SULLIVAN & CROMWELL LLP

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Uncleared Security-Based Swaps

SEC Proposes Rules Requiring the Application of Risk Mitigation Techniques to Uncleared Portfolios of Security-Based Swaps

SUMMARY

On December 19, 2018, the Securities and Exchange Commission ("SEC") proposed rules requiring the application of risk mitigation techniques to uncleared portfolios of security-based swaps by registered security-based swap dealers ("SBSDs") and registered major security-based swap participants ("MSBSPs" and collectively with SBSDs, "SBS Entities"). The proposed rules would require SBS Entities to:

- periodically reconcile outstanding security-based swaps with applicable counterparties;
- engage in portfolio compression exercises; and
- execute written security-based swap ("SBS") trading relationship documentation with each of its counterparties prior to, or contemporaneously with, executing an SBS transaction.

In addition, the proposal also includes corresponding changes to the recordkeeping, reporting and notification requirements applicable to SBS Entities. The SEC proposes to treat the portfolio reconciliation, portfolio compression and trading relationship documentation requirements as "entity level" requirements for purposes of assessing the applicability of SEC rules to cross-border SBS activities and to permit substituted compliance in the case of non-U.S. SBS Entities that are subject to comparable foreign regulatory requirements.

The SEC requests comments on all aspects of the proposals, and comments are due within 60 days after publication of the proposals in the Federal Register.

BACKGROUND

Section 15F(i)(1) of the Exchange Act, as added by Section 764(a) of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), requires each SBS Entity to conform with such standards as may be prescribed by the SEC, by rule or regulation, that relate to timely and accurate confirmation, processing, netting, documentation and valuation of all SBS transactions. Section 15F(i)(2) of the Exchange Act provides that the SEC shall adopt rules governing documentation standards for SBS Entities.

The SEC previously adopted rules requiring SBS Entities to provide trade acknowledgements and to verify those trade acknowledgements with their counterparties to SBS transactions, but has not proposed rules concerning portfolio reconciliation, portfolio compression, or trading relationship documentation. By contrast, the Commodity Futures Trading Commission ("CFTC") has previously implemented rules setting forth standards for the timely and accurate confirmation of swaps, addressing the reconciliation and compression of swap portfolios and setting forth requirements for documenting swap trading relationships between swap dealers and major swap participants and their counterparties.

The SEC notes that it has generally attempted to harmonize its proposals with respect to portfolio reconciliation, portfolio compression and written trading relationship documentation with the existing CFTC rules, and seeks comment on the specific instances where the proposed rules deviate from the CFTC's rules.[1]

In analyzing the costs and benefits of the proposed rules, the SEC reaffirms its prior estimates that approximately 50 entities will meet the definition of an SBS dealer and up to five entities the MSBSP definition. Of the approximately 50 SBS dealers, the SEC estimates that approximately 22 will be non-U.S. entities and eligible to seek substituted compliance.

PORTFOLIO RECONCILIATION

A. OVERVIEW

The proposed portfolio reconciliation rules are designed to establish processes for counterparties to identify and resolve discrepancies involving key terms of their SBS transactions throughout the duration of the SBS transaction. Unlike trade acknowledgement and verification processes,[2] which occur at the onset of an SBS transaction, reconciliation operates on an ongoing basis throughout the lifecycle of the transaction. The SEC views ongoing reconciliation of key transaction terms as particularly important with respect to valuation terms because unresolved discrepancies regarding the valuation of SBS transactions could lead to significant issues, including, for example, disagreements related to the determination of the proper amount of margin that must be posted or collected in connection with the SBS transaction.[3]

Proposed Rule 15Fi-3 under the Exchange Act would generally require SBS Entities, in connection with uncleared SBS transactions, to:

- engage in "portfolio reconciliation"[4] with counterparties who are SBS Entities;
- establish, maintain and follow written policies and procedures reasonably designed to ensure that they engage in portfolio reconciliation with counterparties who are not SBS Entities;
- exchange the material terms of all SBS transactions in the SBS portfolio[5] between counterparties;
- exchange each counterparty's valuation[6] of each SBS in the SBS portfolio between the counterparties as of the close of business on the immediately preceding business day; and
- resolve any discrepancy in valuations or material terms.

