

Security-Based Swaps as Securities: Request for Permanent Exemptions

Introduction

Effective July 16, 2011, the Dodd-Frank Act amended the definition of security for purposes of the Securities Act of 1933 (the “**1933 Act**”) and the Securities Exchange Act of 1934 (the “**1934 Act**”) to include security-based swaps (“**SBS**”). As a result, SBS became subject to the provisions of the 1933 and 1934 Acts, and the underlying rules that applied to securities before July 16, as well as the rules that applied to FINRA members. The Dodd-Frank Act also created an entirely new, comprehensive regulatory regime for SBS (such provisions of the Dodd-Frank Act, and the rules adopted thereunder, the “**SBS provisions**”). Although some of the SBS provisions became effective on July 16, the vast majority did not, either because they are subject to SEC rulemaking or were the subject of a temporary exemption by the SEC.

On July 1, the SEC temporarily exempted SBS from most of the pre-Dodd-Frank provisions, and FINRA similarly took action on July 14. These exemptions preserved the status quo while providing market participants and the SEC additional time to analyze the application of these provisions to SBS, and to consider whether permanent exemptive relief was needed.¹ The SEC’s temporary exemptions remain in effect until the compliance date for final rules defining “security-based swap” and “eligible contract participant” (“**ECP**”). FINRA’s temporary exemptions remain in effect until January 17, 2012, although FINRA intends its exemptions to be coterminous with the SEC’s exemptive relief.

In our June 10, 2011 letter to the SEC requesting relief from application of the pre-Dodd-Frank provisions and SBS provisions we stated that we would provide the SEC with specific requests for exemptions for SBS from the application of the 1933 and 1934 Act provisions that applied to securities prior to July 16. In this letter, we set forth a framework for determining whether the 1934 Act provisions and FINRA rules that applied to securities and registered broker-dealers prior to July 16 (collectively, the “**pre-Dodd-Frank provisions**”) should apply to SBS activities.² We then analyze the pre-Dodd-Frank provisions in light of that framework and request specific exemptions from those provisions, either

¹ SEC Order Granting Temporary Exemptions under the Securities Exchange Act of 1934 in Connection With the Pending Revision of the Definition of “Security” To Encompass Security-Based Swaps, and Request for Comment 76 FR 39,927 (July 7, 2011), *available at* <http://69.175.53.6/register/2011/Jul/07/2011-17040.pdf>; SEC Interim Final Rule on Exemptions for Security-Based Swaps, 76 FR 40,605 (July 11, 2011), *available at* <http://www.sec.gov/rules/interim/2011/33-9231fr.pdf>; FINRA Proposed Rule 0180 (Application of Rules to Security-Based Swaps), 76 FR 42,755 (July 19, 2011), *rule available at* <http://www.gpo.gov/fdsys/pkg/FR-2011-07-19/pdf/2011-18091.pdf>.

² “SBS dealer” as used in this letter refers to an SEC-registered SBS dealer.

with respect to all SBS activities, or more narrowly, with respect to SBS dealing and brokering activities with ECPs.³ Consistent with our June 10 letter, the analysis and the requests in this letter are limited to swap market participants, other than clearing agencies, national securities exchanges, self-regulatory organizations, nationally recognized statistical rating agencies, and the Municipal Securities Rulemaking Board. Furthermore, we do not address application of the 1933 Act to SBS in this letter. Instead, we will submit a separate request to the SEC for no-action relief under the 1933 Act.

Overview of Three Categories of Pre-Dodd-Frank Provisions

- **Category 1.** Category 1 includes pre-Dodd-Frank provisions that should apply to SBS. As a general principle, pre-Dodd-Frank provisions would apply to SBS activities, unless specifically exempted. Some provisions, such as the antifraud provisions, are sacrosanct and should continue to apply to SBS.
- **Category 2.** Category 2 includes pre-Dodd-Frank provisions from which the SEC and FINRA should provide exemptions for SBS because such provisions are **inapplicable or unworkable** for SBS. Exemptions are important to provide clarity and reduce uncertainty about how SBS are regulated. Absent certainty regarding the application of these provisions and rules, SBS participants would be subject to unnecessary compliance burdens.
- **Category 3.** Category 3 includes pre-Dodd-Frank provisions from which the SEC and FINRA should provide exemptions for registered broker-dealers' SBS dealing and brokering activities because such provisions are **unnecessary** in light of the new SBS regulatory regime. Congress created a bespoke new regime for the regulation of SBS dealers and their activities. At the same time, the expanded definition of "security" means that entities that are dual-registered as SBS dealers and broker-dealers will be subject to two sets of regulatory regimes, that is, both SBS and securities regulations. An SBS dealer should not be placed at a competitive disadvantage in its transactions vis-à-vis registered SBS dealers that are not registered broker-dealers as a result of its status as a registered broker-dealer.
 - To be deemed unnecessary, the SBS provision (i) **by its terms must apply** to the activity triggering the application of the pre-Dodd-Frank provision and (ii) **must address the purpose** of the

