

Derivatives - USA

SEC moves closer to registration of security-based swap entities

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September 02 2015

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Introduction

On August 5 2015 the US Securities and Exchange Commission (SEC) took several incremental steps towards completing its regulatory framework for security-based swap dealers and majority security-based swap participants. The SEC unanimously adopted final rules providing the registration process for security-based swap entities, including the detailed forms that registrants will be required to file.⁽¹⁾ The SEC also voted three to two to propose rules to establish a process for a security-based swap entity to apply for permission to continue to carry out security-based swap activity in association with parties that are subject to statutory disqualification.

Compliance date

Registration requirements for security-based swap entities will not take effect immediately.⁽²⁾ The final rules provide for a compliance date for the registration requirement that will be the latest of:

- six months after publication of final rules establishing capital, margin and segregation requirements; or
- the compliance date for final rules establishing:
 - recordkeeping and reporting requirements;
 - business conduct requirements; or
 - a disqualification waiver process.

The ultimate timing of the registration compliance date thus remains uncertain and depends on further publication of rules by the SEC.⁽³⁾

The final rules also provide that potential security-based swap entities will not need to start calculating whether their activities may exceed the relevant registration thresholds until the 'counting date', two months before the registration compliance date. As a result, security-based swap activity before the counting date need not be counted towards the security-based swap dealer *de minimis* threshold or the test for major security-based swap participant status. The SEC has acknowledged that as a result, some security-based swap entities may not be required to register for a year following the counting date, depending on activity levels.

Process

Under the final rules, the SEC will grant conditional registration status to a security-based swap entity once it has filed an application with the SEC and provided the required senior officer certifications. The SEC will then review the application either to grant ongoing registration or institute proceedings to deny registration. As part of the registration process, security-based swap entities will be required to submit extensive information about their business activities, structure and background, as well as information about their control affiliates.

To register, a security-based swap entity must file the appropriate version of Form SBSE electronically through the SEC's EDGAR system.⁽⁴⁾ The final rules provide for a choice of three forms (Form SBSE, Form SBSE-A or Form SBSE-BD), depending on whether the entity is already registered with the SEC as a broker-dealer and/or with the US Commodity Futures Trading Commission (CFTC) as a swap dealer or major swap participant. Under this approach, certain information need not be provided for entities that are already registered with the SEC and/or CFTC in these capacities. The registration

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form appears to be based largely on the Form BD used for broker-dealer registration.

The final rules also require amendments when registration information becomes inaccurate and provide a mechanism for voluntary withdrawal from registration and cancellation or revocation of registration by the SEC in specified cases.

Senior officer certification

As part of the application, the final rules require two certifications by senior officers that the security-based swap entity is meeting applicable requirements.

First, one senior officer must certify that he or she has determined that the applicant has financial, operational and compliance rules and procedures in place to act as a security-based swap dealer or major security-based swap participant.⁽⁵⁾ The officer must also certify that he or she has documented the process for reaching such determination.

Second, the chief compliance officer – or a selected designee – must certify that he or she has performed background checks on associated natural persons who effect or are involved in effecting security-based swaps. The chief compliance officer or designee must further certify that he or she neither knows nor, in exercising reasonable care, should have known that any such associated person is subject to a statutory disqualification, unless a specific exception applies.

Notably, similar certification requirements have not been adopted by the CFTC for the registration of swap dealers and major swap participants under its jurisdiction.

Registration of non-US entities

The final rules impose additional registration requirements on so-called 'non-resident security-based swap entities' (security-based swap entities that are incorporated or have their principal places of business outside the United States). In addition to the requirements for security-based swap entities, non-resident security-based swap entities must:

- appoint a US agent for service of process;
- certify that they legally can and will provide the SEC with prompt access to their books and records and submit to onsite SEC examinations and inspections; and
- provide an opinion of counsel stating that they legally can provide the SEC with prompt access to their books and records and submit to on-site SEC examinations and inspections.