"Material terms" is proposed to be defined using a bifurcated approach: (1) with respect to any SBS that has not yet been reconciled as part of an SBS portfolio, "material terms" would mean each term that is required to be reported to a registered SDR pursuant to Rule 901 under the Exchange Act and/or (2) for all other SBS transactions within an SBS portfolio, the definition of "material terms" would continue to be based on the reporting requirements in Rule 901, but would exclude any term that is not relevant to the ongoing rights and obligations of the parties and the valuation of the SBS.[7]

Proposed Rule 15Fi-3(a)(1) would also require SBS Entities to agree in writing on the terms of the portfolio reconciliation, including agreement on selection of any third-party service provider who may be performing the reconciliation.

With respect to SBS transactions with non-SBS Entities, each SBS Entity would be required to agree to terms of portfolio reconciliation, including the selection of any third-party service provider, if applicable, with its non-SBS Entity counterparties in writing.[8]

B. PORTFOLIO RECONCILIATION WITH OTHER SBS ENTITIES

1. Frequency

Under proposed Rule 15Fi-3(a), a tiered approach to portfolio reconciliation would be employed when two SBS Entities act as counterparties to one another in SBS transactions. Specifically, the frequency at which the two parties must engage in portfolio reconciliation will be determined based on the size of the SBS portfolio between the two parties.

SBS Portfolio Size	Portfolio Reconciliation Frequency
≥ 500 security-based swaps	Each Business Day[9]
500 > security-based swaps > 50	Weekly
≤ 50 security-based swaps	Quarterly

The SEC notes that it believes the above-tiered approach appropriately calibrates the costs to the benefits expected from reconciling a person's SBS portfolio at regular intervals. The varying intervals are based on the concept that all other things being equal, a larger and more complex portfolio represents a greater potential for loss than a smaller, less complex portfolio.[10]

2. Discrepancy Resolution

The proposed rules would also require immediate resolution of any discrepancy in a material term between two SBS Entities, regardless of whether discovered as part of the portfolio reconciliation, or otherwise. The SEC has chosen not to propose a fixed definition of "immediately," in order to provide flexibility based on the particular circumstances surrounding a portfolio and the nature of the discrepancy. The SEC is seeking specific comment on whether this flexible approach is preferable to a fixed standard.

Acknowledging the potential difficulties of resolving valuation discrepancies in a short period of time, the proposed rules would require that discrepancies related to valuation be cured as soon as possible but in any event, within five business days of being identified. The SBS Entity's written policies and procedures must address how variation margin requirements are treated during the pendency of the dispute. Further, in order to ensure that counterparties are focusing limited resources on the largest discrepancies, the proposed rules also include a threshold pursuant to which a difference in valuation between the lower valuation and the higher valuation that is less than 10% of the higher valuation would not be deemed a discrepancy. This threshold is to be calculated on a transaction-by-transaction basis and not at the portfolio level.

C. PORTFOLIO RECONCILIATION WITH NON-SBS ENTITY COUNTERPARTIES

In contrast to the mandatory reconciliation provided for in proposed Rule 15Fi-3(a), proposed Rule 15Fi-3(b) would require each SBS Entity to establish, maintain and follow written policies and procedures reasonably designed to ensure that it engages in portfolio reconciliation with non-SBS Entity counterparties. Similar to the reconciliation requirements that apply to SBS portfolios between two SBS Entities, the written policies required under proposed Rule 15Fi-3(b) include a tiered approach to reconciliation frequency, as follows:

SBS Portfolio Size	Portfolio Reconciliation Frequency
> 100 security-based swaps	Quarterly
≤ 100 security-based swaps	Annually

Similar to the requirements imposed on transactions between two SBS Entities, Rule 15Fi-3(b)(4) would require each SBS Entity to establish, maintain and follow written procedures designed to resolve any discrepancies in the valuation or a material term of each SBS identified as part of a portfolio

reconciliation, or otherwise with a non-SBS Entity counterparty. Any discrepancies in the valuation or material term of each SBS must be resolved in a "timely fashion." Timely fashion has purposely been left undefined so to provide flexibility for different situations. However, the SEC has requested comment on what timing would be appropriate.

