

Derivatives Alert

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Recent SEC No-Action, Re-Proposal for Security-Based Swaps Focus on Comparability With Other US Regulators

In recent days, the Securities and Exchange Commission (SEC) announced a no-action position on enforcing its 2016 Business Conduct Standards against security-based swap dealers (SBSDs) and major security-based swap participants (MSBSPs)¹ who comply with comparable Commodity Futures Trading Commission (CFTC) requirements. Before this announcement, the SEC re-opened for comment its 2012 proposal for capital, margin and segregation requirements for SBSDs. These actions indicate that the SEC plans to rely more heavily on swap rulemakings from the CFTC and other agencies as a blueprint for its own security-based swaps (SBS)² regulatory scheme.

Under Title VII of the Dodd-Frank Act, the SEC has jurisdiction over SBS, which make up about 5 percent of the overall U.S. derivatives market.³ The CFTC has jurisdiction over swaps, which make up the remaining 95 percent of the market.⁴ While both the CFTC and the SEC have proposed and finalized the broad majority of rulemakings required by Dodd-Frank, each commission took a different approach toward implementation. The CFTC required market participants to comply with its regulations once each rulemaking was effective. In contrast, the SEC outlined a general policy for the implementation of its final rules, which deferred the compliance dates of the SBSD rulemakings — including the SBSD registration compliance date — to the effective dates of other rules.⁵

As the majority of market participants have already put policies and programs in place to comply with CFTC requirements, concerns have been raised that the SEC's ultimate regulations would require affected market participants that trade both swaps and SBS to create dual compliance regimes. The SEC's recent actions suggest that the SEC is attempting to avoid that result.

¹ For purposes of this alert, references to SBSDs include MSBSPs.

² The term "security-based swap" generally refers to swaps based on a single equity or debt security, single name credit default swaps or swaps based on narrow-based security (i.e., nine or fewer) indexes. See Section 3(a)(68) of the Securities Exchange Act, 15 U.S.C. 78c(a)(68). The SEC has oversight authority with respect to security-based swaps. See, e.g., Section 15F of the Securities Exchange Act, 15 U.S.C. 78o-10.

³ See U.S. Dep't of the Treasury, "A Financial System That Creates Economic Opportunities: Capital Markets," at 117.

⁴ See *id.*

⁵ See "Statement of General Policy on the Sequencing of the Compliance Dates for Final Rules Applicable to Security-Based Swaps Adopted Pursuant to the Securities Exchange Act of 1934 and the Dodd-Frank Wall Street Reform and Consumer Protection Act," 77 Fed. Reg. 35,625 (June 14, 2012).

Derivatives Alert

SEC Statement on Business Conduct Standards

On October 31, 2018, the SEC issued a statement (SEC Statement)⁶ that takes a no-action enforcement position on certain of its 2016 Business Conduct Standards rule for SBSBs.⁷ As background, the CFTC finalized business conduct standards for swap dealers (SDs) and major swap participants in 2012.⁸ As those requirements were immediately effective, market participants developed and widely adopted standardized documentation to comply with the CFTC requirements.⁹ While the SEC's standards are analogous to the CFTC requirements, certain SEC requirements diverge from what is required by the CFTC.¹⁰ Acknowledging that the CFTC compliance documentation already is used by over 22,000 market participants and "the time and costs that may be associated with a documentation initiative that would be undertaken solely to address the SEC's Business Conduct Rules," the SEC said it would not recommend enforcement action against SBSBs who complied with certain of the CFTC requirements instead of the corollary SEC requirements.¹¹ The SEC is granting this no-action relief for a five-year period starting from the future date on which SBSBs are required to register with the SEC.¹²

⁶ See "Commission Statement on Certain Provisions of Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants," 83 Fed. Reg. 55,486 (Nov. 6, 2018).

⁷ See "Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants," 81 Fed. Reg. 29,960 (May 13, 2016). Although the rules are now effective, the SEC determined not to require compliance with them until entities are required to register as SBSBs. See *id.* at 30,081.