It is unclear to what extent these requirements will, in practice, be an obstacle for non-US entities to register as security-based swap entities. During the comment process, concerns were expressed about the impact of restrictions on sharing of information under the laws of some jurisdictions. Nonetheless, the SEC was unwilling to rely solely on information-sharing arrangements with foreign regulators in this regard and insisted on full direct access. Notably, no corresponding opinion requirement exists in the CFTC registration process for swap dealers and major swap participants.

Non-US market participants may need to consider the appropriate structure for their US security-based swap activity in light of these requirements.

Disqualification waiver process

The Securities Exchange Act generally prohibits a security-based swap entity from operating in association with a party that is subject to statutory disqualification.⁽⁶⁾ The SEC voted three to two to issue proposed rules which would permit a registered security-based swap entity to apply to the SEC for an order permitting associated parties (natural persons or entities) that are subject to a statutory disqualification to effect or be involved in effecting security-based swaps on its behalf, based on a showing that such association is nonetheless consistent with the public interest.⁽⁷⁾

Further, the proposed rules would allow associated entities (not including natural persons) that are statutorily disqualified to continue effecting security-based swap activities on behalf of the security-based swap entity for a certain period as the SEC continues to evaluate the security-based swap entity's application.

Comments on the proposed rules are due 60 days after publication in the *Federal Register*. The SEC is requesting comment on a number of issues, including whether:

- the proposed rules should apply the general prohibition on association to disqualified natural persons only and not entities;
- the proposed 180-day period for temporary relief is appropriate to avoid disruptions in business; and
- the SEC should have to disqualify a business that has already been disqualified by the CFTC or other regulators.

In order to avoid disruption in the markets, the final rules also provide for a limited exception allowing newly registered security-based swap entities to associate with parties that are subject to a statutory disqualification if:

- the associated parties are not natural persons; and

- the statutory disqualification(s) occurred before the registration compliance date.

Security-based swap entities must identify such associated parties on registration forms.

Comment

The final rules and proposed rules outline a more definitive process under which security-based swap entities will be required to register, although actual registration will not commence until several additional rulemakings by the SEC have been completed. In the interim, potential security-based swap entities that are non-US entities may want to consider whether they can satisfy the SEC's requirements as to information sharing or whether alternative structures for US security-based swap businesses may be needed. Potential security-based swap entities may also need to consider the impact of potential disqualification issues for their associated parties in light of the proposed rules.

For further information on this topic please contact Donna M Parisi, Geoffrey B Goldman or Azam H Aziz at Shearman & Sterling LLP by telephone (+1 212 848 4000) or email (dparisi@shearman.com, geoffrey.goldman@shearman.com or aaziz@shearman.com). The Shearman & Sterling website can be accessed at www.shearman.com.

Endnotes

(1) See draft final rules on the SEC website, available at www.sec.gov/rules/final/2015/34-75611.pdf.

(2) The SEC has adopted two other significant final rules relating to security-based swap entities:

- SEC/CFTC joint final rules on the Definitions of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 FR 30596 (May 23 2012), available at www.gpo.gov/fdsys/pkg/FR-2012-05-23/pdf/2012-10562.pdf; and
- SEC final rules for the Application of "Security-Based Swap Dealer" and "Major Security-Based Swap Participant" Definitions to Cross-Border Security-Based Swap Activities, 79 FR 47278 (August 12 2014), available at www.gpo.gov/fdsys/pkg/FR-2014-08-12/pdf/R1-2014-15337.pdf.

(3) CFTC registration for swap dealers and major swap participants was required by December 31 2012 (see CFTC FAQs confirming this timing, available at www.cftc.gov/PressRoom/PressReleases/pr6348-12).

(4) Unlike broker-dealer registration, security-based swap entity registration applications will not be filed with or processed by the Financial Industry Regulatory Authority.

(5) A senior officer for this purpose would be a senior executive such as the chief executive officer, chief financial officer, chief legal officer, chief compliance officer, president or similar person who has the legal authority to bind the applicant.

(6) See the Securities Exchange Act on the SEC website, available at www.sec.gov/about/laws/sea34.pdf.

(7) See the draft proposed on the SEC website, available at www.sec.gov/rules/proposed/2015/34-75612.pdf. Such an order would, in effect, be similar to waivers of the disqualification that the SEC may provide for other registration categories.

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