D. REPORTING OF VALUATION DISPUTES

Proposed Rule 15Fi-3(c) would require each SBS Entity to promptly notify the SEC of any SBS valuation dispute in excess of $20,000,000 (or its equivalent in other currency) at either the transaction or portfolio level. However, such valuation dispute need not be reported if it is otherwise resolved within three business days in the case that the dispute is with an SBS Entity, or within five business days in the case that the dispute is with a counterparty that is not an SBS Entity. This position is nearly identical to the CFTC's rule on reporting of valuation disputes. However, the SEC is requesting comments on whether or not it should adopt the specific aspects of the National Futures Association ("NFA's") approach.[11]

PORTFOLIO COMPRESSION

A. OVERVIEW OF PORTFOLIO COMPRESSION

Compression allows market participants to eliminate redundant derivatives transactions, thereby reducing post-trade risk, typically without reducing overall net exposure. Specifically, the process normally involves terminating or modifying certain contracts and replacing such contracts with a smaller number of substantially similar contracts. In addition to minimizing direct exposure to counterparties, including by eliminating all exposure to certain counterparties, reducing the number of open contracts provides operational benefits and efficiencies by reducing opportunity for processing errors, failures or other problems arising in the life cycle of an SBS transaction. Accordingly, proposed Rule 15Fi-4 would mandate SBS Entities to engage in portfolio compression with one another and would require portfolio compression with non-SBS Entities upon request of the non-SBS Entity. The proposed portfolio compression requirements would not apply to cleared transactions. The SEC preliminarily believes that with respect to cleared transactions, the rules with respect to the clearing agency should govern portfolio compression.

The proposed portfolio compression provisions are designed to mirror the CFTC rules in all possible respects. Therefore, the SEC is seeking comment on whether to allow entities regulated by both the CFTC and the SEC to comply with the SEC proposed rules by complying with the CFTC's requirements.

B. PORTFOLIO COMPRESSION EXERCISES

A portfolio compression exercise currently refers to an exercise by which SBS counterparties wholly terminate or change the notional value of some, or all, of the SBS transactions submitted by the counterparties for inclusion in the portfolio compression exercise and then replace the terminated SBS transactions with other SBS transactions whose combined notional value is less than the combined

notional value of the terminated SBS transactions in the exercise. Under proposed Rule 15Fi-4(a), SBS Entities would be required to establish, maintain and follow written policies and procedures for periodically engaging in both bilateral and multilateral portfolio compression exercises, in each case when appropriate, with any counterparties that are SBS Entities. To the extent that an SBS Entity transacts with counterparties that are not SBS Entities, the proposed rules require portfolio compression exercises occur when appropriate and only to the extent requested by any such counterparty.[12]

The SEC's approach to defining bilateral and multilateral compression exercises is designed to provide maximum flexibility to the counterparties when engaging in compression exercises by offering broad definitions. The definitions of bilateral and multilateral compression exercises are identical, with the only difference between the two being that multilateral compression exercises refers to more than two SBS counterparties, while bilateral compression exercises refers to transactions with only two counterparties. These definitions are also substantively identical to the CFTC's corresponding definitions.[13] The SEC is seeking comment on the flexibility of these definitions and whether a more explicit definition would be preferable.

C. BILATERAL OFFSET

Proposed Rule 15Fi-4(a)(1) would require each SBS Entity to establish, maintain and follow written policies and procedures for terminating each "fully offsetting security-based swap" (defined under the proposed rules as SBS transactions of equivalent terms where no net cash flow would be owed to either counterparty after the offset of payment obligations thereunder) that it maintains with another SBS Entity in a timely fashion, when appropriate. The SEC has included the threshold of appropriateness in recognition that parties may have legitimate reasons for maintaining fully offsetting SBS transactions. Proposed Rule 15Fi-4(b) would apply identical requirements to SBS transactions with non-SBS Entity counterparties, but such requirements would only apply when appropriate and to the extent requested by the counterparty.

DOCUMENTATION REQUIREMENTS

A. OVERVIEW OF TRADING RELATIONSHIP DOCUMENTATION

The SEC believes that requiring each SBS Entity to document the terms of the trading relationship with each of its counterparties before executing a new SBS transaction should promote sound collateral and risk-management practices by enhancing transparency and legal certainty regarding each party's rights and obligations under the transaction. The SEC believes that such documentation requirements should also promote the reconciliation efforts discussed previously in this memorandum.

The corresponding CFTC rule mirrors the structure of proposed Rule 15Fi-5. The majority of variations between the SEC proposed rules and the CFTC's rules are purely technical changes that are not expected to impact the application of the SEC's proposed rules. However, the SEC has requested

comment on any potential substantive differences that could be present. The list of deviations between the CFTC rules and the SEC proposed rules includes among other things:

- the SEC requires policies and procedures be approved in writing by a senior officer of the SBS Entity, whereas the CFTC uses the term senior management;
- the SEC proposed rules require that the trading relationship documentation address "applicable regulatory reporting obligations (including pursuant to Regulation SBSR)," which is designed to help address issues with swap data repositories ("SDRs") and is not included in the CFTC version; and
- the SEC proposed rule uses the term financial counterparty instead of the CFTC's version which uses financial entity.

