

Legal Update

SEC Adopts Security-Based Swaps Recordkeeping and Reporting Rules; *Compliance Countdown Begins Soon*

On Sept. 19, the U.S. Securities and Exchange Commission (SEC) took another significant step toward completing its requirements for the security-based swap and swap activities by finalizing its recordkeeping and reporting rules for security-based swap dealers (SBSDs), major security-based swap participants (MSBSPs) and broker-dealers.¹ With compliance dates approaching, this Legal Update provides a summary of the key recordkeeping and reporting rules adopted.

The SEC's new recordkeeping and reporting rules will impact U.S. banks, U.S. broker-dealers and many non-U.S. banks engaging in security-based swap activities. Addressing seven key areas, the SEC adopted rules that:

1. establish record making requirements for SBSBs and MSBSPs and amend the existing record making requirements for broker-dealers to account for their security-based swap activities;
2. establish record preservation requirements for SBSBs and MSBSPs and amend the existing record preservation requirements for broker-dealers to address records relating to their security-based swap activities;
3. establish periodic reporting and annual audit requirements for SBSBs and MSBSPs and amend

the existing reporting requirements for broker-dealers to account for their security-based swap activities;

4. establish early warning notification requirements for SBSBs and MSBSPs;
5. establish security count requirements for SBSBs that are not registered as broker-dealers and do not have a prudential regulator² (stand-alone SBSBs);
6. provide a mechanism to request "substituted compliance" with respect to the recordkeeping and reporting requirements for SBSBs and MSBSPs; and
7. permit certain SBSBs that are registered as swap dealers and predominantly engage in a swaps business to comply with CFTC requirements in lieu of SEC requirements.

Additionally, the SEC adopted substituted compliance in connection with certain recordkeeping and reporting requirements.

The recordkeeping and reporting rulemaking is the penultimate rule set necessary to trigger the SEC's registration and compliance requirements for the SBSB and MSBSP regime under Title VII of Dodd-Frank.³ Only the cross-border final rules remain.⁴

Scope and Applicability

The SEC relied on its authority under Title VII of the Dodd-Frank Act⁵ to amend its rules under the Securities Exchange Act of 1934 (the Exchange Act), establishing new recordkeeping and reporting rules based on four categories of market participants:

1. stand-alone SBSDs and MSBSPs;
2. security-based swap activities of SBSDs and MSBSPs that are also registered as broker-dealers;
3. broker-dealers that engage in security-based swap activities but not at a level that requires SBSD or MSBSP registration; and
4. SBSDs that are also registered as OTC derivatives dealers (Special-Purpose Broker-Dealers).

Below is a chart of the new and amended rules and their applicability based on the foregoing categories.

Rule Area	Stand-Alone SBSDs and MSBSPs	Broker-Dealer SBSDs and MSBSPs	Broker-Dealers engaged in security-based swaps activities below SBSD or MSBSP registration threshold	Special-Purpose Broker-Dealers*
Record Making	Rule 18a-5	Rule 17a-3	Rule 17a-3	Rule 17a-3
Record Preservation	Rule 18a-6	Rule 17a-4	Rule 17a-4	Rule 17a-4
Periodic Reporting and Annual Audit	Rule 18a-7 (limited reporting for bank SBSDs and MSBSPs, which are not required to file annual audited reports)	Rule 17a-5	Rule 17a-5	Rule 18a-7 *
Early Warning Notification	Rule 18a-8	Rule 17a-11	Rule 17a-11	Rule 18a-8*
Security Count	Rule 18a-9 (inapplicable to MSBSPs)	Rule 17a-13	Rule 17a-13	Rule 18a-9 (must perform a quarterly securities count)
Alternative Compliance Mechanism for CFTC SDs	Rule 18a-10 (available to stand-alone SBSDs that elect to comply with the Commodity Exchange Act and CFTC rules for capital, margin and segregation)	-	-	-

*Special-Purpose Broker-Dealers will be subject to Rules 18a-7 and 18a-8 because they will be subject to the capital rule for stand-alone SBSDs (Rule 18a-1) rather than 15c-1.

Note that certain requirements applicable to bank SBSBs and MSBSBs, such as the recordkeeping rules, are more limited in scope because:

1. the SEC's authority under Section 15F(f)(1)(B)(i) of the Exchange Act⁶ is tied to activities related to the conduct of the firm's business as an SBSB or MSBSB;
2. bank SBSBs and MSBSBs are subject to recordkeeping requirements applicable to banks with respect to their banking activities; and
3. prudential regulators – rather than the SEC – are responsible for capital, margin, and other prudential requirements applicable to bank SBSBs and MSBSBs.⁷

Record Making

Exchange Act Rule 17a-3 requires a broker-dealer to make and keep current certain financial and accounting records, including:

- blotters itemizing a daily record of all purchases and sales of securities;
- ledgers reflecting all assets and liabilities, income and expense, and capital accounts;
- a securities record; and
- a memorandum of each brokerage order and proprietary securities transaction.

Additionally, the SEC amended Rule 17a-3 to require broker-dealers (including broker-dealer SBSBs and MSBSBs) to make and keep current records relating to their security-based swap activities.

New SEC Rule 18a-5 will require non-broker-dealer SBSBs and MSBSBs to make and keep current financial and accounting records and records relating to their security-based swap activities. However, Rule 18a-5 is more narrowly tailored than Rule 17a-3, particularly with respect to the requirements for bank SBSBs and MSBSBs.

Record Preservation

The SEC amended Rule 17a-4 to prescribe the time periods that the new security-based swap records required under Rule 17a-3 must be retained by broker-dealers (including those dually registered as SBSBs and MSBSBs) and to subject the records to preservation requirements in the rule. Those include requirements relating to storing records electronically and promptly producing records to the SEC. Rule 17a-4 identifies additional types of records that must be preserved if the record is made or received by the broker-dealer (*e.g.*, written communications and agreements relating to the broker-dealer's business).

