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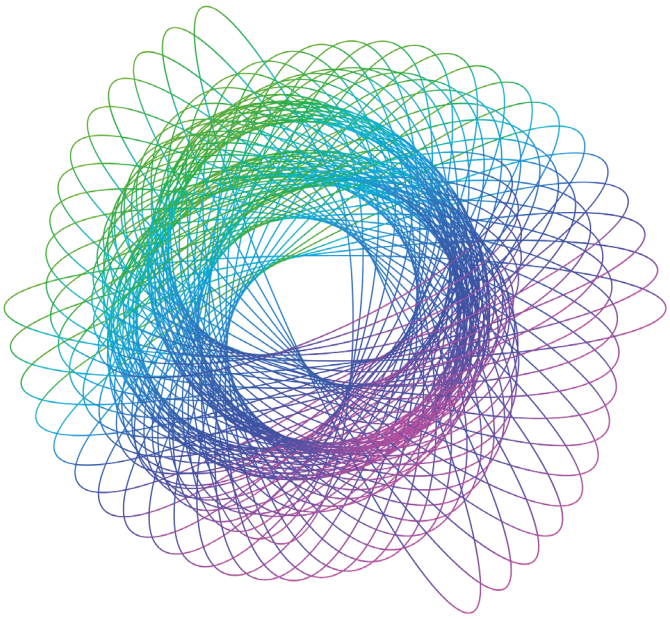

Seven Months and Counting to Swap Dealing Registration and Compliance

Introduction

The Securities Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) have both finalized a key piece of regulation for Security-based Swap Dealers (SBSDs) and Swap Dealers (SDs), namely the Capital Rules.[1] Finalization of the capital rules represents a significant milestone due to its impact and interconnectedness to other swaps regulations. While the two regulators have taken different approaches to registering SBSDs and SDs, and made a great effort to harmonize elements of the rules, finalization of the SEC's net capital rules will kick into gear registration of SBSDs and a host of other SEC regulations (e.g., books and records, business conduct and reporting rules). This will require provisionally registered SDs to understand what this means to existing compliance programs and regulatory obligations. Outlined below are some areas for considerations and perspectives on the potential future developments.

Rule comparison – differences in approach

Given some differences in SEC and CFTC's swap dealing regulations, registrants will have to understand where these two rule sets overlap and where they do not, and the potential impact to compliance programs.

Eligible and Alternative Forms of collateral –

- In its proposed capital rule, the CFTC requested comment on whether Futures Commission Merchant (FCM)-SDs or covered SDs should be permitted to recognize alternative forms of collateral (e.g., letters of credit and liens), provided by commercial end-users that are exempt from clearing and the uncleared margin requirements, in computing the FCM-SDs' or covered SDs' counterparty credit risk charges for uncleared swap transactions. Furthermore, Prudential Regulators' final rule on the standardized approach to counterparty credit risk (SA-CCR), provides that banks may consider non-cash collateral in computing credit risk charges for OTC derivatives[2]. *In its final Capital Rules, the CFTC has not modified the credit risk charges to recognize non-cash collateral.*[3]
- The margin rules of the CFTC and the Prudential Regulators, list the specific types of securities that can serve as eligible collateral and include: (1) cash; (2) US Treasury securities; (3) certain securities guaranteed by the US; (4) certain securities issued or guaranteed by the European Central Bank, a sovereign entity, or the BIS; (5) certain corporate debt securities; (6) certain equity securities contained in major indices; (7) certain redeemable government bond funds; (7) a major foreign currency; (8) the settlement currency of the non-cleared security-based swap or swap; or (9) gold. *While the SEC's final margin rules have been modified to permit the types of collateral that are eligible under the margin rules of the CFTC and the Prudential Regulators, unlike the margin rules of the CFTC and the prudential regulators, the SEC's final margin rules do not list the specific types of securities that can serve as eligible collateral.* The SEC's final margin rule does, however, require, among other things, that the collateral have a ready market[4] and is readily transferable.

Customer Reserve Requirements – SEC's final rules require SBSDs, including OTC Derivative Dealers, to perform a "Customer Reserve Account Computation," reflecting the Formula for Determination of Security-Based Swap Customer Reserve Requirements under §240.18a-4. *Although the CFTC has customer segregation reporting requirements for cleared swaps, commodity futures and foreign futures products, a similar reporting requirement does not appear to be required for OTC derivatives.*

Other Considerations

While most firms are operating with risk, compliance, and internal control frameworks already in place, certain aspects of the SEC and CFTC regulations may require some effort, lead time, and planning to meet the new requirements.

Model-based Capital – As prescribed in the rules, the standardized approach to capital is punitive, related to counterparty credit risk charges and can require a significant capital infusion. If a firm operates with a risk infrastructure that is, or can be, aligned to the CFTC's regulatory requirements, a model-based capital approach is less punitive. Approval to use capital models (both market and credit risk) is a lengthy process that includes application drafting, operational readiness reviews, and on-site regulator examination. It requires a well thought out plan and aggregation of documents and deep analysis of capabilities across risk stripes (e.g., market, credit, liquidity, legal risk). Generally, this can take several months (from gap assessment through to implementation) and require a cross-functional team (e.g., risk, finance, operations and compliance) working together to achieve the desired outcome.