B. SCOPE OF DOCUMENTATION REQUIREMENTS

Proposed Rule 15Fi-5(a)(2) would require each SBS Entity to establish, maintain and follow written policies and procedures reasonably designed to ensure that it executes written SBS trading relationship documentation with each of its counterparties prior to, or contemporaneously with, executing an SBS with any counterparty. These policies and procedures must be approved by a "senior officer" and a record of the approval must be retained.

The written policies and procedures would be required to provide that the SBS trading relationship documentation be in writing and include all terms governing the trading relationship, including, without limitation:

- terms addressing payment obligations;
- netting of payments;
- events of default or other termination events;
- calculation and netting of obligations upon termination;
- transfer of rights and obligations;
- allocation of any applicable regulatory reporting obligations (including pursuant to Regulation SBSR);
- governing law;
- valuation; and
- dispute resolution.[14]

SBS trading relationship documentation would be required to include credit support arrangements that address without limitation:

- initial and variation margin requirements, if any;
- types of assets that may be used as margin and asset valuation haircuts, if any;
- investment and re-hypothecation terms for assets used as margin for uncleared SBS transactions, if any; and

- custodial arrangements for margin assets, including whether margin assets are to be segregated with an independent third party.

The credit support documentation would need to include all terms required by the SEC or the relevant prudential regulator for the SBS Entity.[15]

C. DOCUMENTING VALUATION METHODOLOGIES

The proposed rule would require that applicable policies and procedures provide that the relevant swap trading relationship documentation between certain types of counterparties include written documentation in which the parties agree on the process, which may include any agreed-upon methods, procedures, rules and inputs, for determining the value of each SBS for the purposes of complying with the margin requirements under Section 15F(e) of the Exchange Act and the risk-management requirements under Section 15F(j) of the Exchange Act. These documentation requirements will apply to any SBS between:

- two SBS Entities; or
- an SBS entity and a "financial counterparty."[16]

The proposed rules require, to the maximum extent practicable, the valuation of each SBS be based on recently executed transactions, valuations provided by independent third parties or other objective criteria. If models are used to value an SBS, the proposed rules make clear that the party using the model does not need to disclose confidential or proprietary information to the counterparty to comply with the proposed rule.

In order to prevent potential harm in the event that there is a valuation dispute with regards to an SBS, the SEC has proposed rules requiring a secondary valuation process to be present in the transaction documentation. Under the proposed rule, the documentation must include either: (1) alternative methods for determining the value of the SBS in the event of the unavailability, or other failure of any input required to value the SBS; or (2) a valuation dispute resolution process by which the value of the SBS will be determined for the purposes of complying with the proposed rule. Thus, the parties will have to select one of these alternatives to resolve any valuation dispute.

D. OTHER DISCLOSURE REQUIREMENTS

Because of the introduction of an alternative insolvency regime for the orderly liquidation of large financial companies contained in Title II of the Dodd-Frank Act, the proposed rules require each party to an SBS to disclose to its counterparty its legal and bankruptcy status. To carry this out, proposed Rule 15Fi-5(b)(5) would require that the relationship documentation disclose whether either party to the transaction is an insured depository institution or financial company (within the meaning of Dodd-Frank). If either counterparty is subject to these regulatory regimes, the relationship documentation is required to state that the orderly liquidation provisions of the Dodd-Frank Act and the Federal Deposit Insurance Act may limit the rights of the parties under their trading relationship documentation should either party be deemed

a "covered financial company" or is otherwise subject to having the FDIC appointed as receiver and that such limitations relate to the right of the non-covered party to terminate, liquidate or net any SBS by reason of appointment of the FDIC as receiver, notwithstanding the agreement of the parties in the SBS trading relationship documentation, and to certain rights of the FDIC to transfer SBS transactions of the covered party. The trading relationship documented must also require a counterparty to notify the other if it becomes or ceases to be an insured depository institution or a financial company.