New Rule 18a-6 sets forth the period of time the records required to be made and kept current under new Rule 18a-5 must be preserved by non-broker-dealer SBSBs and MSBSBs and the manner in which the records must be preserved. New Rule 18a-6 will require that additional types of records be preserved (*e.g.*, written communications and agreements relating to the firm's business) if the record is made or received by the non-broker-dealer SBSB or MSBSB.

Periodic Reporting and Annual Audit

Rule 17a-5 currently has two main components:

- 1.a requirement that broker-dealers periodically (monthly or quarterly) file an unaudited FOCUS Report containing information about their financial and operational condition, including a balance sheet, income statement, and capital and segregation computations; and
2. a requirement that broker-dealers annually file financial statements and certain reports audited by a Public Company Accounting Oversight Board (PCAOB)-registered accountant in accordance with PCAOB standards (annual audited reports).

The SEC is amending the FOCUS Report Part II to, among other things, gather information about the capital and segregation calculations of nonbank SBSBs and MSBSBs and information about

security-based swap and swap transactions and positions of broker-dealers and nonbank SBSBs and MSBSPs. Amended Rule 17a-5 also will require broker-dealers (including broker-dealer SBSBs and MSBSPs) to file the FOCUS Report Part II. Rule 17a-5 will be broadened to require broker-dealer SBSBs and MSBSPs to file the annual audited reports.

New Rule 18a-7 will require non-broker-dealer SBSBs and MSBSPs to file the amended FOCUS Report Part II or bank SBSBs and MSBSPs to file a new FOCUS Report Part IIC. The FOCUS Report Part IIC will be more limited than the amended Part II and will require bank SBSBs and MSBSPs to report certain information about their financial condition (similar to that provided to its prudential regulator) and information about their security-based swap activities. For stand-alone SBSBs, Rule 18a-7 will require annual audited reports. However, bank SBSBs and MSBSPs will not be required to file annual audited reports.

Early Warning Notification

Rule 17a-11 sets forth circumstances under which a broker-dealer must notify the SEC and other regulators of adverse changes in the firm's financial or operational condition.⁸ The SEC amended Rule 17a-11 to require notice if the broker-dealer (including a broker-dealer SBSB or MSBSP) fails to make a required deposit into the security-based swap customer reserve account, which would be a failure to comply with the security-based swap segregation requirement.

New Rule 18a-8 creates notification requirements for non-broker-dealer SBSBs and MSBSPs when, for example, a firm's capital levels fall below required amounts, it fails to make required books and records, or it fails to make required deposits into its security-based swap customer reserve accounts.

Security Counts

The SEC broadened Rule 17a-13 to include broker-dealer SBSBs and MSBSPs in its requirement, on a quarterly basis, to examine and:

- count the securities it physically holds,
- account for the securities that are subject to its control or direction but are not in its physical possession,
- verify the locations of securities under certain circumstances, and
- compare the results of the count and verification with its records.

Additionally, new Rule 18a-9 will require stand-alone SBSBs to perform a quarterly securities count.

Substituted Compliance

Rule 18a-10 provides a mechanism for SBSB's who avail themselves of substituted compliance by electing to comply with Commodity Futures Trading Commission (CFTC) capital, margin and segregation requirements to also comply with the CFTC's recordkeeping and reporting rules.

In addition, Rule 3a71-6 has been amended to permit foreign SBSBs and MSBSPs to avail themselves of substituted compliance to satisfy the recordkeeping and reporting requirements.

Conclusion and Next Steps

The recordkeeping and reporting rules will become effective 60 days after publication in the Federal Register. The compliance date for the rule amendments and new rules will be 18 months after the effective date of any final rules addressing the cross-border application of certain security-based swap requirements.⁹

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Endnotes

¹ *Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers* (Sept. 19, 2019) ("Adopting Release"), available at: <http://bit.ly/353074x>.

² "Prudential regulator" is defined in Section 1a(39) of the Commodity Exchange Act, 7 U.S.C. 1a(39), and that definition is incorporated by reference in Section 3(a)(74) of the Exchange Act, 15 U.S.C. 78c(a)(74). Pursuant to the definition, the Board of Governors of the Federal Reserve System (Federal Reserve Board), the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration, or the Federal Housing Finance Agency is the "prudential regulator" of an SBSB, MSBSP, swap dealer, or major swap participant if the entity is directly supervised by that agency.

³ *SEC Adopts New Rules and Amendments under Title VII of Dodd-Frank*, Press Release (Sept. 19, 2019), available at: <http://bit.ly/2AGI4TI>.

⁴ *See Proposed Rule Amendments and Guidance Addressing Cross-Border Application of Certain Security-Based Swap Requirements*, 84 Fed. Reg. 24206 (July 23, 2019), available at <http://bit.ly/2OjLqWf>.

⁵ The Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376, Title VII, Subtitle B (2010).

⁶ 17 C.F.R. § 15F(f)(1)(B)(i).

⁷ Adopting Release, at p. 275.

⁸ The "early warning" rule requires a broker-dealer to provide notice when, among other things, its net capital falls below 120% of the minimum required amount or below the minimum required amount, when the firm fails to make and keep current the books and records required by SEC rules, or when a broker-dealer discovers or is notified by its accountant of a "material weakness" as defined in Rule 17a-5.

⁹ *SEC Adopts New Rules and Amendments under Title VII of Dodd-Frank*, Press Release (Sept. 19, 2019), available at: <http://bit.ly/2AGI4TI>.