SEC Adopts Business Conduct Rules for Security-Based Swap Dealers

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Contents

The SEC adopted **Business Conduct Rules** for security-based swap dealers ("**SBSDs**") on April 14, 2016.[1] The Business Conduct Rules address requirements analogous to those covered by the CFTC's external business conduct rules for swap dealers ("**SDs**") and also include two sets of requirements characterized under CFTC rules for SDs as internal business conduct standards—diligent supervision and requirements for a designated chief compliance officer ("**CCO**") and CCO annual reports.

The SEC expects that a majority of the entities that register as SBSDs will be dually registered as SDs. Given the significant overlap in the security-based swap ("**SBS**") and swap markets, the SEC states that it sought to harmonize the Business Conduct Rules with the CFTC's conduct rules for SDs. While the two sets of rules are similar in approach and principle, there are differences between the Business Conduct Rules and CFTC conduct rules that may result in operational and compliance challenges for firms. Firms that will dually register as SDs and SBSDs will need to determine the extent to which their existing SD external business conduct, CCO and supervisory compliance infrastructure can be used to comply with the SEC's Business Conduct Rules. SBSDs that will be dually registered as broker-dealers and SBSDs will also need to engage in this comparative analysis.

The Business Conduct Rules will not apply until at least the compliance date of the SBSD registration rules ("**Registration Compliance Date**"), which is not expected to occur in the near future. As such, the Business Conduct Rules will not have an immediate impact on firms engaged in SBS business.

External Business Conduct Standards

The Business Conduct Rules impose several types of obligations on an SBSD and its associated persons ("**APs**") regarding interactions with counterparties. These obligations vary depending upon whether the SBSD's counterparty is an SD, SBSD, major swap participant ("**MSP**") or major security-based swap participant (each a "**Swap/SBS Entity**"); an entity that is not a Swap/SBS Entity; or a Special Entity (as defined in the sidebar).

[1] This memorandum focuses on the impact of the Business Conduct Rules on SBSDs. Many of the Business Conduct Rules also apply to major security-based swap participants.

Definition of Special Entity

The SEC defines Special Entity as:

(1) a federal agency;

(2) a state, state agency, city, county, municipality, other political subdivision of a state, or any instrumentality, department, or a corporation of or established by a state or political subdivision of a state;

(3) any employee benefit plan subject to Title I of ERISA (an "**ERISA Special Entity**");

(4) any employee benefit plan defined in Section 3 of ERISA (including a plan not otherwise subject to ERISA regulation, such as a church plan) and not otherwise defined as a Special Entity;

(5) any governmental plan as defined in Section 3(32) of ERISA; or

(6) any endowment, including an organization described in Internal Revenue Code Section 501(c)(3).

The SEC's definition is identical to the CFTC's definition of Special Entity, except with respect to employee benefit plans in prong (4) above. Under the SEC's rules, prong (4) plans would be considered Special Entities unless they elect to opt out of Special Entity status by notifying the SBSD of their election prior to entering into an SBS. In contrast, the CFTC has an opt-in regime for these counterparties.

Reliance on Counterparty Representations

An SBSD may generally rely on a counterparty's (or representative's) written representation to satisfy the various diligence requirements of the Business Conduct Rules (*e.g.,* whether the counterparty is an ECP), so long as the representation permits the SBSD to form a reasonable basis for believing that the applicable requirement is satisfied, and unless the SBSD has information that would cause a reasonable person to question the representation's accuracy.

Interactions with All Counterparties

Some external business conduct standards under the Business Conduct Rules apply to an SBSD with respect to its interactions with *all* counterparties.

Verification of a Counterparty's ECP and Special Entity Status

Before entering into an SBS, an SBSD must verify that the participant is an eligible contract participant ("**ECP**"), except where the SBS is executed on a national securities exchange. This exception does not extend to SBS conducted on an SBS execution facility ("**SBSEF**") even where the counterparty is not known to the SBSD prior to execution.

An SBSD also must verify whether the counterparty is a Special Entity, except where the identity of the SBSD's counterparty is not known at a reasonably sufficient time prior to the execution of an SBS to permit the SBSD to comply with the verification obligation. This exception is available for bilateral transactions as well as SBS conducted on an exchange or SBSEF.