Second, in the case of a cleared SBS transaction, the proposed rules would require the SBS trading relationship documentation of each SBS Entity to contain a notice that, upon acceptance of an SBS by a clearing agency:

- the original SBS is extinguished;
- the original SBS is replaced by equal and opposite SBS with the clearing agency; and
- all terms of the SBS will conform to the product specification of the cleared SBS established under the agency's rules.

This disclosure is designed to assist the parties in understanding the effects of clearing a trade and clarify the status of the contract following its acceptance and novation at the clearing agency.

E. AUDIT OF SBS TRADING RELATIONSHIP DOCUMENTATION

Proposed Rule 15Fi-5(c) would require each SBS Entity to have an independent auditor conduct periodic audits sufficient to identify any material weakness in its documentation policies and procedures required by proposed Rule 15Fi-5. The proposal also would require that a record of the results of each audit be retained for a period of three years after the conclusion of the audit. Unlike the corresponding CFTC rule, which allows for the use of an independent internal auditor, the SEC requires an "independent" auditor, and it is unclear whether an internal auditor could meet the required "independence" test. The SEC acknowledges that an internal auditor may not be independent due to its employment relationship with the issuer, but does not categorically state that an internal auditor could never be independent. For example, if internal audit has been outsourced to an independent public accounting firm, that firm may be independent for purposes of the proposed rule.

F. EXCEPTIONS TO THE TRADING RELATIONSHIP DOCUMENTATION REQUIREMENTS

Proposed Rule 15Fi-5(a)(1) would establish three different exceptions from the basic trading relationship documentation requirements.

First, an exception would be provided for SBS transactions executed prior to the date on which an SBS Entity is required to be in compliance with the documentation rule. This exception is rooted in the belief that it would be impractical to require SBS Entities to have policies and procedures to bring existing transactions into compliance with the potential rules. Therefore, this exception only applies with respect to transactions within a portfolio existing prior to the required compliance date. If an SBS Entity enters

into a new trade with a counterparty with whom the SBS Entity already has an existing trading relationship, after becoming required to comply with the documentation rules, that new trade would not qualify for the exception.

Second, an exception would be provided for any "clearing transaction" which is defined as an SBS that has a clearing agency as a direct counterparty. This exception recognizes the fact that once a swap is cleared, the transaction is governed primarily by the terms of the agreements in effect between the clearing member and the clearing agency.

Finally, an exception would be provided for an SBS transaction executed anonymously on a national securities exchange or an SBS execution facility ("SBSEF"), provided that:

- such SBS transaction is intended to be cleared and is actually submitted for clearing to a clearing agency;
- all terms of such SBS transaction conform to the rules of the clearing agency; and
- upon acceptance of such SBS transaction by the clearing agency: (i) the original SBS transaction is extinguished; (ii) the original SBS transaction is replaced by equal and opposite SBS with the clearing agency; and (iii) all terms of the SBS transaction conform to the product specifications of the cleared SBS transaction established under the clearing agency's rules.

This exception recognizes the fact that documentation between anonymous parties would be practically impossible. In the event the clearing agency rejects the transaction, the proposed rules require the parties to promptly comply with documentation requirements after the notice of rejection.[17]

VERIFICATION OF TRANSACTION DATA BY SDRs

Under Section 13(n) of the Exchange Act, each registered SDR is required to confirm with all counterparties to the SBS transaction the accuracy of the data that was submitted. This represents a difficult task for SDRs, especially when reaching out to counterparties who are not its members to verify the accuracy of their data.[18]

The SEC expresses a preliminary view that the proposed rules could be relevant to SDRs in seeking to meet their statutory and regulatory obligations to verify the accuracy of the reported data when the SBS Entity is not a member of the SDR. The SEC is seeking comment as to whether this preliminary analysis is correct.

RECORDKEEPING REQUIREMENTS

The SEC is also proposing amendments to its recordkeeping rules in order to provide for recordkeeping requirements regarding the documentation produced under these proposed risk-mitigation rules. The updated rules would require that SBS Entities maintain records of each SBS portfolio reconciliation, whether pursuant to Rule 15Fi-3 or otherwise, including the number of portfolio reconciliation

discrepancies, the number of valuation disputes (including the time to resolve the dispute and the age of outstanding disputes) and the name of any third party providing portfolio reconciliation services. SBS Entities would also need to retain a copy of each valuation dispute notification required to be provided to the SEC, a record of each bilateral offset and each bilateral portfolio compression exercise or multilateral portfolio compression exercise in which it participates. The proposed amendments would require this documentation to be kept for at least three years, with the first two being stored in an easily accessible place. Some documents, including, but not limited to, the SBS Entity's written policies and procedures, trading relationship documents and portfolio reconciliations would be required to be stored until three years after the termination of those documents or trading relationships.[19]

