

# SECURITY-BASED SWAP DEALERS: GEARING UP FOR REGISTRATION

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**T**he **Securities and Exchange Commission** is slowly finalizing its rules under Title VII of the Dodd-Frank Act for the registration and regulation of security-based swap dealers (SBSDs). While a compliance date for SBSBD registration has not yet been established, many firms are starting to consider implementation plans for the new regime. Meanwhile, a number of substantive requirements—such as trade reporting and margin for uncleared swaps effected by SBSBDs that are banks—may not depend on firms being registered and will kick in even before that deadline.

This is the first in a series of articles providing an overview of the implementation tasks that lay ahead for SBSBDs. This installment focuses on the registration process. Later articles will cover issues such as reporting of security-based swaps

(SBS); business conduct requirements; and margin for uncleared SBS.

## WHO MUST REGISTER AS AN SBSBD?

### What Is An SBSBD?

An SBSBD is a person who engages in any of the following types of activities:

- Holding oneself out as a dealer in SBS;
- Making a market in SBS;
- Regularly entering into SBS with counterparties as an ordinary course of business for one's own account;
- Engaging in activity causing oneself to be commonly known in the trade as a dealer or market maker in SBS.

The term SBSBD does not include a person that enters into SBS for their own account, either individually or in a fiduciary capacity, but not as part of a regular business; for example, per-

sons that enter into swaps to hedge commercial risks.

In contrast, a person is more likely to be considered an SBSBD if it exhibits indicia of dealing activity, including, among other things, providing liquidity to market professionals; providing advice in connection with SBS; having regular clientele and actively soliciting clients; and using interdealer brokers. The SEC's view of whether a person is an SBSBD or engaging in swaps not as part of a regular business is heavily informed by the so-called "dealer-trader distinction," which has been developed over time by the SEC in the context of broker/dealer regulation.

Naturally, in analyzing whether an entity is an SBSBD, it is important to have an effective system to identify when the entity is trading SBS, as opposed to swaps or other instruments. Generally speaking, SBS include credit default swaps (CDS) and total return swaps on a single security (other than a U.S. government security) or a narrow-based index of securities or on a single loan.

The system should carefully exclude other instruments, such as **Commodity Futures Trading Commission**-regulated swaps—such as swaps on broad-based securities indices and U.S. government securities—and security-based derivatives that are not SBS; for example, options and physically-settled forwards on securities.

### Exclusions From The Definition Of SBSBD

The definition of SBSBD includes an exception for entities that engage in a *de minimis* level of SBS dealing activity. Specifically, a person will not need to register as an SBSBD if the SBS positions entered into in a dealing capacity by the person or any of its affiliates over the previous 12 months do not exceed any of the following thresholds:

- \$8bn aggregate gross notional with respect to CDS entered into with all counterparties;
- \$400m aggregate gross notional for SBS other than CDS entered into with all counterparties; or
- \$25m aggregate gross notional for SBS entered into with "special entity" counterparties; for example, municipalities, endowments and employee benefit plans.

These initial *de minimis* thresholds may be reduced in the future.

SBS transactions that are not entered into in a dealing capacity, such as commercial hedging transactions, do not count against the *de minimis* thresholds. But an SBS used to hedge a position that was entered *Continued on page 15*

## COMPLIANCE CHECKLIST: WHAT SHOULD FIRMS BE DOING NOW?

- Determine the most appropriate legal entity to house SBS dealer activity, such as an existing bank, B/D, OTC derivatives dealer or a new stand-alone SBSBD, taking into account various factors such as capital efficiency, funding, which uncleared SBS margin rules would apply, tax implications, efficiency of establishing customer documentation, overlapping regulation of the entity, jurisdiction of key personnel and the other business activities these people and that entity will conduct.
- Develop a system to determine the extent of your firm's (and affiliates') SBS activities, whether the transactions constitute "dealing" and are of an amount expected to exceed or approach the existing *de minimis* thresholds. As part of this process, for non-U.S. persons, the firm's system for tracking SBS activity should be able to determine the extent to which SBS dealing transactions are with a U.S. person (other than non-U.S. branches of a U.S. SBSBD), guaranteed by any of your U.S. affiliates, or arranged, negotiated or executed by personnel that are located in the U.S.
- Develop policies and procedures; systems and controls; and an appropriate supervisory structure to ensure compliance with the many requirements that will apply to registered SBSBDs. These include business conduct standards, reporting, recordkeeping and the prohibition on entering into off-exchange SBS transactions with non-eligible contract participants.
- Prepare questionnaires and employment applications for existing and new associated persons that will support the CCO certification—for example, by identifying any relevant personnel that are subject to a statutorily disqualification—and the necessary processes to ensure that these questionnaires are obtained from relevant personnel.
- Start reviewing the applicable registration form and gathering the necessary information to populate it, which may be a significant undertaking for firms that are not already (or those that do not have subsidiaries that are) registered B/Ds or registered investment advisers.
- As rules are finalized, develop training for personnel that will be engaging in or supervising SBS activities.
- For non-U.S. firms, initiate consultations with local counsel in applicable foreign jurisdictions regarding whether the firm will be able to give the necessary certification and obtain the necessary legal opinions.