⁸ See "Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties," 77 Fed. Reg. 9734 (Feb. 17, 2012).

⁹ See SEC Statement at 55,486-7.

¹⁰ See *id.* at 55,487.

¹¹ The relief provided in the SEC Statement applies only to the particular SBS business conduct rules set out in 15Fh-1 to 15Fh-6 under the Securities Exchange Act of 1934, and only to the extent specified in the SEC Statement.

¹² See SEC Statement at 55,487 ("Although the rules are now effective, the [SEC] determined not to require compliance with them until entities are required to register as [SBSBs] or Major SBS Participants.") The compliance date for the SBSB and major SBS participant registration requirements will be the later of: (1) six months after the date of publication of final rules establishing capital, margin and segregation requirements for SBSBs and MSBSPs; (2) the compliance date of final rules establishing recordkeeping and reporting requirements for SBSBs and MSBSPs; (3) the compliance date of final rules establishing business conduct requirements; or (4) the compliance date for final rules establishing a process for a registered SBSB or MSBSP to make an application to the SEC to allow an associated person who is subject to a statutory disqualification to effect or be involved in effecting security-based swaps on the SBSB or MSBSP's behalf. See "Registration Process for Security-Based Swap Dealers and Major Security-Based Swap Participants," 80 Fed. Reg. 48,963 (Aug. 14, 2015).

SEC Proposed Capital, Margin and Segregation Requirements

The SEC also reopened the comment period for previously proposed SEC rules related to capital and margin requirements for non-cleared SBS and the cross-border treatment of the capital and margin requirements (Request for Comment).¹³ The SEC proposed these requirements in 2012 (2012 Proposal),¹⁴ but the last time the SEC accepted comments on the proposal was in 2013.¹⁵ In May 2013, the SEC proposed provisions addressing the cross-border treatment of SBS capital, margin and segregation requirements,¹⁶ and in April 2014, it proposed an additional capital requirement for SBSBs that are not subject to regulation by U.S. banking regulators (nonbank SBSBs).¹⁷

Recognizing the various comments on the previously proposed rules (the Proposals),¹⁸ the SEC said it believes that "it is prudent to reopen the comment period for the Proposals in light of these comments and regulatory developments. In addition, the [SEC] believes the public should have the opportunity to provide comment on the potential economic effects of the Proposals in light of regulatory and market developments since they were published."¹⁹ The Request for Comment also seeks public comment on some newly proposed language modifications to the Proposals.²⁰

¹³ See "Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers," 83 Fed. Reg. 53,007 (Oct. 19, 2018).

¹⁴ See "Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers," 77 Fed. Reg. 70,214 (Nov. 23, 2012) (hereinafter "2012 Proposal"), see also SEC Fact Sheet, "[Proposing Rules Governing Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants](#)," (hereinafter "SEC Fact Sheet").

¹⁵ See "Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers," 78 Fed. Reg. 4365 (Jan. 22, 2013); and "Reopening of Comment Periods for Certain Rulemaking Releases and Policy Statements Applicable to Security-Based Swaps," 78 Fed. Reg. 30,800 (May 23, 2013).

¹⁶ See "Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants," 78 Fed. Reg. 30,968 (May 23, 2013).

¹⁷ See "Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers; Capital Rule for Certain Security-Based Swap Dealers," 79 Fed. Reg. 25,194, 25,254 (May 2, 2014).

¹⁸ The comment letters to the 2012 Proposal are [available here](#). The comment letters to the proposed cross-border rule are [available here](#), and the comment letters to the nonbank SBSB capital requirement are [available here](#).

¹⁹ Request for Comment at 53,008.

²⁰ *Id.*; see also SEC Press Release, "[SEC Reopens Comment Period for Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants](#)" (Oct. 11, 2018), for other topics on which the SEC seeks additional comment.

