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SEC Provides Relief to Security-Based Swap Dealers From Business Conduct Rules

Relief From Certain Documentation Requirements Under the SEC's Business Conduct Rules Would Apply for Five Years After the Registration Requirement Takes Effect

EXECUTIVE SUMMARY

On October 31, 2018, the U.S. Securities and Exchange Commission ("SEC") issued a statement (the "Statement")¹ setting forth its position that failing to comply with certain documentation requirements of the SEC's business conduct rules (the "SEC Business Conduct Rules") applicable to registered security-based swap dealers ("SBS Dealers") and major security-based swap participants ("Major SBS Participants" and, together with SBS Dealers, the "SBS Entities") will not provide a basis for an SEC enforcement action. The Statement seeks to harmonize the SEC Business Conduct Rules with the swap dealer business conduct rule requirements that have been adopted by the U.S. Commodity Futures Trading Commission (the "CFTC Business Conduct Rules"). The relief would expire five years following the compliance date of the SBS Entity registration requirement.

The Statement provides relief from the following categories of requirements under the SEC Business Conduct Rules:

- the mechanism by which non-ERISA employee benefit plans may elect to be treated as a "special entity" by SBS Entities, a status entitled to heightened protections;
- the written representations that an SBS Dealer must receive not to be considered an advisor to an ERISA plan special entity;
- the written representations that an SBS Entity must receive from a qualified independent representative of a special entity to which it is acting as a counterparty; and

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- reliance by SBS Dealers on written representations from a counterparty or representative previously obtained in connection with swaps for purposes of security-based swaps.

The Statement encourages market participants to come forward to the extent there are additional differences between the CFTC Business Conduct Rules and the SEC Business Conduct Rules that present further documentation implementation difficulties that in turn could result in market disruption.

BACKGROUND

In 2010, Congress passed Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act to establish a framework for regulating swaps and security-based swaps markets, to be overseen by the CFTC and the SEC, respectively. In 2012, the CFTC adopted the CFTC Business Conduct Rules for swap dealers and major swap participants, including trading relationship documentation requirements.² Since 2012, swap industry participants have developed standardized counterparty relationship documentation to facilitate compliance with the CFTC Business Conduct Rules.³

In 2016, the SEC adopted final rules pursuant to Section 15F of the Securities Exchange Act of 1934, setting forth the SEC Business Conduct Rules for SBS Entities, intended to be analogous to the CFTC Business Conduct Rules.⁴ However, certain requirements of the SEC Business Conduct Rules—including those to be effectuated through standardized counterparty relationship documentation—diverged from those of the analogous CFTC Business Conduct Rules, leading to concerns about time, costs and the practical difficulties faced by market participants registered with both the SEC and CFTC who would need to comply with two different frameworks.

By seeking to harmonize the initial implementation of its rules with the CFTC Business Conduct Rules through the Statement, the SEC has sought to minimize potential market disruptions to existing counterparty relationships that could arise from documentation implementation issues. In connection with the SEC issuing the Statement, SEC Chairman Jay Clayton observed that the Statement is intended to provide market participants “appropriate time to assess and update their documentation” while reiterating “the agencies’ shared commitment to achieving greater harmonization of Title VII rules.”⁵

SEC POSITION

The SEC’s position applies only to the SEC Business Conduct Rules and the SEC’s enforcement discretion with respect to these rules. The SEC’s position will apply for a period of five years following the compliance date for the SEC’s registration rules for SBS Entities.⁶

1. Non-ERISA Employee Benefit Plans

SEC Rule 15Fh-2(d)(4) defines “special entity” to include “[a]ny employee benefit plan defined in section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002) [(“Non-ERISA Plan”)] and

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not otherwise defined as a special entity, unless such employee benefit plan elects not to be a special entity by notifying a [SBS Entity] of its election prior to entering into a security-based swap with the particular [SBS Entity].”

According to the Statement, the SEC will not pursue an enforcement action against an SBS Entity for purposes of the provisions relating to special entities under the SEC Business Conduct Rules if an SBS Entity considers a Non-ERISA Plan not to be a “special entity” based on the following set of circumstances:

- the Non-ERISA Plan has previously made a written representation to the SBS Entity that it is not a “special entity” for swap purposes under the CFTC Business Conduct Rules;
- the SBS Entity provides written notice at a reasonably sufficient time prior to entering into a security-based swap with a Non-ERISA Plan that the plan is entitled to opt into “special entity” status under SEC Rule 15Fh-2(d)(4); and
- the Non-ERISA Plan does not opt into “special entity” status.