³ SIFMA notes that the SEC has not yet proposed rules on capital, margin, books and records, protection of cleared SBS requirements, or extraterritorial application of SBS regulation. Nor has the SEC finalized the definition of SBS dealer and SBS. Requests for relief are subject to change pending the SEC's release and SIFMA's analysis of these proposed and final rules.

pre-Dodd-Frank provision with respect to the triggering activity, or clearly evince an intent to not regulate the activity.

- Where SBS dealing activities are conducted in a registered broker-dealer it is not necessary to provide a number of pre-Dodd-Frank provisions because both SBS dealer provisions and the pre-Dodd-Frank provisions will apply to the broker-dealer.
- SBS dealing activities with non-ECPs trigger broker-dealer registration and regulation. However, SBS dealing with ECPs does not trigger broker-dealer registration. Congress only intended to subject SBS dealing with non-ECPs activities to broker-dealer requirements. Therefore, the application of pre-Dodd-Frank broker-dealer provisions to SBS dealing activities with ECPs is unnecessary, and exemptions for such activities should be granted.
- SBS brokering activities trigger a broker-dealer registration requirement and thus would be subject to pre-Dodd-Frank provisions. Broker-dealers that engage in SBS brokering activities should be exempt from pre-Dodd-Frank provisions to the extent they comply with the corresponding SBS provisions that apply to SBS dealers. Unlike the pre-Dodd-Frank provisions, SBS provisions are tailored for SBS and more appropriately designed to regulate SBS.
- Our request for exemptions from the pre-Dodd-Frank provisions in Category 3 is tailored to a registered broker-dealer dealing or brokering SBS for ECPs. In each case, the registered broker-dealer may also be an SBS dealer.
- With respect to the pre-Dodd-Frank provisions in Category 3 for which we do not request an exemption, the SEC and FINRA should consider adapting these provisions where appropriate to reflect the unique characteristics of SBS. The tailoring of securities requirements for OTC derivatives dealers (“BD lite”) could serve as a precedent.

Illustration of Three Categories of Pre-Dodd-Frank Provisions

- **Category 1 Provisions.** Certain provisions should apply to all SBS activities, including SBS dealing and brokering activities with ECPs. These provisions are set forth in Appendix A. These non-exempt provisions generally fall into the following categories:
 - Provisions that prohibit fraud and manipulation, and insider trading (but not reporting or recordkeeping requirements), and that relate to the SEC’s and FINRA’s enforcement authority in connection

with violations of such provisions. In accordance with the temporary relief granted by the SEC and FINRA in June and July, these provisions should continue to apply to SBS.

- The beneficial ownership reporting requirements in Sections 13 and 16 of the 1934 Act, in accordance with the final rule adopted by the SEC in June 2011.
- Provisions that apply to the SEC and FINRA and their staff, such as rules relating transactions with FINRA employees.
- Provisions that apply to all financial institutions, such as Regulation S-P and Regulation S-AM.
- **Category 2 Provisions. Inapplicable or unworkable provisions** for which exemptions should be provided in the context of SBS are listed in Appendix B. Provisions in Category 2 are of the following types:
 - Provisions that are unworkable for SBS as written because they are designed for traditional securities, such as rules that relate to issuer disclosures. If the SEC wants to apply provisions like these to SBS, the SEC should adopt rules that are customized for SBS, as the SEC did for exchange-traded options.
 - Some provisions simply do not apply to SBS as written, such as options rules, rules on missing and stolen securities, short sale delivery requirements, and Regulation NMS.
 - Some provisions do not apply to SBS at this time because of how the SBS market functions. For example, the rule on identification of quotations (Rule 15c2-7) that applies to registered broker-dealers. If an inter-dealer quotation system develops for SBS, the SEC should adopt a rule that applies to all SBS dealers, not just registered broker-dealers.
- **Category 3 Provisions.** Provisions that need to be analyzed to determine whether they are **unnecessary** when applied to SBS dealing activities in light of the new SBS regulatory regime. These provisions are set forth in Appendix C. Provisions that are unnecessary for SBS dealing activities should similarly not apply to SBS brokering activities, and instead, the corresponding SBS provision should apply.
 - “Entity-level” pre-Dodd-Frank provisions are necessary to apply to registered broker-dealers because they are effective only on a cross-activity basis, are necessary to protect the integrity of the broker-dealer, and cannot be operational on a transaction-by-transaction basis. Some of these rules are also necessary to ensure

