2</sup> The Proposal does not include rules permitting registration on a “limited designation” basis, but seeks comment on this topic.

The Proposal also explains the Commission’s overall approach to implementing the new security-based swap regime. After it publishes proposals for all of the key Title VII rules, the SEC will publish an implementation plan detailing the roll-out of the new security-based swap requirements under Title VII. The Commission also plans to issue a concept release to collect information and consider the policy objectives of registration and the relative benefits and costs of available means of achieving them.

The Proposal does not include guidance concerning how the registration requirements or the other provisions of Title VII would apply to the global operations of registered SBS Entities. However, the SEC intends to address these issues in a separate, forthcoming release.

### SBS Entity Registration

The Proposal would require an SBS Entity to seek registration with the SEC by filing Form SBSE and a “Senior Officer Certification,” discussed below. Form SBSE is based on Form BD, the SEC’s registration form for broker-dealers. Form SBSE would be filed electronically via EDGAR, and its contents would be made publicly available.<sup>3</sup>

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<sup>1</sup> SEC Proposed Rule on Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, Release No. 34-65543, available at <http://www.sec.gov/rules/proposed/2011/34-65543.pdf>. Proposed Forms SBSE, SBSA (for CFTC registered swap dealers and major swap participants), SBSBD (for SEC registered broker-dealers), and SBSE-C (senior officer certification) are available on the SEC’s website at <http://sec.gov/rules/proposed.shtml>.

<sup>2</sup> Commissioner Troy A. Paredes voted against the Proposal, expressing concerns about, among other aspects of the Proposal, the Senior Officer Certification. Commissioner Paredes’ dissent is available on the SEC’s website at <http://www.sec.gov/news/speech/2011/spch101211tap-sbs.htm>.

<sup>3</sup> The SEC expects that Form SBSE will be available to be filed electronically via EDGAR when the final rules are adopted, however if the technological capability is not available on that date, SBS Entities would be required to file applications and additional documents in paper form.

Like Form BD, Form SBSE elicits information regarding any criminal record of the SBS Entity, regulatory or civil disciplinary actions, bankruptcy proceedings, identification of direct and indirect owners of the SBS Entity and its executive officers, control<sup>4</sup> relationships, and locations. Many of the disclosure items that have proved difficult for new broker-dealers that are part of complex or global organizations, such as disciplinary matters affecting “control affiliates,” have been imported from Form BD without modification.

Form SBSE also asks for additional information not required by Form BD, including, for example:

- whether the applicant is subject to regulation by a prudential regulator;
- whether the SBS Entity is registering as a major security-based swap participant because it maintains a substantial position, has substantial counterparty exposure, or is highly leveraged relative to its capital position (if applicable);
- whether the applicant intends to use mathematical models to calculate any applicable capital or margin or to price customer or proprietary positions;
- information on the SBS Entity’s business arrangements (e.g., execution, trading, custody, and clearing or settlement arrangements); and
- information on prior investment-related experience of individual owners of the SBS Entity who are not otherwise registered through CRD or IARD.

Under the Proposal, short-form filings are permitted for SBS Entities registered, or planning to register, with the SEC as a broker-dealer or with the CFTC as a swap dealer or major swap participant.

The proposed rules would require an SBS Entity to amend its registration form within 30 days to correct any information it determines is, or has become, inaccurate for any reason. The SEC may censure, place limitations on the activities, functions, or operations of, or revoke the registration of an SBS Entity for offenses specified under the Securities Exchange Act of 1934 (the “Exchange Act”).<sup>5</sup>

## Senior Officer Certification

The proposed Senior Officer Certification requirement is meant to address matters that, in the case of SEC registered broker-dealers, would be reviewed by FINRA staff prior to granting registration. When a firm applies to register as a broker-dealer, FINRA conducts an in-depth review of the firm’s application, which is designed to ensure that the firm will be able to meet applicable substantive requirements under the Exchange Act, SEC rules and FINRA rules.

In lieu of such a review, the Proposal would require a senior officer of the SBS Entity to certify that the SBS Entity is capable of meeting the requirements applicable to the entity. Specifically, the senior officer would be required to certify that, after “due inquiry,” he or she has determined that the SBS Entity has the financial, operational and compliance capabilities to act as a security-based swap dealer or major security-based swap participant, as applicable. The Proposal does not define the terms “operational, financial and compliance capabilities” but provides guidance regarding the factors that a senior officer would use in his or her assessment and it seeks comment on issues relevant to the proposed

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<sup>4</sup> The definition of “control” in Form SBSE and the simplified registration forms tracks that in Form BD – i.e., “the power, directly or indirectly to direct the management or policies of a company, whether through ownerships of securities, by contract, or otherwise.” A person is presumed to control another person under certain circumstances, including, for example, the direct or indirect right to vote 25% or more of a class of voting securities. As with Form BD, there is no stated mechanism for rebutting this presumption of control – a circumstance that has often raised difficult interpretive challenges for registered broker-dealers and applicants for registration.