Derivatives Alert

The SEC's SBS margin requirements, in particular, when ultimately final and effective will fill a long-standing regulatory gap, as market participants already are required to comply with non-cleared swap margin requirements set by other regulators. In 2015, federal banking regulators (Prudential Regulators)²¹ finalized non-cleared margin requirements and a cross-border rule for all bank SDs and SBSDs in 2015 (PR Rules),²² and the CFTC finalized uncleared margin requirements and a cross-border rule for all nonbank SDs in 2016 (CFTC Rules).²³ Foreign regulators also have adopted similar requirements.²⁴ The variation margin (VM) requirements set out by the PR Rules and the CFTC Rules became effective in 2017.²⁵ Prudential Regulator and CFTC initial margin (IM) requirements are being phased in until 2020.²⁶

Margin Requirements. The SEC's 2012 Proposal was largely consistent with the PR Rules and CFTC Rules in terms of the overall margin requirements and limitations on SBSDs, although there were certain differences, such as:

- **Exception for Swaps Between SBSDs.** The 2012 Proposal required nonbank SBSDs to collect IM and VM from each counterparty, unless an exception applied.²⁷ However, the 2012 Proposal suggested two possible alternatives when the SBS is between two SBSDs (and one SBS is a nonbank SBS). One alternative was to require each SBS to collect both IM and

VM from the other SBS, which is consistent with the PR Rules and CFTC Rules. Under the second alternative, an SBS would only need to collect VM, but not IM, from the other SBS.²⁸ The SEC has requested comments and supporting data to assist in determining which of the alternatives should be adopted and suggested language to implement each alternative.²⁹

- **IM Calculation Models.** The 2012 Proposal required nonbank SBSDs to calculate daily IM by using either standardized or proposed model-based deductions.³⁰ The Request for Comment acknowledges that the PR Rules and CFTC Rules also permit other models if approved by the regulators.³¹ Since then, SDs and SBSDs that are subject to the PR Rules and CFTC Rules have widely adopted an industry-developed uniform model (the Standard Initial Margin Model) to calculate IM.³² Accordingly, the Request for Comment seeks comments on whether the SEC should similarly consider accepting a uniform initial margin model.³³
- **Minimum Transfer Amount (MTA).** The 2012 Proposal established an MTA of \$100,000.³⁴ Although the Request for Comment does not propose language to modify this proposed amount, the proposed MTA is now inconsistent with the PR Rules and CFTC Rules, each of which permit a maximum MTA of \$500,000.
- **Eligible Collateral.** The 2012 Proposal did not specifically identify which types of collateral could be posted by SBSDs for purposes of the margin requirements³⁵ and proposed to permit a counterparty to the SBS to meet its margin requirements by posting cash, securities and/or money-market instruments to the SBS, subject to applicable "haircuts."³⁶ Though the Request for Comment does not propose language to modify this proposed requirement, the proposed eligible collateral requirement is inconsistent with the PR Rules and CFTC Rules, each of which limit the types of eligible collateral that can be posted or collected by SDs and SBSDs to an enumerated list of assets.

²¹The Prudential Regulators consist of the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency.

²²"Margin and Capital Requirements for Covered Swap Entities," 80 Fed. Reg. 74,839 (Nov. 30, 2015). For additional information, see November 2, 2015, Skadden client alert, "[Prudential Regulators Finalize Margin Requirements for Non-Cleared Swaps](#)."

²³See "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants," 81 Fed. Reg. 636 (Jan. 6, 2016); "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants — Cross-Border Application of the Margin Requirements," 81 Fed. Reg. 34,818 (May 31, 2016). See also June 3, 2016, Skadden client alert, "[CFTC Finalizes Cross-Border Margin Rules for Uncleared Swaps](#)."

²⁴Regulators in Europe, Japan, Australia, Hong Kong and Singapore, for example, each have finalized margin requirements on a similar timeline to the Prudential Regulators and the CFTC. See February 24, 2017, Skadden client alert, "[Regulators Provide Some Flexibility on the Swaps Variation Margin Compliance Deadline](#)."