Know Your Counterparty

An SBSD is required to establish, maintain and enforce written know your counterparty ("**KYC**") policies and procedures that are reasonably designed to obtain and retain a record of essential facts concerning a counterparty that are necessary for conducting business with that counterparty. Essential facts concerning a counterparty are:

- facts required to comply with applicable law and regulations;
- facts required to implement the SBSD's credit and operational risk management policies; and
- information regarding the authority of any person acting on behalf of the counterparty.

This KYC requirement applies only where the identity of the counterparty is known to the SBSD. Unlike under the analogous CFTC Rules, however, its application is not limited to only transactions where the identity of the counterparty becomes known to the SBSD prior to the execution of the SBS. The information that an SBSD is required to gather from counterparties to satisfy its KYC obligations is generally the same as under the CFTC's KYC requirements.

Fair and Balanced Communications

An SBSD must communicate with counterparties in a fair and balanced manner, based on principles of fair dealing and good faith. The Business Conduct Rules specify that communications must provide a sound basis for evaluating the facts regarding any particular SBS or trading strategy involving an SBS and must not imply that past performance will recur or make any exaggerated or unwarranted claim, opinion or forecast. Any statement referring to potential opportunities or advantages must be balanced by an equally detailed statement of related risks. This requirement is worded similarly to the parallel provision in the FINRA

communication rules, though the rule notably does not contain FINRA's general prohibition on predicting or projecting performance.

Antifraud Rules

The Business Conduct Rules prohibit fraud, manipulation and deception by an SBSD. Unlike the CFTC, the SEC declined to adopt an affirmative defense from liability where the SBSD did not act intentionally or recklessly and complied in good faith with written policies and procedures reasonably designed to meet the particular requirement that is the basis for the alleged violation.

The Business Conduct Rules also contain additional antifraud rules that apply to an SBSD when interacting with a Special Entity.

Interactions with Non-Swap/SBS Entities

The Business Conduct Rules impose heightened obligations on an SBSD that apply when it interacts with a counterparty that is not a Swap/SBS Entity.

Disclosures and Notifications

Pre-Trade Disclosures

The pre-trade disclosure requirements described below apply only where the SBSD knows the identity of its counterparty at a reasonably sufficient time prior to execution of an SBS to permit the SBSD to comply with the disclosure obligations (whether an SBS transaction is bilateral or exchange- or SBSEF-traded). At a reasonably sufficient time prior to entering into an SBS, an SBSD must disclose to a non-Swap/SBS Entity counterparty information concerning:

- the material risks and characteristics of the SBS, including the material economic terms of the SBS; and
- the SBSD's material incentives or conflicts of interest with respect to the SBS, including any compensation or other incentives from any source other than the counterparty in connection with the SBS.

The SEC provides as examples of material incentives or conflicts of interest that would need to be disclosed revenue sharing arrangements or affiliations or material business relationships that create a material incentive or conflict of interest. Expected cash flows received from a hedging transaction would not be considered to be a material incentive or conflict of interest.

An SBSD must also inform its non-Swap/SBS Entity counterparty of its rights with respect to clearing decisions. In particular, before entering into an SBS:

- for SBS subject to mandatory clearing, an SBSD must disclose (1) the names of the clearing agencies that accept the SBS for clearing and through which the SBSD is authorized or permitted to clear, and (2) the counterparty's right to select where the SBS is cleared from among those clearing agencies; and

- for SBS not subject to mandatory clearing, an SBSD must determine whether the SBS is accepted for clearing by a clearing agency and, if so, provide the disclosure described in the bullet above for SBS subject to mandatory clearing. While the Business Conduct Rules do not explicitly require that the SBSD provide disclosure regarding the effect of clearing on the price of an SBS, the adopting release suggests that such disclosure may be required in particular circumstances based on principles of fair dealing and good faith and based on an SBSD's obligation to communicate with counterparties in a fair and balanced manner.

Unlike under the CFTC's rules, an SBSD is not required to provide a mid-market mark as part of its pre-trade conflicts disclosure. An SBSD is also not required to provide a scenario analysis even if requested by the counterparty.

An SBSD must make a written record of these pre-trade disclosures if they were not provided to the counterparty in writing, and provide the counterparty with a written version of the disclosure in a timely manner, but in no event later than the delivery of the trade acknowledgment for the SBS.