Chief Compliance Officer (CCO) Annual Compliance Report – Both the SEC and CFTC require annual compliance reporting from the CCOs of SBSDs and SDs. This reporting is meant to provide a holistic assessment of the firm's compliance structure, including operations, policies and procedures, material non-compliance matters, and remediation efforts. Recent revisions to both SEC and CFTC rules highlight the regulators' expectation that this reporting be a meaningful self-evaluation rather than a "check the box" activity. This will require CCOs to evaluate elements of their current annual reporting process, from how the reporting is prepared and what is included, to how the reporting is disseminated and how feedback is incorporated. CCOs may need to revisit existing attestation processes to ensure these expectations are being met.

Reporting Requirements – SEC's proposed capital rules (new Rule 18a-7) required stand-alone SBSDs to annually file with the SEC a financial report. The proposed rule also required stand-alone SBSDs to file a compliance report that contained statements about the firm's compliance with the proposed SBSD capital and segregation rules and statements about the firm's internal control over compliance with those rules and the proposed SBSD securities count rule. The proposed rule further required stand-alone SBSDs to file reports of an independent public accountant covering the financial report and the compliance report:

- In its final rule the proposed annual reports provisions in Rule 18a-7 were modified to require a stand-alone SBSD or OTCDD/SBSD operating under the exemption from Rule 18a-4[5] to file an exemption report instead of the compliance report.
- A stand-alone SBSDs and OTCDD/SBSDs operating under the exemption from Rule 18a-4 will also be required to file the exemption report instead of the compliance report.
- Stand-alone SBSDs and MSBSPs and OTCDD/SBSDs may also engage an independent public accountant that is *not* registered with the PCAOB, and that the accountant must undertake, as part of the engagement, to prepare its reports based on an examination or review, as applicable, per GAAS in the United States or PCAOB standards.

Permitting these firms to file the exemption report in lieu of the compliance report should reduce the costs of an audit.

Securities Counts – The SEC's final capital rules require stand-alone SBSD's to perform quarterly counts of securities they hold and account for securities which are under their control, even though the securities may not be in the SBSD's actual possession, and to verify the locations of securities under certain circumstances. SBSDs are required to physically examine, count and verify all securities positions (e.g., equities, corporate bonds, government securities) and compare the count and verification results with the firm's records at least once each calendar quarter. The SEC anticipates that this may require stand-alone SBSDs to make some investments in technology to accurately track and safeguard securities.

Things to look out for

Although the SEC and CFTC continue to expend significant effort with the swap dealing rules, certain aspects of the rules will continue to evolve. Some areas for additional consideration are below:

Substituted Compliance and Comparability Determination - The CFTC and SEC have proposed a substituted compliance framework that allows covered SBSDs and SDs organized and domiciled in a foreign jurisdiction to rely on compliance with their applicable home country regulator's capital, financial reporting, and business conduct requirements in lieu of meeting all or parts of the CFTC's and/or SEC's capital adequacy and financial reporting requirements. While this comparability determination has not yet been made for capital rules, it will be key in determining compliance efforts and something to look out for.

Recordkeeping – In 2017, the CFTC revised Regulation 1.31 to modernize recordkeeping obligations beyond "write once, read many" (WORM) storage technology[6]. While this change has yet to be adopted by the SEC in its 17a-4 recordkeeping requirements, the SEC has adopted new Rule 18a-6 as the record retention requirement applicable only to SBSDs. SEC Rule 18a-6 does NOT require that the electronic storage system to preserve records be exclusively in a non-rewriteable and non-erasable format

(i.e., a WORM format)[7]. The SEC is uses this rule as a "Beta test" for future replacement of the WORM requirement in Rule 17a-4.

Despite the differences and areas of clarification above, there are several areas of harmonization in the rules including: (1) allowing the Alternative Compliance Mechanism for SBSDs that are registered as SDs and have limited security-based swap activities to comply with capital, margin, segregation recordkeeping, and reporting requirements of the Commodity Exchange Act as oppose to that of the SEC. (2) Adopting harmonization in the report filings of Bank-SDs, in line with the quarterly reporting timeframe of the Call Report. (3) Requiring a more limited set of notification requirements for SBSDs and SDs supervised by a prudential regulator, thereby giving deference to the supervision of such regulator.

How Deloitte can help?

Given additional rule clarifications and/or revisions that may lie ahead, firms will need to continue monitoring these rules to ensure required capabilities, compliance and internal control frameworks continue to meet regulatory obligations. Deloitte continues to be at the forefront of assisting clients with meeting their regulatory obligations and welcomes the opportunity to discuss how our Advisory professionals can help your organization with meeting these regulatory needs and/or challenges.

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Endnotes

1. See CFTC Federal Register/Vol. 85, No. 179/ dated Tuesday, September 15, 2020 and SEC Release No. 34-86175; File No. S7-08-12 for final rules.
2. See CFTC Federal Register/Vol. 85, No. 179/ dated Tuesday, September 15, 2020, page 57478
3. While the CFTC is not modifying the final rules to reflect non-cash collateral, it will continue to monitor and assess FCM-SD's and covered SD's acceptance of non-cash collateral from commercial end-users and consider possible revisions to the rules after it gains further understanding through the experiences of such firms.
4. *The term ready market includes a recognized established securities market in which there exist independent bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined for a particular security almost instantaneously and where payment will be received in settlement of a sale at such price within a relatively short time conforming to trade custom.*
5. Rule 18a-4 establishes segregation requirements for cleared and non-cleared security-based swap transactions for bank and stand-alone SBSDs, as well as notification requirements for these entities.
6. Refer to https://www.cftc.gov/LawRegulation/FederalRegister/finalrules/2017-11014.html
7. Refer to https://www.sec.gov/rules/final/2019/34-87005.pdf page 56

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