

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Part 240

[Release No. 34-87782; File No. S7-28-18]

RIN 3235-AL83

### Risk Mitigation Techniques for Uncleared Security-Based Swaps

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Final rule.

**SUMMARY:** The Securities and Exchange Commission (“SEC” or “Commission”) is adopting final rules requiring the application of specific risk mitigation techniques to portfolios of uncleared security-based swaps. In particular, these final rules establish requirements for each registered security-based swap dealer (“SBS dealer”) and each registered major security-based swap participant (“major SBS participant”) (each SBS dealer and each major SBS participant hereafter referred to as an “SBS Entity” and together referred to as “SBS Entities”) with respect to, among other things, reconciling outstanding security-based swaps with applicable counterparties on a periodic basis, engaging in certain forms of portfolio compression exercises, as appropriate, and executing written security-based swap trading relationship documentation with each of its counterparties prior to, or contemporaneously with, executing a security-based swap transaction. In addition, the Commission is issuing an interpretation addressing the application of the portfolio reconciliation, portfolio compression, and trading relationship documentation requirements to cross-border security-based swap activities and is amending its regulations to address the potential availability of substituted compliance in connection with those requirements. Lastly, the final rules include corresponding amendments to the recordkeeping, reporting, and notification requirements applicable to SBS Entities.

**DATES:**

*Effective Date:* These final rules and rule amendments are effective April 6, 2020.

*Compliance Date:* The compliance date is discussed in Section V of this adopting release.

**FOR FURTHER INFORMATION CONTACT:**

Carol McGee, Assistant Director, or Andrew Bernstein, Senior Special Counsel, at (202) 551-5870, Office of Derivatives Policy, Division of Trading and Markets, Securities and Exchange

Commission, 100 F Street NE, Washington, DC 20549-8010.

**SUPPLEMENTARY INFORMATION:** The Commission is adopting the following new rules:

Commission reference	CFR citation (17 CFR)
Securities Exchange Act of 1934 (“Exchange Act”): <sup>1</sup>	
Rule 15Fi-3 .....	§ 240.15Fi-3.
Rule 15Fi-4 .....	§ 240.15Fi-4.
Rule 15Fi-5 .....	§ 240.15Fi-5.

The Commission also is adopting amendments to:

Commission reference	CFR citation (17 CFR)
Exchange Act:	
Rule 3a71-6 .....	§ 240.3a71-6.
Rule 15Fi-1 .....	§ 240.15Fi-1.
Rule 17a-3 .....	§ 240.17a-3.
Rule 17a-4 .....	§ 240.17a-4.
Rule 18a-5 .....	§ 240.18a-5.
Rule 18a-6 .....	§ 240.18a-6.

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<sup>1</sup> 15 U.S.C. 78a et seq.

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## I. 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”),<sup>2</sup> requires each SBS Entity to conform with such standards as may be prescribed by the Commission, by rule or regulation, that relate to timely and accurate confirmation, processing, netting, documentation, and valuation of all security-based swaps.<sup>3</sup> Section 15F(i)(2) of the Exchange Act provides that the Commission shall adopt rules governing documentation standards for SBS Entities.<sup>4</sup>

In June 2016, the Commission adopted rules requiring SBS Entities to provide trade acknowledgments and to verify those trade acknowledgments with their counterparties to security-based swap transactions.<sup>5</sup> At the time, however, the Commission had not proposed rules concerning other documentation requirements, such as portfolio reconciliation, portfolio compression, or trading relationship documentation. By contrast, in 2012 the Commodity Futures Trading Commission (“CFTC”) implemented rules setting forth standards for the timely and accurate confirmation of swaps, as well as addressing the reconciliation and compression of swap portfolios and setting forth requirements for documenting the swap trading relationship between swap dealers or major swap participants (each swap dealer and each major swap participant hereafter referred to as a “Swap Entity”

and together referred to as “Swap Entities”) and their counterparties.<sup>6</sup>