Post-Trade Disclosure

Following execution of an SBS, an SBSD must provide to its non-Swap/SBS Entity counterparty the SBS's daily mark. Specifically:

- for a cleared SBS, an SBSD must provide the counterparty, upon request, the daily mark from the appropriate clearing agency unless the SBS has been novated to the clearing agency; and
- for an uncleared SBS, an SBSD must provide the counterparty with the SBS's daily mark and the data sources, methodologies and assumptions used in calculating the mark, along with specified disclosures. The SEC declined to provide an opt-out for a counterparty from the delivery of the daily mark from its SBSD.

Suitability of Recommendations

Whenever an SBSD recommends an SBS or trading strategy involving an SBS to a non-Swap/SBS Entity, the SBSD must:

- undertake reasonable diligence to understand the potential risks and rewards of the SBS or trading strategy ("**reasonable basis suitability**"); and
- have a reasonable basis to believe that the recommendation is suitable for the counterparty based on the counterparty's investment profile, trading objectives and ability to absorb potential losses ("**customer-specific suitability**").

The SEC has not provided a bright-line test for what constitutes a recommendation, but it has embraced the approach that FINRA has adopted for broker-dealers that a recommendation is a communication that a counterparty would reasonably consider a "call to action" that would influence an investor to enter into an SBS. This is generally consistent with the CFTC's approach for recommendations involving swaps and swap trading strategies.

Institutional Counterparty

An institutional counterparty is (1) any person (whether a natural person, corporation, partnership, trust or otherwise) that has total assets of at least $50 million or (2) any counterparty that meets one of the following prongs of the ECP definition under Section 1a(18) of the Commodity Exchange Act: under clause 1a(18)(A), (i) financial institutions, (ii) eligible insurance companies, (iii) eligible investment companies, (iv) eligible commodity pools, (viii) U.S. or foreign broker-dealers, eligible associated persons or investment bank holding companies, (ix) U.S. or foreign futures commission merchants, or (x) eligible floor brokers or floor traders; or under clause 1a(18)(B), eligible investment advisers, commodity trading advisors, investment managers or fiduciaries. The definition of institutional counterparty does not include an entity that qualifies as an ECP only under Section 1a(18)(A)(v) (by having $10 million of total assets, is guaranteed by an ECP, or having $1 million of total assets and entering into SBS for hedging purposes).

Determining Whether a Representative is Independent

A representative will be deemed independent of an SBSD if:

- the representative does not have a relationship with the SBSD that reasonably could affect the independent judgment or decision-making of the representative;
- the representative currently is not and was not an AP of the SBSD within one year of representing the Special Entity in connection with the SBS;
- the representative provides timely disclosure to the Special Entity of all material conflicts of interest that could reasonably affect the judgment of the representative with respect to its obligations to the Special Entity, and complies with policies and procedures designed to manage and mitigate such material conflicts of interest; and
- the SBSD has not referred, recommended or introduced the representative to the Special Entity within one year of the representation.

The Business Conduct Rules provide a safe harbor with respect to an SBSD's customer-specific suitability obligations to an institutional counterparty (as defined in the sidebar). While the safe harbor provisions are very similar to the CFTC's requirements, because the CFTC's external business conduct rules do not specify what types of counterparties may rely on the institutional suitability safe harbor, an SBSD that wishes to leverage existing information and documentation from swaps customers may need to seek additional information from counterparties.

For an SBSD to avail itself of the institutional counterparty safe harbor:

- the SBSD must reasonably determine that the counterparty (or its agent) is capable of independently evaluating investment risks associated with the recommended SBS or trading strategy (as is the case under the CFTC's rules, an SBSD may rely on a specified representation from a non-Swap/SBS Entity to satisfy this requirement);
- the counterparty or its agent must affirmatively represent in writing to the SBSD that it is exercising independent judgment; and
- the SBSD must disclose that it is acting as a counterparty and is not undertaking to assess the suitability of the SBS or trading strategy involving the SBS for the counterparty.

Interactions with Special Entities

The Business Conduct Rules impose additional requirements on an SBSD when interacting with a Special Entity.

