

Security-based swap dealers: Tackling the business conduct rules

A practical guide for implementing the SEC's recently approved requirements. Part two in a series on the new SBSB regulatory framework.



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The Securities and Exchange Commission recently finalized its business conduct requirements for security-based swap dealers (SBSBs).

Under the new rules, SBSBs will have to establish detailed procedures for their interactions with counterparties, including:

- Disclosing the material characteristics of security-based swaps (SBS);
- Disclosing any material incentives or conflicts of interest of the SBSB;
- Providing daily marks and disclosing information regarding clearing rights to counterparties;
- Gathering know-your-counterparty information;
- Making recommendations;
- Communications standards;
- Verifying eligible contract participant (ECP) status of counterparties for certain transactions;
- Political contribution tracking and limitations; and
- Special heightened obligations when dealing with and acting as advisors to U.S. governmental entities, pension plans and other defined "special entities."

In addition, registrants will need to establish and maintain a comprehensive system of supervision; adopt, enforce and update written supervisory procedures; and appoint a chief compliance officer with specific responsibilities, including the production of an annual compliance report, which must be submitted to the SEC.

Here, we discuss how firms will need to go about complying with these requirements. The first article in this series addressed SBSB registration and related readiness issues (ComplianceReporter.com, 4/12), and future articles will cover SBS reporting and margin for uncleared SBS.

Conduct requirements

Dealing With Counterparties

The business conduct rules impose extensive obligations on SBSBs when dealing with counterparties, including:

- Counterparty status verification. Before entering into an SBS other than, in some cases, on a regulated trading venue, an SBSB must confirm whether its counterparty is an eligible contract participant or a special entity.
- Disclosures. At a reasonably sufficient time before executing an SBS, an SBSB generally must disclose to known counterparties that are not SBSBs, swap dealers, major swap participants or major SBS participants (collectively, "non-swap entities") material information about the SBS, including material risks and characteristics, material incentives and conflicts of interest, and information regarding the counterparty's rights with respect to clearing. The SBSB must make a written record of these disclosures if they were not provided to the counterparty in writing, and must provide such record to the counterparty no later than the delivery of the trade acknowledgment. SBSBs must also disclose to non-swap entity counterparties the daily mark of an SBS (together with additional information, in the case of uncleared SBS) on each business day for an uncleared SBS and upon request for a cleared SBS.
- Know your counterparty. SBSBs must establish and enforce written policies and procedures to obtain and retain essential facts concerning known counterparties that are necessary to conduct business with that counterparty, including those necessary to comply with applicable law, implement the SBSB's credit and operational risk management policies and know the authority of persons acting for the counterparty.
- Suitability of recommendations. When recom-

mending an SBS or an SBS trading strategy to a non-swap entity, the SBSD must undertake reasonable diligence on the potential risks and rewards 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)

However, an SBSD may satisfy customer-specific suitability with respect to "institutional counterparties" (a subset of ECPs including certain regulated entities and persons with at least \$50m in total assets) if:

- The SBSD reasonably determines that the counterparty or its agent is capable of independently evaluating investment risks (this determination may, in some cases, be based on a representation as to the counterparty's policies for evaluating recommendations);
- The counterparty or its agent represents in writing that it is exercising independent judgment in evaluating the recommendation; and
- The SBSD discloses that it is not assessing the suitability of the recommendation.

Although the Commodity Futures Trading Commission has adopted an analogous customer-specific suitability safe harbor for swap dealers, the CFTC's safe harbor is not limited to "institutional counterparties."

- Communications standards. SBSDs must communicate with counterparties in a fair and balanced manner, based on principals of fair dealing and good faith.
- Anti-fraud rules. SBSDs are prohibited from engaging in fraudulent, deceptive or manipulative activities.

Interactions With Special Entities

The rules impose additional requirements when SBSDs interact with special entities. The definition of special entity is similar to the definition contained in the CFTC's business conduct rules. But under the SEC's rules, an employee benefit plan defined in, though not subject to, the Employee Retirement Income Security Act (ERISA) would be a special entity unless such entity *opts out* of special entity status, whereas the CFTC has adopted an *opt-in* framework for such entities.

- Acting as an advisor. An SBSD that "acts as an advisor" to a special entity must determine that any recommendation is in the special entity's best interests, and make reasonable efforts to obtain various information necessary to make this determination. An SBSD would be deemed to be an advisor to a special entity when it recommends an SBS or an SBS trading strategy.

Due to the difficulty of meeting the best interest standard as a counterparty, the rules provide a safe harbor pursuant to which an SBSD would not be deemed to be acting as an advisor where:

- The special entity acknowledges in writing that the SBSD is not acting as an advisor and represents that it will rely on advice from a qualified independent representative (QIR); and
- The SBSD discloses that it is not undertaking to act in the special entity's best interest.

The rules also contain an alternative safe harbor for certain ERISA special entities.

- Special entity representative. SBSDs that enter into or offer to enter into an SBS with a special entity (unless transacting anonymously on a regulated trading venue or with an ERISA special entity) must have a reasonable basis to believe that the special entity has a QIR. A QIR is a representative that meets certain qualifications; undertakes to act in the special entity's best interest; evaluates the fair pricing and appropriateness of the SBS; and meets certain other conditions, including having specified indicia of independence from the SBSD. SBSDs are considered to have a reasonable basis to believe that a special entity has a QIR on the basis of having received particular representations from the special entity and the QIR.
- Disclosures. Before initiating an SBS with a special entity (unless transacting anonymously on a regulated trading venue), an SBSD must disclose to the special entity the capacity in which the SBSD is acting and, if it engages in business with the special entity in more than one capacity, the material differences between such capacities and any other financial transaction or service involving the special entity.