CROSS-BORDER APPLICATION AND AVAILABILITY OF SUBSTITUTED COMPLIANCE

Consistent with its approach in both the Cross-Border Proposing Release and the Trade Acknowledgement and Verification Adopting Release,[20] the SEC believes that the requirements being proposed in the proposed rulemaking pursuant to Section 15F(i) of the Exchange Act, as they relate to portfolio reconciliation, portfolio compression and trading relationship documentation, should be treated as entity-level requirements that apply to an SBS Entity's entire SBS business without exception, including in connection with any SBS business it conducts with foreign counterparties. The SEC indicates that this treatment is justified by the fact that the proposed risk mitigation requirements play an important role in addressing risks to the SBS Entities as a whole, including risks related to the safety and soundness of the SBS Entity. The CFTC has taken a different approach with regard to corresponding requirements pursuant to the Commodity Exchange Act. Instead of applying requirements at the entity level, the CFTC approach categorizes these rules as transaction level requirements. The SEC has requested comment on whether or not it should treat the risk mitigation measures at the transaction level rather than at the entity level to conform with the CFTC's approach.

Consistent with the entity level approach, the SEC is proposing to provide non-U.S. persons with the potential to avail themselves of substituted compliance to satisfy these risk mitigation requirements. In proposing to permit substituted compliance, the SEC has preliminarily concluded that the principles associated with substituted compliance, as previously adopted in connection with both the business conduct requirements and the trade acknowledgement and verification requirements, in large part should similarly apply to the portfolio compression, portfolio reconciliation and trading relationship documentation requirements.

PUBLIC COMMENT

The SEC will accept public comment on the proposed rules until the date 60 days following the publishing date of these proposed rules in the Federal Register.

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ENDNOTES

1 For the full text of the release, *see Risk Mitigation Techniques for Uncleared Security-Based Swaps*, SEC Release No. 34-84861, *available at* https://www.sec.gov/rules/proposed/2018/34-84861.pdf (the "Proposing Release") (Dec. 19, 2018).

2 The trade acknowledgement and verification rules relate to the process by which the parties to an SBS transaction verify that the trade accurately reflects the terms of the trade. Generally, one party to the SBS transaction acknowledges an SBS transaction and its counterparty verifies the transaction. For more information regarding acknowledgement and verification rules, *please see* the SEC Release "*Trade Acknowledgement and Verification of Security-Based Swap Transactions*," 81 FR 39807, *available at* https://www.sec.gov/rules/final/2016/34-78011.pdf.

3 For further discussion regarding the margin requirements applicable to SBS transactions, *please see* our Memorandum to Clients, dated November 19, 2012, entitled "Security-Based Swaps: Capital, Margin and Segregation Requirements" *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Proposed_Rules_on_Capital_Requirements_Margin_for_Security_Based_SDs_and_MSPs.pdf. *See also* our Memorandum to Clients, dated October 22, 2018, entitled "SEC Reopens Comment Period on Proposed Rules Regarding Security-Based Swaps" *available at* https://www.sullcrom.com/files/upload/SC-Publication-SEC-Reopens-Comment-Period-on-Proposed-Rules-Regarding-Security-Based-Swaps.pdf.

4 "Portfolio reconciliation" is proposed to be defined as any process by which the counterparties to one or more uncleared SBS transactions:

- exchange the material terms of all SBS transactions in the SBS portfolio;
- exchange each counterparty's valuation of each SBS in the SBS portfolio; and
- resolve any discrepancies in material terms or valuations.

5 "Security-based swap portfolio" is proposed to be defined as all SBS transactions currently in effect between a particular SBS Entity and a particular counterparty.

6 "Valuation" is proposed to be defined as the current market value or net present value of an SBS.

7 For more information on Rule 901, *see* our Memorandum to Clients, dated September 10, 2015, entitled "Security-Based Swaps," *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Security_Based_Swaps_09_10_2015.pdf.

8 While the CFTC uses the term "qualified third party," the SEC requires only that the "third party [be] selected by the counterparties." The CFTC's definition allows counterparties to determine whether the third party is "qualified" based on their own internal policies. Therefore, the SEC decided to remove the "qualified moniker" and allow the parties to select a given third party.