Special Entity Representatives

An SBSD that enters or offers to enter into an SBS with a Special Entity other than an ERISA Special Entity must have a reasonable basis to believe that the Special Entity has a qualified independent representative ("**QIR**") that:

- is independent of the SBSD (as discussed in the sidebar);
- has sufficient knowledge to evaluate the SBS and its risks;
- is not subject to statutory disqualification;
- undertakes a duty to act in the best interests of the Special Entity;
- makes appropriate and timely disclosures to the Special Entity of material SBS information;
- evaluates, consistent with any guidelines provided by the Special Entity, the fair pricing and appropriateness of the SBS; and
- in the case of a governmental Special Entity (other than a Federal agency) or a governmental plan Special Entity, is subject to pay-to-play restrictions of the SEC, CFTC or a self-regulatory organization subject to the jurisdiction of the SEC or CFTC.

When entering into, or offering to enter into, an SBS with an ERISA Special Entity, an SBSD must have a reasonable basis to believe that the plan has a representative that is an ERISA fiduciary.

Special Entity Representative Safe Harbors

An SBSD will be deemed to have a reasonable basis to believe that a Special Entity has an ERISA fiduciary or a QIR, as applicable, if:

- in the case of an ERISA Special Entity counterparty, the ERISA Special Entity represents in writing that its representative is an ERISA fiduciary and provides the representative's name and contact information; and
- for all other Special Entity counterparties,
  - the Special Entity represents in writing to the SBSD that it complied in good faith with written policies and procedures to select a QIR, and that such policies and procedures provide for ongoing monitoring of the QIR's performance to ensure that the representative maintains its qualified independent status; and
  - the QIR represents in writing to the Special Entity and SBSD that it (1) has policies and procedures designed to ensure that it satisfies the applicable criteria; (2) meets the independence test; (3) has sufficient knowledge to evaluate the SBS and risks; (4) is not subject to statutory disqualification; (5) undertakes a duty to act in the best interests of the Special Entity; (6) is subject to pay-to-play requirements; and (7) is legally obligated to comply with the applicable duties to the Special Entity.

Like the CFTC, the SEC provides SBSDs with safe harbors for demonstrating compliance with the Special Entity representative requirements, as explained in the sidebar.

Disclosures

Before the initiation of an SBS with a Special Entity, an SBSD must disclose to the Special Entity in writing the capacity in which it is acting in connection with the SBS and, if it engages in business with the Special Entity in more than one capacity, the material differences between the capacities and any other financial transaction or service involving the Special Entity. The SEC clarifies that this requirement can be met through general, rather than counterparty-specific, disclosure explaining the capacities in which the SBSD or its APs (or affiliates) have acted or may act with respect to the Special Entity along with a statement distinguishing those capacities from its acting as counterparty to the Special Entity.

Best Interests Standard for SBSDs Acting as Advisors to Special Entities; Safe Harbors

An SBSD will be deemed to be acting as an advisor to a Special Entity when it recommends an SBS or trading strategy that involves an SBS to a Special Entity. As an advisor to a Special Entity, an SBSD would be required to make a reasonable determination that its recommendations are in the best interests of the Special Entity and make reasonable efforts to obtain information to make that best interest determination. Whereas an SD under the analogous CFTC rules would be considered to be acting as an advisor to a Special Entity only where it makes a recommendation that is tailored to the particular needs or characteristics of the Special Entity, an SBSD would be deemed to be acting as an advisor if it engages in any communication that would constitute recommending an SBS or trading strategy involving an SBS to a Special Entity.

The Business Conduct Rules include two safe harbors under which an SBSD would not be considered to be acting as an advisor. The safe harbor requirements are similar to analogous requirements in the CFTC's external business conduct rules, but have some noteworthy differences.

The first safe harbor is available when an SBSD is interacting with any type of Special Entity. For the SBSD to qualify:

- the Special Entity must represent in writing to the SBSD that it (1) acknowledges that the SBSD is not acting as an advisor, and (2) will rely on advice from a QIR; and
- the SBSD must disclose to the Special Entity that it is not undertaking to act in the Special Entity's best interests.

Unlike under the CFTC's rules, an SBSD is not required to refrain from expressing an opinion on whether the Special Entity should enter into a recommended SBS or strategy in order to be able to rely on this safe harbor.