Accordingly, on December 19, 2018, the Commission proposed Rules 15Fi-3, 15Fi-4, and 15Fi-5, which would establish requirements applicable to SBS Entities addressing, among other things, reconciling and compressing portfolios of uncleared security-based swaps and executing written trading relationship documentation with each counterparty prior to or contemporaneously with executing an uncleared security-based swap.<sup>7</sup> As the Commission explained in the Trade Acknowledgement and Verification Adopting Release, the process of confirming the terms of a transaction is essential for SBS Entities “to effectively measure and manage market and credit risk.”<sup>8</sup> In particular, “a backlog of unconfirmed trades could hinder the settlement process, particularly if errors go undetected or a counterparty disputes the terms of a transaction.”<sup>9</sup> Such disruptions or breakdowns in the

settlement process resulting from unconfirmed trades could, in turn, lead to broader market instability in the case of a credit event involving a reference entity on which many different counterparties have, in the aggregate, a large notional outstanding exposure.<sup>10</sup>

In this regard, portfolio reconciliation addresses many of these same issues, but unlike the confirmation process, which occurs at the outset of a transaction, reconciliation operates throughout the life of the transaction. If a discrepancy is *not* identified during the trade acknowledgement and verification process, such discrepancy could still be identified during a subsequent reconciliation exercise. Furthermore, even if a security-based swap transaction is accurately confirmed by both parties during the trade acknowledgement and verification process, reconciliation would help to identify any discrepancies in terms that do not remain constant throughout the life of a trade.

Accordingly, portfolio reconciliation serves as an important mechanism for promoting risk mitigation by requiring security-based swap counterparties to have established processes for identifying and resolving discrepancies involving key terms of their transactions. To illustrate this point, if a term necessary for calculating the market value of a security-based swap is not accurately confirmed during the trade acknowledgement and verification process, due for example to some form of systems or human error, that discrepancy could lead to complications at various points throughout the life of the transaction, which could become particularly problematic if it remains undetected until the parties are required to perform on their obligations.<sup>11</sup> Thus, portfolio reconciliation could help to mitigate the possibility of a discrepancy unexpectedly affecting performance under the security-based swap

<sup>6</sup> See Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 77 FR 55904 (Sept. 11, 2012) (“CFTC Risk Mitigation Adopting Release”). Other jurisdictions, such as the European Commission (“EC”) and Republic of Singapore, have implemented similar measures. See Commission Delegated Regulation (European Union (EU)) No. 149/2013 (Dec. 18, 2012) supplementing Regulation (EU) No. 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on indirect clearing arrangements, the clearing obligation, the public register, access to a trading venue, non-financial counterparties, and risk mitigation techniques for over-the-counter (“OTC”) derivatives contracts not cleared by a central counterparty (Feb. 23, 2013), available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:052:0011:0024:en:PDF>; and Monetary Authority of Singapore, Guidelines on Risk Mitigation Requirements for Non-Centrally Cleared Over-The-Counter Derivatives Contracts, (published on Apr. 25, 2019), available at: <https://www.mas.gov.sg/regulation/guidelines/guidelines-on-risk-mitigation-requirements-for-non-centrally-cleared-otc-derivatives-contracts>. Regulatory authorities in other jurisdictions (e.g., the Hong Kong Monetary Authority) have also proposed requirements similar to those adopted by the CFTC and the EC. In addition, the Canadian Securities Administrators (“CSA”) published a consultation paper in 2016 proposing a requirement that financial institutions enter into a written agreement documenting the material terms and conditions of any non-centrally cleared derivative, including standards related to the maintenance, review, and contents of that documentation. See CSA Consultation Paper 95-401—Margin and Collateral Requirements for Non-Centrally Cleared Derivatives (Jul. 7, 2016), available at: [http://www.osc.gov.on.ca/documents/en/Securities-Categories/csa\\_20160707\\_95-401\\_collateral-requirements-cleared-derivatives.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Categories/csa_20160707_95-401_collateral-requirements-cleared-derivatives.pdf).

<sup>7</sup> See Risk Mitigation Techniques for Uncleared Security-Based Swaps, Exchange Act Release No. 84861 (Dec. 19, 2018), 84 FR 4614 (Feb. 15, 2019) (“Proposing Release”).

<sup>8</sup> See Proposing Release, 84 FR at 4616 (citing Trade Acknowledgement and Verification Adopting Release, 81 FR at 39833).

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> See Summary of OTC Commitments, Attachment to the July 31, 2008 letter from the Operations Management Group to Timothy Geithner, President, Federal Reserve Bank of New York (“FRBNY”), available at: <https://www.newyorkfed.org/medialibrary/media/newsevents/news/markets/2008/CommitmentSummaryTable.pdf> (“Positive affirmation of trade economics is a key risk mitigation technique for OTC derivatives because it assures that each counterparty’s risk management systems accurately reflect the economic details of trades that have not yet been matched.”). Although this specific commitment was made in the context of the trade affirmation process, we believe that the same basic principle supports the need to reconcile terms throughout the life of a trade, even if a term is accurately reflected in a firm’s system as a result of the affirmation process, particularly in the case of terms that do not remain constant during the life of a trade.