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into as part of dealing activity would itself be considered dealing activity and, as a result, any such hedges would count toward the person's *de minimis* thresholds. In addition, SBS entered into with majority-owned affiliates do not need to be considered for purposes of the *de minimis* thresholds.

### What About Non-U.S. Dealers?

As with U.S. persons, non-U.S. persons must register as SBSDs if they exceed one of the *de minimis* thresholds. However, non-U.S. persons must only count toward its *de minimis* threshold those SBS transactions entered into in a dealing capacity:

- With U.S. persons (generally other than non-U.S. branches of U.S. SBSDs);
- With non-U.S. persons, to the extent the counterparty has a right of recourse against a U.S. affiliate of the counting entity; and
- That are arranged, negotiated or executed by personnel of the non-U.S. person or its agent located in a U.S. branch or office.

A non-U.S. person would also generally not need to count toward the *de minimis* thresholds any SBS entered into anonymously on an execution facility or national securities exchange and cleared through a clearing agency.

Notwithstanding these limitations, as an anti-evasion mechanism, certain non-U.S. persons that act as “conduits”—i.e. that enter into SBS in a dealing capacity on behalf of an unregistered U.S. affiliate offshore and subsequently transfer the risk of such SBS to such affiliate—are required to count all such transactions against their *de minimis* thresholds.

### WHEN MUST SBSDS REGISTER?

The compliance date for SBS registration is the latest of:

- Six months after Federal Register publication of final SEC rules establishing capital, margin and segregation requirements; and
- The compliance date of final recordkeeping and reporting requirements, business conduct requirements and rules pertaining to statutorily disqualified persons of SBSDs.

To determine whether it qualifies as an SBS, an entity must begin counting its SBS dealing activities against the *de minimis* threshold two months before the SBS registration compliance date. Following the compliance date, a person that exceeds one of the *de minimis* thresholds will have two months after the end of the month in which it exceeded the relevant threshold to submit a completed application to register as an SBS.

### HOW TO REGISTER AN SBS

#### Registration Forms

To register with the SEC, an applicant must file Form SBSE, which is generally based on Form BD—the SEC’s registration form for B/Ds. Like Form BD, Form SBSE elicits information regarding any criminal record of the SBS, regulatory or civil disciplinary actions, bankruptcy proceedings, ownership and executive officers, among other things. A short-form filing is available for an applicant that is already registered with the SEC as a B/D (Form SBSE-BD) or with the CFTC as a swap dealer or major swap participant (Form SBSE-A).

The registration form must be filed electronically via EDGAR and will generally be made publicly available. In addition, these forms must be updated “promptly” (generally within 30 days) if the information on the form is, or has become, inaccurate for any reason.

#### Compliance Program Prerequisites To Registration

To complete its application, an applicant must also complete a one-time Form SBSE-C, which includes two separate certifications. First, a senior officer must certify that:

- After “due inquiry,” the senior officer has reasonably determined that the SBS applicant has developed and implemented written policies and procedures reasonably designed to prevent violation of federal securities laws and the rules thereunder;
- The senior officer has documented the process by which this determination was reached.

Since SBSDs will need to comply with extensive regulatory obligations, comparable to those for

registered B/Ds and CFTC-registered swap dealers, such a certification will need to be preceded by a long period of implementation of systems, controls and policy and procedure development.

Second, the applicant’s chief compliance officer (or designee) must certify that the applicant has performed background checks on all of its natural person associated persons who effect or are involved in effecting SBS on its behalf. An SBS must obtain from each such natural person a questionnaire or application for employment that would provide specified information regarding disciplinary matters, and the SBS’s CCO (or designee) must review and sign each questionnaire or application.

#### Special Requirements For Non-U.S. SBSDs

As part of the registration process, a non-U.S. SBS would additionally be required to, among other things:

- Appoint a U.S. agent for service of process and provide the SEC with the name and address of the agent on the registration form;
- Certify that it can, as a matter of law, and will provide the SEC with prompt access to its books and records and submit to onsite SEC inspections and examinations; and
- Provide an opinion of counsel concurring with the non-U.S. SBS’s certification regarding SEC access to its books and records and onsite inspections and examinations.

#### Conditional Registration

Upon filing a completed application for registration, including the required certifications, to the SEC via EDGAR, an SBS applicant will be conditionally registered as an SBS. This conditional registration allows an applicant to continue to engage in SBS activities while its application is pending before the SEC. The SBS’s conditional registration is effective until the SEC takes action on the application.

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### AROUND TOWN

Last week’s *Compliance Reporter* breakfast briefing at **The Harvard Club of New York** featured a discussion about the legal, compliance and operational issues facing mutual fund firms in regards to fair valuation and the use of pricing services—including how to approach due diligence of service providers and how to involve the compliance function in the pricing process.

The panelists were **Ian Blance**, managing director with **Voltaire Advisors**; **Norm Champ**, partner with **Kirkland & Ellis**; **Paul Kraft**, U.S. mutual fund and investment adviser practice leader with **Deloitte**; **Chris Franzek**, managing director with **Duff & Phelps**; and **Douglas Dick**, partner with **Dechert**.