The second safe harbor is available to an SBSD only when interacting with an ERISA Special Entity. For the SBSD to qualify:

- the ERISA Special Entity must represent in writing that:
  - it has an ERISA fiduciary; and
  - (1) it will comply in good faith with written policies and procedures reasonably designed to ensure that any recommendation the ERISA Special Entity receives from the SBSD involving an SBS is evaluated by the fiduciary before the SBS is entered into, or (2) any recommendation it receives from the SBSD involving an SBS will be evaluated by the fiduciary before that SBS is entered into; and
- the ERISA fiduciary must represent in writing that it acknowledges that the SBSD is not acting as an advisor.

Restrictions on Political Contributions by SBSDs

The Business Conduct Rules establish pay-to-play restrictions on SBSDs that are substantially similar to those under the CFTC's rules. Subject to certain *de minimis* and other exceptions, the Business Conduct Rules prohibit any SBSD from offering to enter into, or entering into, an SBS or trading strategy involving an SBS with municipal entities where the SBSD or any covered associate of the SBSD has made a contribution to an official of that entity within the prior two years. For a general description of the pay-to-play restrictions, please refer to Davis Polk's **Client Memorandum on the CFTC's Business Conduct Rules**.

Majority-Owned Affiliates

A counterparty is a "majority-owned affiliate" if one counterparty, directly or indirectly, owns a majority interest in the other, or if a third party directly or indirectly owns a majority interest in both counterparties to the SBS. A ''majority interest'' is the right to vote or direct the vote of a majority of a class of voting securities of an entity, the power to sell or direct the sale of a majority of a class of voting securities of an entity, or the right to receive upon dissolution or the contribution of a majority of the capital of a partnership.

Inapplicability of Certain Business Conduct Rules to Majority-Owned Affiliates

The requirements regarding verification of counterparty status, pre- and post-trade disclosures, KYC and suitability obligations, and obligations when acting as a counterparty to or advising a Special Entity do not apply to transactions between an SBSD and a "majority-owned affiliate" (as defined in the sidebar) of the SBSD. However, requirements relating to fair and balanced communications, antifraud, pay-to-play, diligent supervision and CCO obligations apply to an SBSD even when it transacts with a majority-owned affiliate.

Internal Business Conduct Standards

Diligent Supervision

An SBSD must establish and maintain a system to diligently supervise, and must diligently supervise, its SBS dealing business and the activities of its APs. The system must be reasonably designed to prevent violations of federal securities laws and related rules relating to the SBSD's business as such. The supervision provisions are modeled after FINRA rules that apply to broker-dealers and are more detailed and prescriptive than the CFTC's supervision rules for SDs.

At a minimum, an SBSD's supervisory system must:

- designate at least one person with authority to carry out the supervisory responsibilities of the SBSD in each business for which SBSD registration is required;

- use reasonable efforts to ensure that all supervisors are qualified; and
- establish, maintain and enforce written policies and procedures addressing the supervision of the types of SBS business in which the SBSD is engaged and the activities of its APs that are reasonably designed to prevent violations of applicable laws and regulations.

Such written supervisory policies and procedures must include at a minimum procedures for:

- the review by a supervisor of incoming and outgoing written (including electronic) correspondence with counterparties or potential counterparties and internal written communications relating to the SBSD's business;
- a periodic review (at least annually) of the SBSD's business that is reasonably designed to assist in detecting and preventing violations of federal securities laws and regulations;
- conducting a reasonable investigation regarding the good character, business repute, qualifications and experience of any person prior to association with the SBSD;
- considering whether to permit an AP to establish or maintain a securities or commodities account or a trading relationship at another firm, and if permitted, to supervise the trading at such firm;
- prohibiting an AP supervisor from supervising his or her own activities (subject to exceptions);
- preventing the supervisory system from being compromised due to specified conflicts of interest; and
- complying with the duties for SBSDs listed in Section 15F(j) of the Securities Exchange Act (as outlined in the sidebar).

Securities Exchange Act 15F(j) Duties

A registered SBSD must, at all times, comply with the following requirements:

- monitor trading to prevent violations of applicable position limits;
- establish sound and professional risk management systems;
- disclose to the SEC and prudential regulators information concerning its SBS trading;
- establish and enforce internal systems and procedures to obtain any necessary information to perform required statutory functions and provide that information to the SEC or prudential regulators, on request;
- implement conflict-of-interest systems and procedures; and
- address antitrust considerations.