Political Contributions

Subject to certain *de minimis* and other exceptions, SBSDs are prohibited from offering, or entering into, an SBS or trading strategy involving an SBS with municipal entities where the SBSD or certain of its associates has made a contribution to an official of that municipal entity within the past two years.

Supervisory Requirements

- Diligent supervision. An SBSD must establish and maintain a system to supervise diligently its business and the activities of its associated persons. An SBSD must designate qualified supervisors for each of its SBS businesses and adopt policies and procedures reasonably designed to prevent violations of applicable law through, among other things, a supervisory review of transactions, correspondence and the business generally, and through investigation into the character and qualifications of associated persons.

SBSDs must also develop procedures regarding trade monitoring, risk management systems, regulatory disclosures, information access systems, conflicts of interest and antitrust considerations.

- **CCO requirements.** An SBSB must designate a CCO that reports directly to the board of directors or senior officer of the SBSB. The CCO's compensation and removal must be approved by a majority of the SBSB's board of directors. Among other things, the CCO must ensure that the SBSB establishes the required written policies and procedures designed to achieve compliance and must prepare an annual compliance report, which must be submitted to the SEC, that assesses the effectiveness of the SBSB's policies and procedures relating to its business, identifies any material non-compliance matters and describes the resources set aside for compliance with applicable law, among other things.

Reliance on representations

As noted above, an SBSB is in some cases permitted to rely reasonably on written representations to satisfy various requirements under the business conduct rules.

Similar to the manner in which many of the CFTC's external business conduct requirements for swap dealers are satisfied through multilateral protocols published by the International Swaps and Derivatives Association, known as the "ISDA Dodd-Frank protocols," the SEC suggested that the representations in the ISDA Dodd-Frank protocols may be used to comply with certain of the SEC's SBS business conduct requirements, depending on the facts and circumstances. Alternatively, market participants may establish new protocols or amendments to the ISDA Dodd-Frank protocols to address the SBSB business conduct requirements specifically.

What about non-U.S. activities?

The business conduct requirements are categorized as either "entity-level" or "transaction-level," with entity-level including the supervisory and CCO obligations, and transaction-level including requirements such as disclosure and suitability. The entity-level requirements will apply to all SBSBs regardless of their U.S. person status. The transaction-level requirements will apply only to the "U.S. business" of an SBSB.

For a U.S. SBSB, U.S. business includes any SBS of the SBSB, other than an SBS conducted through a non-U.S. branch with either: (i) a non-U.S. person; or (ii) a non-U.S. branch of a U.S. person (subject to conditions). For a non-U.S. SBSB, "U.S. business" includes: (i) any SBS offered to or entered into with a U.S. person (other than a non-U.S. branch of a U.S. person, subject to conditions); as well as (ii) any SBS arranged, negotiated or executed by personnel of the non-U.S. SBSB, or its agent, located in a U.S. branch or office.

A non-U.S. SBSB may be able to satisfy certain of the business conduct requirements by complying with comparable requirements in the non-U.S. SBSB's home jurisdiction, if the SEC makes a determination (upon application) that such non-U.S. requirements are com-

parable to the otherwise applicable SEC rules and the non-U.S. SBSB complies with any conditions that the SEC may impose.

What about transactions with affiliates?

The transaction-level business conduct rules generally do not apply to SBS that SBSBs enter into with their majority-owned affiliates.

When must SBSBs' business conduct procedures be implemented?

SBSBs generally need not comply with the business conduct requirements until the compliance date for SBS registration, which is not expected to be until at least 2017.

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Compliance checklist: What should firms be doing now?

- Start developing standardized disclosures and related processes, in some cases by leveraging existing templates, delivery mechanisms and record creation/retention processes currently used in the firm's CFTC-regulated swap dealer business (if applicable).
- Consider whether to adhere to the ISDA Dodd-Frank protocols and become familiar with the adherence process, if they are not already. Firms will also need to consider the extent to which the SEC's business conduct standards will not be satisfied by the ISDA Dodd-Frank protocols and how the firm will systematically obtain any representations from counterparties that decide not to adhere to the protocols.
- Start putting in place the supervisory structure required by the rules, including by creating and adopting the requisite policies and procedures.
- Consider how to leverage existing processes designed to satisfy KYC, suitability and political contribution requirements.
- Identify a potential CCO, taking into consideration reporting line, compensation and other requirements and consider how to leverage existing processes for creating the annual compliance report.
- Non-U.S. SBSBs using U.S.-based personnel to arrange, negotiate or execute SBS with non-U.S. counterparties should consider whether it would be advantageous to move those activities outside of the U.S. in order to eliminate application of the transaction-level requirements that do not apply to the non-U.S. activities of non-U.S. SBSBs.
- Non-U.S. SBSBs should consider whether it would be appropriate to apply for substituted compliance and gather (or assist others in gathering) the necessary materials to apply for the substituted compliance determination.