9 The proposed rules opted not to use the CFTC's definition of business day. The CFTC's definition of business day includes any day other than Sunday or a holiday. On the other hand, the SEC's definition includes any day other than a Saturday, Sunday or legal holiday. The concept of a "legal holiday" is designed to provide flexibility over the CFTC's model, but comment is solicited on this point.

10 The CFTC has adopted rules that utilize identical levels as the SEC proposal.

11 The NFA released an Interpretive Notice to its Rule 2-49, which listed specific types of disputes which would trigger a notice requirement. Specifically, a notice requirement is triggered where: (1) the amount of initial margin to be posted or collected pursuant to a collateralized eligible master netting agreement if the dispute exceeds the $20 million reporting threshold and (2) the amount of variation margin to be posted or collected pursuant to such master netting agreement if the dispute exceeds the $20 million reporting threshold. The SEC is seeking comment on whether to incorporate some or all of the NFA's notice requirements.

ENDNOTES (CONTINUED)

[12] The corresponding CFTC rule does not contain the "when appropriate" qualifier. This qualifier was added to the SEC definition in order to provide counterparties with more flexibility in their compression exercises. Under the SEC's formulation, individual circumstances of the counterparties can be taken into account. Similarly, both the SEC and CFTC use the term "timely fashion" in a flexible manner, and therefore there is no definitive timeline. Instead, the SEC indicates in the Proposing Release that the timely fashion requirement will be met so long as (1) termination of the offsetting SBS transactions occurs within a reasonable period of time given the circumstances and (2) the relevant SBS Entity is in compliance with its policies and procedures regarding bilateral offset.

[13] There are two technical differences between the SEC and CFTC rules relating to bilateral and multilateral compression exercises. First, the CFTC requires that any policies and procedures related to multilateral portfolio compression exercises address, among other things, participation in all multilateral portfolio compression exercises required by CFTC regulation or order. The SEC has preliminarily decided to not include a comparable requirement in order to avoid confusion, as there are currently no SEC regulations or orders mandating participation in any particular type of portfolio compression exercise. Second, the CFTC rules require that any policies and procedures related to multilateral portfolio compression exercises evaluate, among other things, any services that are initiated, offered or sponsored by any third party; this requirement does not extend to bilateral compression. The proposed SEC rule requires a third-party evaluation for both multilateral and bilateral compression exercises.

[14] Furthermore, all trade acknowledgements and verifications of SBS transactions required under Rule 15Fi-2 would be deemed to be SBS trading relationship documents.

[15] Prudential regulators include the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency.

[16] "Financial counterparty" is defined as any counterparty that is not an SBS Entity, and is any of a swap dealer, a major swap participant, a commodity pool as defined in the Commodity Exchange Act, a private fund as defined in Section 202(a)(29) of the Investment Advisers Act of 1940, an employee benefit plan as defined in paragraphs (3) and (32) of Section 3 of Employee Retirement Income Security Act of 1974, or a person predominantly engaged in activities that are in the business of banking or activities that are financial in nature, as defined in Section 4(k) of the Bank Holding Company Act of 1956.

[17] Due to the similarities between the requirements of Rule 15Fi-5 and the corresponding CFTC rules, the SEC is requesting several comments on the extent to which SBS Entities could achieve compliance with both regulatory regimes. For example, the SEC is seeking comment as to whether an SBS Entity that is already in compliance with the CFTC rules would also satisfy the proposed rule's requirements. Similarly, the SEC is seeking comment as to whether an SBS Entity should be able to comply with Rule 15Fi-5 on an ongoing basis by complying with the corresponding CFTC rules.

[18] For more information on SDRs and the regulations governing them, *please see* "Security-Based Swap Data Repository Registration, Duties, and Core Principles," Exchange Act Release No. 74246 (Feb. 11, 2015), 80 FR 14437 (Mar. 19, 2015), *available at* https://www.sec.gov/rules/final/2015/34-74246.pdf.

[19] For more information on recordkeeping requirements, *please 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," Exchange Act Release No. 71958 (Apr. 17, 2014), 79 FR 25194 (May 2, 2014), *available at* https://www.sec.gov/rules/proposed/2014/34-71958.pdf.

[20] For more information, *please see* our Memorandum to Clients, dated June 7, 2013, entitled "Cross-Border Security-Based Swaps," *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Cross_Border_Security_Based_Swaps.pdf.

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