The SEC notes that, as with diligent supervision under FINRA rules, an SBSD could use a risk-based review system to satisfy its supervisory obligations, rather than conducting detailed reviews of every transaction or every communication.

Designation and Obligations of a Chief Compliance Officer

An SBSD must designate a CCO who will report directly to the board of directors (or similar body) or senior officer (defined as the CEO or equivalent officer) of the SBSD. The CCO's compensation and removal require majority approval of the SBSD's board (or a similar body).

The CCO is responsible for:

- taking reasonable steps to ensure that the SBSD establishes, maintains and reviews written policies and procedures reasonably designed to achieve compliance with the Securities Exchange Act and SEC regulations relating to the SBSD's business as such by:
  - reviewing the SBSD's compliance with Section 15F of the Securities Exchange Act (relating to the registration and regulation of SBSDs);

Compliance Report

The compliance report must:

- contain a description of the SBSD's written policies and procedures, including the code of ethics and conflicts of interest policies;
- assess the effectiveness of the policies and procedures relating to the SBSD's business;
- list material changes to the SBSD's policies and procedures;
- discuss areas for improvement and make appropriate recommendations;
- describe any material noncompliance issues that the board would reasonably need to know to oversee compliance; and
- describe financial, managerial, operational, and staffing resources for compliance and any deficiencies.

  - taking reasonable steps to ensure that the SBSD (1) establishes, maintains and reviews policies and procedures reasonably designed to remediate noncompliance issues identified by the CCO, and (2) establishes and follows procedures reasonably designed to handle, respond, remediate, retest and resolve those noncompliance issues;

- taking reasonable steps to resolve any material conflicts of interest in consultation with the board of directors or senior officer;
- administering the required policies and procedures; and
- preparing and signing a compliance report, described in more detail in the sidebar, and meeting with the senior officer at least annually.

The CCO must provide the compliance report to the board, audit committee (or equivalent) and senior officer for their review. In addition, the CCO must submit the report to the SEC within 30 days of the deadline for filing the SBSD's annual financial report. The CCO or senior officer must certify that, to the certifier's best knowledge and reasonable belief and under penalty of law, the information in the compliance report is accurate and complete in all material respects.

Application of Rules to Pre-Compliance Date SBS

Requirements under the Business Conduct Rules that by their terms apply when an SBSD offers to enter into or enters into an SBS—such as verification of counterparty status, disclosures, requirements for Special Entities as counterparties and pay-to-play requirements—generally will not apply to any SBS entered into prior to the compliance date of the Business Conduct Rules. These requirements will apply, however, where a *new* SBS is deemed to be created after the compliance date based on a material amendment or modification to a pre-compliance date SBS, as explained in the accompanying sidebar.

Examples of When An Amended or Modified SBS Is Viewed as a New SBS:

- The material terms of an SBS are amended or modified during its life based on an exercise of discretion and not through predetermined criteria or a predetermined self-executing formula.
- The material terms of either an SBS option or the resulting SBS are amended or modified based on an exercise of discretion (in contrast, if the terms upon which a party can exercise an SBS option and the terms of the resulting SBS are governed by pre-existing terms that were set prior to the compliance date of the Business Conduct Rules, then neither the exercise of the option nor the resulting SBS will be deemed to result in a new SBS).

In contrast, the SEC states that some business conduct requirements—such as those relating to KYC, suitability of recommendations, fair and balanced communications and anti-fraud, requirements when acting as an advisor to a Special Entity, supervision and CCO obligations—will be triggered by actions taken after the compliance date that implicate that requirement. For example, if an SBSD recommends that a counterparty terminate a pre-compliance date SBS, the SBSD will need to comply with the Business Conduct Rules' suitability requirements even if no new SBS results from the recommendation.

Cross-Border Applicability

The SEC categorizes the requirements relating to diligent supervision and the CCO as "entity-level requirements" that would apply to all SBS of an SBSD, regardless of the U.S. person status of the SBSD or its counterparty in any particular transaction.

Cross-Border Definitions

For a non-U.S. SBSD, "U.S. business" is:

- any SBS entered into, or offered to be entered into, by or on behalf of the non-U.S. SBSD with a U.S. person (other than an SBS conducted through a foreign branch of that person); or
- any SBS arranged, negotiated or executed by personnel of the non-U.S. SBSD (or personnel of the non-U.S. SBSD's agent) located in a U.S. branch or office.