<sup>5</sup> See Section 15F(l)(2) of the Exchange Act.

requirement, including the desirability of additional definitional guidance concerning the certification, possible alternative approaches, and potential exceptions to the requirement for registrants in other capacities. The SEC declined to define “due inquiry” or prescribe any single method that must be used for the senior officer’s assessment. Instead, the Proposal would give the senior officer discretion to employ a variety of processes to support the certification.

In his dissent from the SEC’s issuance of the Proposal, Commissioner Paredes criticized the “operational, financial, and compliance capabilities” standard of the Senior Officer Certification as “unduly vague and indeterminate,” failing to give “fair notice” to SBS Entities and their senior officers of what the new registration regime demands, and affording the Commission too much room for “after-the-fact second-guessing.”

## Conditional Registration

The Proposal includes a conditional registration process to address situations where an SBS Entity is required to register but its senior officer is unable to provide the required Senior Officer Certification. The Proposal identifies two circumstances in which this might occur. First, an SBS Entity (whether a security-based swap dealer or major security-based swap participant) may need to file for registration, as required by final registration rules adopted by the SEC, before the final rules setting out the substantive requirements applicable to the SBS Entity are effective. Second, an entity that exceeds the major security-based participant thresholds in a given fiscal quarter would have two months to file for registration but may need additional time to build the operating and compliance structures that would be required once it registers.

Under the proposed conditional registration process, an SBS Entity would file a Form SBSE (or SBSE-A or SBSE-BD) but not the Senior Officer Certification. Conditional registration for security-based swap dealers would expire once the applicable substantive requirements become effective. This date would be specified and published by the SEC in its Title VII implementation plan (referenced above). Conditional registration for major security-based swap participants under the second category described above would expire four months after conditional registration was granted, subject to extension by the SEC.<sup>6</sup>

To apply to convert a conditional registration to an ongoing registration, an SBS Entity would file the Senior Officer Certification with the SEC.

## Requirements for Associated Persons

The Proposal would require an SBS Entity to certify on its registration form that none of its associated persons<sup>7</sup> who effect or are involved in effecting security-based swaps are subject to a statutory disqualification. To support this certification, an SBS Entity must obtain from any such associated person

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<sup>6</sup> The proposed definition of major security-based swap participant provides an entity whose security-based swap portfolio crosses specified thresholds in a fiscal quarter with a two-month grace period to submit an application for registration as a major security-based swap participant. This grace period, along with the four-month conditional registration period, would give a new major security-based swap participant six months from the date in which it triggers the registration threshold to build the operational and compliance structures needed to comply with the applicable laws and regulations.

<sup>7</sup> Under Exchange Act § 3(a)(70) a “person associated with a security-based swap dealer or major security-based swap participant” is defined as: (i) any partner, officer, director, or branch manager (or any person occupying a similar status) with the SBS Entity; (ii) any person directly or indirectly controlling, controlled by, or under common control with the SBS Entity; and (iii) any employee of such SBS Entity. The definition excludes persons whose functions are solely clerical or ministerial.

an executed document (*i.e.*, questionnaire or employment application) that would provide sufficient information to allow the SBS Entity to make the certification.

The SBS Entity's chief compliance officer, or his or her designee, would be required to review and sign each questionnaire or application.

The Proposal seeks comment on, among other things, whether background checks, credit checks or fingerprinting of associated persons should be required and whether the SEC should develop an alternative review process to allow associated persons of SBS Entities who are subject to a statutory disqualification to effect security-based swaps on behalf of the SBS Entity.

## Registration Requirements for Nonresident SBS Entities

Under the Proposal, non-resident SBS Entities (SBS Entities incorporated in or that have their principal place of business in any place outside the United States) would be required to:

- appoint a U.S. agent for service of process and provide the SEC with the identity and address of the agent on the registration form;
- certify that the entity can, as a matter of law, submit to onsite SEC examinations and inspections; and
- provide an opinion of counsel concurring with the SBS Entity's certification and that the SBS Entity may provide the SEC with prompt access to its books and records.

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If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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