<sup>2</sup> Public Law 111-203, 124 Stat. 1376 (2010). Unless otherwise indicated, references to “Title VII” in this release are to Subtitle B of Title VII of the Dodd-Frank Act.

<sup>3</sup> 15 U.S.C. 78o-10(i)(1).

<sup>4</sup> 15 U.S.C. 78o-10(i)(2).

<sup>5</sup> See Trade Acknowledgment and Verification of Security-Based Swap Transactions, Exchange Act Release No. 78011 (June 8, 2016), 81 FR 39807 (June 17, 2016) (“Trade Acknowledgment and Verification Adopting Release”).

transaction by increasing the likelihood that the parties are and remain in agreement with respect to all material terms.<sup>12</sup>

Portfolio reconciliation is especially relevant with respect to terms used to perform a valuation of the financial instrument. Specifically, unresolved discrepancies regarding the value of a security-based swap can lead to, among other things, difficulties in the application of any processes that depend on the valuation being accurate, such as determining the amount of margin that must be posted or collected during the life of a security-based swap transaction. In the aggregate, such errors and other complications could result in significant uncollateralized exposure in the uncleared security-based swap markets (or, alternatively, potentially inefficient overcollateralization).<sup>13</sup>

In addition, valuation discrepancies identified during reconciliation could help to identify problems with one or both of the counterparties' internal valuation systems and models, or possibly even with a firm's internal controls. For example, in a report analyzing federal assistance to American International Group, Inc. ("AIG") following the events of September 2008, the General Accountability Office ("GAO") noted that in structuring this relief one of the many open issues the FRBNY had to address was the number of collateral disputes AIG had with its counterparties.<sup>14</sup> GAO further explained that "[t]o the extent that lower valuations (more CDO value lost) produced greater collateral postings, counterparties had an interest in seeking lower valuations. Similarly, to the extent that higher valuations (less CDO value lost) meant smaller collateral postings, AIG had an interest in seeking higher valuations."<sup>15</sup>

Portfolio compression is another process that should help SBS Entities better manage their outstanding security-based swap transactions, albeit in a different way. Portfolio compression generally refers to a post-trade processing exercise that allows two or more market participants to eliminate redundant derivatives

transactions within their portfolios in a manner that does not change their net exposure. Compression exercises typically take place in "cycles," whereby each participating counterparty designates particular contracts within its portfolio as being eligible for compression and specifies its risk tolerances with respect to the composition of its derivatives portfolio following completion of the cycle.<sup>16</sup> Following an analysis of the submitted contracts, counterparties may be provided with the option of terminating or modifying those contracts and replacing them with a smaller number of substantially similar contracts. In most cases, the gross notional value of the position is reduced, although the counterparty's net exposure, represented by the replacement and remaining contracts, typically remains the same.<sup>17</sup>

By reducing the total number of open contracts, portfolio compression is intended to help market participants manage their post-trade risks in a number of important ways. For example, two or more counterparties that are active in the OTC derivatives markets might have built up positions in the same (or comparable) products that, when analyzed at the portfolio level across all applicable counterparties, offset each other. Eliminating these offsetting and redundant uncleared derivatives transactions through compression—as measured both by the number of contracts and the total notional value—reduces a market participant's gross exposure to its direct counterparties, including by eliminating all exposure to certain counterparties.<sup>18</sup>

<sup>16</sup> See, e.g., ISDA Study, Interest Rate Swaps Compression: A Progress Report, (Feb. 2012), available at: <http://www2.isda.org/attachment/NDAzMw==/IRS%20compression%20progress%20report%20-%20Feb%202012.pdf>.

<sup>17</sup> In 2011, the Commission issued an order granting temporary exemptions from the requirement to register as a clearing agency under Section 17A of the Exchange Act for entities providing certain clearing services for security-based swaps including, among other things, tear-up and compression services. That order contains general descriptions of the portfolio compression process, based on discussions between Commission staff and market participants prior to the issuance of the exemptive order. See Order Pursuant to Section 36 of the Securities Exchange Act of 1934 Granting Temporary Exemptions from Clearing Agency Registration Requirements under Section 17A(b) of the Exchange Act for Entities Providing Certain Clearing Services for Security-Based Swaps, Exchange Act Release No. 64796 (Jul. 1, 2011), 76 FR 39963 (Jul. 7, 2011) ("Clearing Services Exemptive Order").