For a U.S. SBSD, "U.S. business" is:

- any SBS by or on behalf of the U.S. SBSD, wherever entered into or offered to be entered into, other than an SBS conducted "through a foreign branch" (as defined below) of the U.S. SBSD (1) with a non-U.S. person or (2) with the foreign branch of a U.S. person, where the "through a foreign branch" conditions are also satisfied on the counterparty's side.

An SBS will be considered conducted "**through a foreign branch**" of a U.S. person where:

(1) the foreign branch is the counterparty to the SBS; and

(2) the SBS is arranged, negotiated, and executed on behalf of the foreign branch solely by persons located outside the United States.

Business conduct requirements other than these entity-level requirements, *i.e.*, the transaction-level business conduct requirements, apply only to the "U.S. business" of an SBSD (as defined in the accompanying sidebar) and not to its "foreign business." **Foreign business** is defined in the Business Conduct Rules as any SBS entered into, or offered to be entered into, by or on behalf of the SBSD that is not part of its U.S. business. The following types of transactions would be viewed as the foreign business of an SBSD:

- *Foreign business for a Non-U.S. SBSD* includes any SBS:
  - with a non-U.S. person, unless the SBS is arranged, negotiated or executed by personnel located in a U.S. branch or office of the non-U.S. SBSD or its agent; and
  - with a U.S. person that is conducted **through a foreign branch** of such U.S. person (as defined in the sidebar).
- *Foreign business for a U.S. SBSD* includes only SBS conducted through a foreign branch of the U.S. SBSD:
  - with a non-U.S. person; or
  - with the foreign branch of another U.S. person, where the "through a foreign branch" conditions are satisfied by the counterparty.

The general principles underlying the cross-border application of the Business Conduct Rules to SBS transactions are similar to the CFTC's approach as encapsulated in its cross-border guidance and CFTC Staff Advisory No. 13-69. However, due to differences in the definition of U.S. person, definition of foreign branch, conditions required to be satisfied to qualify as a transaction "conducted with" (in CFTC parlance) or "conducted through" (in SEC parlance) a foreign branch, among other things, the cross-border analysis involving the same types of counterparties will sometimes yield different results depending on whether the transaction involves a swap or an SBS. For example, a foreign branch of an SD that is a U.S. person facing a foreign branch of a U.S. bank that is not registered as an SD or MSP will be subject to the CFTC's external business conduct rules in all cases (since, unlike under the SEC's rules, under the CFTC's cross-border guidance, the definition of foreign branch is limited to that of a registered SD or MSP), whereas a foreign branch of an SBSD that is a U.S. person facing such a branch will not be subject to the SEC's external business conduct requirements, so long as the SEC's "through a foreign branch" conditions can be satisfied.

Substituted compliance may be available to non-U.S. SBSDs with respect to the Business Conduct Rules, including most of the entity-level requirements. The SEC states, however, that substituted compliance will not be available with respect to the antifraud provisions and the duties of an SBSD under Section 15F(j) of the Exchange Act relating to disclosure of information concerning SBS trading and provision of information on request to the SEC and prudential regulators.

To qualify for substituted compliance, an eligible non-U.S. SBSD or a financial regulatory authority that supervises it must file with the SEC an application requesting that the SEC make a substituted compliance

determination that a foreign regime's rules are comparable to the relevant SEC's rules and the SEC must approve the application.

For a summary of the SEC's cross-border definitional rule, please see Davis Polk's **Client Memorandum on the SEC's Cross-Border Definitional Rule**.

Compliance Date

An SBSD need not comply with the Business Conduct Rules until the Registration Compliance Date applicable to SBSDs, which will not be until at least six months after the publication in the Federal Register of the SEC's rules establishing capital, margin and segregation requirements. However, the compliance date for the application of the customer protection requirements (other than diligent supervision) to SBS arranged, negotiated or executed by U.S.-located personnel or agents of a non-U.S. SBSD will not occur until the later of May 13, 2017 and the Registration Compliance Date.

For information regarding the Registration Compliance Date, please refer to Davis Polk's **Client Memorandum on SBSD Registration Rules**.

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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