²⁵See December 2, 2016, Skadden client alert, "[Non-Cleared Swap Variation Margin Requirements to Spark Credit Support Annex Amendments for Financial End Users](#)"; and February 24, 2017, Skadden client alert, *supra* note 24.

²⁶See July 26, 2018, Skadden client alert, "[Final Phases of Initial Margin Requirements for Uncleared Swaps Expected to Spark Additional Margin Compliance Efforts](#)."

²⁷Request for Comment at 53,013; see also 2012 Proposal at 70,265-70,270.

²⁸Request for Comment at 53,013-50,014; see also 2012 Proposal at 70,267-8.

²⁹Request for Comment at 53,014.

³⁰Request for Comment at 53,013; see also 2012 Proposal at 70,260-1.

³¹Request for Comment at 53,013.

³²*Id.*

³³Request for Comment at 53,013.

³⁴2012 Proposal at 70,272.

³⁵2012 Proposal at 70,273-4.

³⁶See SEC Fact Sheet.

Derivatives Alert

Because market participants already have taken steps to comply with the PR Rules and CFTC Rules, the forthcoming comment period is likely to elicit comments suggesting how the SEC can better conform its proposed rulemaking to the other regulators' rules.

Capital and Segregation Requirements. The 2012 Proposal also contains SEC approaches to capital and segregation requirements that differ from the rule adopted by the Prudential Regulators and proposed by the CFTC, which has not yet finalized the capital requirements that it proposed in 2016.³⁷ For example, the SEC's 2012 Proposal would establish a financial ratio-derived minimum net capital requirement equal to 8 percent of a nonbank SBS's "risk margin amount,"³⁸ while the CFTC's proposed capital requirements for SDs propose a simpler calculation for risk margin amount similar to the current capital requirements for futures commission merchants (FCMs).³⁹ Accordingly, the SEC is requesting comments and supporting data on the

³⁷ "Capital Requirements of Swap Dealers and Major Swap Participants," 76 Fed. Reg. 27,802 (May 12, 2011); "Capital Requirements of Swap Dealers and Major Swap Participants," 81 Fed. Reg. 91,252 (Dec. 16, 2016).

³⁸ Request for Comment at 53,008. The risk margin amount is defined by the 2012 Proposal to mean the sum of: (1) the greater of the total margin required to be delivered by the nonbank SBS with respect to SBS transactions cleared for security-based swap customers at a clearing agency or the amount of the deductions (haircuts) that would apply to the cleared SBS positions of the SBS customers pursuant to the proposed capital requirements; and (2) the total margin amount calculated by the nonbank SBS with respect to non-cleared SBS.

³⁹ See Request for Comment at 53,009 n. 18; see also Capital Requirements of Swap Dealers and Major Swap Participants, 81 Fed. Reg. at 91,266.

proposed capital requirements, including whether the input to the risk margin amount should be modified to better align with the CFTC's existing rules and proposals.⁴⁰

There are also differences between the SEC's segregation requirements and those finalized by the CFTC and the Prudential Regulators. For example, in addition to requiring that a counterparty to a non-cleared SBS has the right to either segregate IM at a third-party custodian or waive that right, the 2012 Proposal included a third alternative where the SBS could hold IM subject to omnibus segregation requirements that are modeled on the broker-dealer customer protection rule.⁴¹ Also, the SEC's approach differs from the approaches taken in the PR and CFTC Rules, which require IM to be segregated and held by an independent custodian and also do not provide an option for SBSs and SDs to hold collateral. The Request for Comment does not propose language to resolve these differences, although comments suggesting greater regulatory coordination of segregation requirements can be expected.

Comments on the SEC 2012 Proposal — as well as the additional topics raised in the Request for Comment⁴² — must be submitted to the SEC by November 19, 2018.⁴³

⁴⁰ See Request for Comment at 53,009.

⁴¹ See Request for Comment at 53,016; 2012 Proposal at 70,276.

⁴² See note 9.

⁴³ Request for Comment at 53,007.