

Derivatives Alert

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SEC Finalizes Registration Rules for Security-Based Swap Entities

On August 5, 2015, the Securities and Exchange Commission (SEC) adopted final registration rules for security-based (SB) swap dealers and major SB swap participants (collectively SBS Entities). Concurrently, the SEC also proposed a process to permit certain persons with statutory disqualifications that are associated persons (APs) of SBS Entities to continue to effect SB swaps on behalf of an SBS Entity. SBS Entities will not need to comply with the final registration rules until a series of additional rules for SBS Entities, including the proposed statutory disqualification process, are adopted or implemented.¹

Under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the SEC is required to issue rules for the registration of SB swap dealers² and major SB swap participants.³ Furthermore, the Dodd-Frank Act amendments to the Securities Exchange Act of 1934 (Exchange Act) expressly provide that an AP of an SBS Entity⁴ that is subject to a statutory disqualification⁵ is prohibited from effecting SB swaps on behalf of an SBS Entity, unless the SEC makes an exception by rule, regulation or order.⁶ The SEC's proposed rule addresses this prohibition by providing a process for SBS Entities to apply to the SEC for an order permitting an AP subject to a statutory disqualification that is associated with the SBS Entity to effect or be involved in effecting SB swaps.

¹ The compliance date for the final rules will be the later of: (a) six months after the date of publication in the Federal Register of the final rules establishing capital, margin and segregation requirements for SBS Entities, (b) the compliance date for the final rules establishing recordkeeping and reporting requirements for SBS Entities, (c) the compliance date for business conduct rules for SBS Entities, or (d) the compliance date related to rules for SB dealer APs that are subject to statutory disqualifications. Exchange Act Release No. 75611 at 90.

² An SB swap dealer is defined as any person that holds itself out as a dealer in SB swaps, makes markets in SB swaps and regularly enters into SB swaps with counterparties in the regular course of its business for its own account. 17 C.F.R. § 240.3a71-1. An SB swap is defined as a "swap" (as defined under the Commodity Exchange Act Section 1a) that is on a narrow-based security index, a single security or loan, or an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index, provided that the event affects the finances of the issuer. 15 U.S.C. § 78c(a)(68).

³ A major SB swap participant is a person that holds a substantial position in SB swaps but is not a SB swap dealer. 17 C.F.R. § 240.3a67-1; *see also* 17 C.F.R. § 240.3a67-2.

⁴ The term "persons associated with" or "associated persons of" an SBS Entity are defined to include: (a) partners, officers or directors of an SBS Entity, (b) any person controlling, controlled by or under common control with an SBS Entity, and (c) any employee of an SBS Entity other than employees whose functions are solely clerical or ministerial. 15 U.S.C. 78c(a)(70). The definition covers both natural persons and entities (*i.e.*, affiliates). 15 U.S.C. 78c(a)(9).

⁵ A list of enumerated statutory disqualifications is provided in 15 U.S.C. § 78c(a)(39).

⁶ 15 U.S.C. § 78o-10(b)(6). The Commodity Exchange Act has a parallel provision for swap dealers and major swap participants registered with the Commodity Futures Trading Commission (CFTC). *See* 7 U.S.C. § 6s(b)(6); *see also* 17 C.F.R. § 23.22.

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Final Rule: Registration for SB Swap Dealers and Major SB Swap Participants

The final rules lay out the mechanics of how to register as an SBS Entity. Unlike the SEC's broker-dealer registration regime, which the Financial Industry Regulatory Authority administers, the SEC will administer the registration of SBS Entities.⁷ The final rule for SBS Entity registration does not permit substituted compliance with comparable foreign registration laws in lieu of registration with the SEC.⁸ The SEC specifically noted its inspection and examination authority over registered SBS Entities as a reason for not permitting substituted compliance.⁹ The final rule also provides additional requirements for nonresident SBS Entities applying for registration.¹⁰

Associated Persons

The Exchange Act defines APs of an SBS Entity to include natural persons and affiliated entities.¹¹ As a result, the Exchange Act prohibits both natural persons and affiliates that are subject to a statutory disqualification from effecting or being involved in effecting SB swaps on behalf of the associated SBS Entity.¹² Conversely, the "associated person" definition for swap dealers and major swap participants registered with the CFTC only extends to natural persons.¹³ The SEC's final rule provides that unless otherwise ordered by the SEC, when an SBS Entity applies to register, an AP of the SBS Entity that is subject to a statutory disqualification may continue to effect or be involved in effecting SB swaps. However, the person must not be a natural person and the statutory disqualification must have occurred prior to the compliance date of the final rule.¹⁴ Furthermore, the SBS Entity applying for registration must disclose all such statutorily disqualified entities.¹⁵

The final rule references persons that "effect" or are "involved in effecting" SB swaps on behalf of an SBS Entity. The SEC clarified that the latter phrase generally means persons engaged in functions necessary to facilitate the SBS Entity's SB swap business. Some examples include drafting and negotiating master agreements and confirmations, recommending SB swaps to counterparties, executing an SB swap on a trading desk, pricing SB swap positions and directly supervising persons involved in all of the above mentioned activities.¹⁶

In addition to the final registration rules relating to APs, the SEC has simultaneously proposed to establish a process through which an SBS Entity could apply to the SEC for an order permitting an AP subject to a statutory disqualification to effect or be involved in effecting SB swaps.¹⁷ Proposed Rule of Practice 194 would apply to both natural persons and entities that are subject to statutory disqualifications. However, the SEC proposes to give only AP entities — not natural person APs — a temporary exclusion to continue to effect or be involved in effecting SB swaps while the application for an order is under consideration.¹⁸

Dates for Calculating SB Entity Thresholds

SBS Entities will not be required to begin calculating whether their activities exceed the thresholds to become SB swap dealers or major SB swap participants until two months prior to the registration compliance date.¹⁹ Only SB swap positions held on or after this date will count toward determining if an SBS Entity must register.²⁰

⁷ The National Futures Association oversees the registration of swap dealers and major swap participants under the Commodity Exchange Act.

⁸ Although substituted compliance is not available under the final rules for registration, the SEC stated that it was not considering whether substituted compliance was available for other rules to which SB swap dealers would be subject as registered entities. Exchange Act Release No. 75611 at 36.

⁹ *Id.*

¹⁰ For example, any nonresident SBS Entity registering with the SEC must obtain a written irrevocable consent and power of attorney appointing an agent for service of process in the United States. *Id.* at 63.

¹¹ See fn. 4.

¹² Exchange Act Release No. 75611 at 41.

¹³ See 17 CFTC 1.3(aa)(6).

¹⁴ Exchange Act Release No. 75611 at 42.

¹⁵ *Id.* at 42. The rule also requires the SBS Entity applying for registration to certify on form SBSE-C that the entity neither knows, nor in the exercise of reasonable care should have known, that any person associated with it who effects or is involved in effecting SB swaps is subject to statutory disqualification. *Id.* at 54. To support this certification, the chief compliance officer (CCO) of the SBS Entity, or one of the CCO's designees, must review and sign each questionnaire or application for employment executed by each natural person who effects or is involved in effecting SB swaps. *Id.* at 55.

¹⁶ *Id.* at 48.

¹⁷ Exchange Act Release No. 75612, 7 (Aug. 5, 2015). For the SEC to issue an order, it would need to find that it would be consistent with the public interest to allow the statutorily disqualified AP of the SBS Entity to effect or be involved in effecting SB swaps. *Id.* at 22.

¹⁸ *Id.* at 44.

¹⁹ See fn. 1.

²⁰ *Id.* at 93.