2. Reliance on Written Representations From Special Entity

a. Any Special Entity

Under SEC Rule 15Fh-2(a), an SBS Dealer is considered to be acting as an advisor to a “special entity” when it recommends a security-based swap or a trading strategy that involves the use of a security-based swap to the special entity, subject to certain exceptions, including if the SBS Dealer receives a written representation from the special entity that acknowledges that the SBS Dealer is not acting as an advisor. According to the Statement, the SEC will take the position that it will not pursue an enforcement action if, instead of such an acknowledgement, the SBS Dealer obtains from the special entity a written representation that it will not rely on recommendations provided by the SBS Dealer, which is consistent with the analogous representation that is generally required to be obtained for swap purposes under the CFTC Business Conduct Rules.

b. ERISA Plan Special Entity

SEC Rule 15Fh-2(d)(3) defines “special entity” to include “[a]ny employee benefit plan, subject to Title I of the Employee Retirement Income Security Act of 1974” (“ERISA Special Entity”).

Under SEC Rule 15Fh-2(a), an SBS Dealer would be excepted from being considered an advisor to an ERISA Special Entity if, among other requirements, the SBS Dealer relies on a written representation from the ERISA Special Entity’s fiduciary that acknowledges that the SBS Dealer is not acting as an advisor. According to the Statement, the SEC will not pursue an enforcement action if, instead of such an acknowledgement, the SBS Dealer obtains from the fiduciary a written representation that such fiduciary is not relying on recommendations provided by the SBS Dealer, which is consistent with the analogous representation that is generally required to be obtained for swap purposes under the CFTC Business Conduct Rules.

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Further, instead of requiring an ERISA Special Entity to represent in writing that any recommendation it receives from the SBS dealer involving a security-based swap transaction will be evaluated by a fiduciary, the Statement permits for SBS Dealers to rely on a written representation from the ERISA Special Entity that any recommendation it receives from the SBS Dealer materially affecting a security-based swap will be evaluated by a fiduciary before the transaction occurs. This representation is consistent with the analogous representation that is generally required to be obtained for swap purposes under the CFTC Business Conduct Rules.

c. Safe Harbor for SBS Entities Acting as Counterparties to Special Entities

SEC Rule 15Fh-5(a) provides that SBS Entities acting as counterparties to a special entity other than an ERISA Special Entity are required to have a reasonable basis to believe that such special entity has a qualified independent representative. SEC Rule 15Fh-5(b) sets forth a safe harbor by providing that SBS Entities will be deemed to have such reasonable bases to satisfy SEC Rule 15Fh-5(a) if the SBS Entity, among other requirements, obtains written representations from such qualified independent representative that the representative:

- meets the independence test as required by SEC Rule 15Fh-5(a)(1)(vii);
- has the knowledge required under SEC Rule 15Fh-5(a)(1)(i);
- is not subject to a statutory disqualification under SEC Rule 15Fh-5(a)(1)(ii);
- undertakes a duty to act in the best interests of the special entity as required by SEC Rule 15Fh-5(a)(1)(iii); and
- is subject to the requirements regarding political contributions, as applicable, under SEC Rule 15Fh-5(a)(1)(vi).

According to the Statement, the SEC will not pursue an enforcement action with respect to the safe harbor requirements if, instead of these representations, an SBS Entity relies on a written representation from the qualified independent representative that the representative has written policies and procedures reasonably designed to ensure that the representative satisfies the requirements for acting as a qualified independent representative, which is consistent with the analogous representation that is generally required to be obtained for swap purposes under the CFTC Business Conduct Rules.

The SEC's position is applicable only where the SBS Entity meets all other requirements under SEC Rule 15Fh-5(b).

3. Reliance on Previously Obtained Written Representations

SEC Rule 15Fh-1(b) permits an SBS Entity to rely on written representations from a counterparty or its representative to satisfy its due diligence requirements under the SEC Business Conduct Rules, unless the SBS Entity has information that would cause a reasonable person to question the accuracy of the representations. The Statement provides that the SEC will not pursue an enforcement action if an SBS Dealer relies on representations previously obtained in connection with *swaps* (*i.e.*, the representations

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that were generally required to be obtained for swap purposes under the CFTC Business Conduct Rules), so long as the SBS Dealer is not aware of information that would cause a reasonable person to question the accuracy of the representation if the representation were given in relation to *security-based swaps*.

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ENDNOTES

- ¹ Securities and Exchange Commission, Release No. 34-784511; File No. S7-24-18, *Commission Statement on Certain Provisions of Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants* (Oct. 31, 2018) (“SEC Statement”), available at <https://www.sec.gov/rules/policy/2018/34-84511.pdf>.
- ² Commodity Futures Trading Commission, *Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties*, 77 FR 9734 (Feb. 17, 2012).
- ³ See International Swaps and Derivatives Association, Inc. (“ISDA”) DF Protocol, List of Adhering Parties, available at <https://www.isda.org/protocol/isda-august-2012-df-protocol/adhering-parties>.
- ⁴ Securities and Exchange Commission, Release No. 34-77617; File No. S7-25-11, *Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants* (Jul.Thank 12, 2016).
- ⁵ SEC Press Release 2018-249, *SEC Issues Statement on Certain Provisions of Business Conduct Standards for Security-Based Swap Dealer and Major Security-Based Swap Participants* (Oct. 31, 2018), available at <https://www.sec.gov/news/press-release/2018-249>.
- ⁶ See SEC Statement, *supra* note 1, at 4.

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