compliance with rules that apply on a transaction-by-transaction basis. Therefore, broker-dealers should not be exempt from these pre-Dodd-Frank provisions.

- Capital requirements. These are entity-level requirements that should apply to all activities of registered broker-dealers.
 - Capital rules must apply to all instruments in a broker-dealer. However, because the existing capital rules for broker-dealers are extremely inhospitable for SBS, the SEC and FINRA should modify existing capital requirements for SBS and reconcile them with the (yet-to-be-proposed) SBS dealer capital requirements.
- Financial reporting rules. These are entity-level requirements that should apply to all activities of registered broker-dealers.
 - For example: filing of Focus and related forms (FINRA Rule 4521), verification of assets (FINRA Rule 4160), and net capital failure notification (FINRA Rule 4120).
- Business continuity and disaster recovery plan requirement (FINRA Rule 4370). This is an entity-level requirement that should apply to all activities of registered broker-dealers.
- Supervisory requirements. The supervisory requirements in Category 3 should apply to all activities of registered broker-dealers.
- Margin requirements and disclosures. All SBS dealing activities with ECPs should be exempt from these provisions, so long as the broker-dealer complies with the SBS dealer margin requirements.
 - All SBS brokering activities should be exempt from the pre-Dodd-Frank margin provisions (*e.g.*, Section 7, Regulation T) to the same extent as SBS dealing activities. Without such exemptions, counterparties would be subject to duplicative margin requirements: they would need to post margin to the dealer and to the broker of their SBS, or, if the dealer and broker are the same, would need to post margin twice. Instead, only the SBS provisions for margin should apply, including those that apply to cleared SBS.

- Books and records requirements (Section 17 of the 1934 Act and Rules 17a-3-5). All SBS dealing and brokering activities with ECPs should be exempt from Category 3 books and records requirements, so long as the broker-dealer complies with the corresponding SBS provision.
- Business conduct. SBS dealing and brokering activities with ECPs should be exempt from the Category 3 business conduct requirements, so long as the broker-dealer complies with the corresponding SBS provision. These Category 3 business conduct requirements include, among others:
 - Business conduct rules (*e.g.*, know your customer (FINRA Rule 2090), suitability obligations (NASD Rule 2310), and trading ahead of customer orders (FINRA 5320)).
 - Customer information controls: new account review and approval (NASD 2310, 3110(c))
 - Best execution (NASD Rule 2320)
- Customer protection. SBS dealing and brokering activities with ECPs should be exempt from the following Category 3 customer protection requirements, so long as the broker-dealer complies with the corresponding SBS provision.
 - Requirements for borrowing and lending between associated persons and customers (FINRA Rule 3240)
 - Gifts and gratuities (FINRA Rule 3220).
 - Changes in customer account name or designation system and operations controls (NASD Rule 3110(j))
 - Cold callers and telemarketing scripts (NASD Rule 2212)
 - Prohibition against guarantees (FINRA Rule 2150)
 - Material event and customer complaint reporting (FINRA Rule 4530)
- Customer information (disclosure and account statements). SBS dealing and brokering activities with ECPs should be exempt from the following customer disclosure and account statement requirements in Category 3, so long as the broker-dealer complies with the corresponding SBS provision.
 - Rule 10b-10 (Confirmations). We note that the SEC has proposed to exempt registered broker-dealers from Rule 10b-10 if the broker complies with the SBS confirmation rule that applies to SBS dealers. We recommend that the SEC similarly also exempt a broker from Rule 10b-10 with

respect to its SBS brokering activities, whether or not such broker is an SBS dealer.

- Disclosure of financial condition to customers (FINRA Rule 2261)
- Disclosure for bank affiliated broker-dealers (FINRA Rule 3160(c))
- Account statements (NASD Rule 2340)
- Investor education and protection (FINRA Rule 2267)