<sup>18</sup> See Darrell Duffie, Ada Li, and Theo Lubke, Policy Perspectives of OTC Derivatives Market Infrastructure, FRBNY Staff Report No. 424, dated Jan. 2010, as revised Mar. 2010, available at: [http://www.newyorkfed.org/research/staff\\_reports/sr424.pdf](http://www.newyorkfed.org/research/staff_reports/sr424.pdf) ("FRBNY OTC Derivatives Report") ("In

Reducing the total number of outstanding contracts within a derivatives portfolio also provides important operational benefits and efficiencies for market participants in that there are fewer open contracts to manage, maintain, and settle, resulting in fewer opportunities for processing errors, failures, or other problems that could develop throughout the lifecycle of a transaction.<sup>19</sup> Accordingly, the Commission believes that the use of portfolio compression by SBS Entities, where appropriate (and to the extent that such activity is not already occurring), should provide important processing improvements consistent with the overall framework of Section 15F(i) of the Exchange Act.<sup>20</sup>

Finally, just as portfolio reconciliation is designed to allow counterparties to manage their internal risks by better ensuring agreement with respect to the material terms and valuation of the transaction (and thereby avoiding complications at various points throughout the life of the transaction), requiring each SBS Entity to document the terms of the trading relationship with each of its counterparties before executing a new security-based swap 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. This, in turn, should help to reduce counterparty credit risk and promote certainty regarding the agreed-upon valuation and other material terms of a security-based swap.<sup>21</sup> Having

some types of derivatives that are not cleared, major market participants tend to build offsetting positions with different counterparties, long with one set of counterparties, and short with the others. In many cases, these offsetting positions are redundant. They serve no useful business purpose and create counterparty risk. Market participants should continue to engage in regular market-wide portfolio compression exercises in order to eliminate these redundant positions." See also, John Kiff, et al., Credit Derivatives: Systemic Risks and Policy Options, IMF Working Paper No. 254 (Nov. 2009), available at: <http://www.imf.org/external/pubs/ft/wp/2009/wp09254.pdf> ("Multilateral netting, typically operationalized via 'tear-up' or 'compression' operations that eliminate redundant contracts, reduces both individual and system counterparty credit risk.").

<sup>19</sup> See Portfolio compression platform launched to reduce CDS operational risk, Hedgeweek (Sept. 8, 2008) (explaining that a portfolio compression platform "reduces operational risk while leaving market risk profiles unchanged," which is achieved "by terminating existing trades and replacing them with a smaller number of new replacement trades that carry the same risk profile and cash flows as the initial portfolio but have less capital exposure").

<sup>20</sup> See 15 U.S.C. 78o–10(i).

<sup>21</sup> See, e.g., Sylvie A. Durham, Terminating Derivatives Transactions: Risk Mitigation and Close-Out Netting § 8:1 (Nov. 2010) ("[L]egal contractual provisions are the foundation on which

<sup>12</sup> See Proposing Release, 84 FR at 4616.

<sup>13</sup> See *id.*

<sup>14</sup> See GAO, Financial Crisis: Review of Federal Reserve System Financial Assistance to American International Group, Inc., GAO–11–616 (Sept. 2011), available at: <http://www.gao.gov/assets/590/585560.pdf> ("According to information we reviewed, on a [collateralized debt obligation ("CDO")] portfolio of \$71 billion . . . , AIG and its counterparties had valuation differences totaling \$4.3 billion. Among a group of 15 counterparties, 9 had valued their assets differently than AIG.").

<sup>15</sup> *Id.* at 82.

adequate written documentation prior to, or contemporaneously with, executing a security-based swap should also facilitate the ability of the counterparties to engage in portfolio reconciliation in an efficient and cost-effective manner.

In consideration of the above, the Commission proposed new Rules 15Fi-3, 15Fi-4, and 15Fi-5 under the Exchange Act.<sup>22</sup> As proposed, Rule 15Fi-3 generally would have required SBS Entities, in connection with uncleared security-based swaps, to (1) engage in portfolio reconciliation with counterparties who are SBS Entities and (2) 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. In both cases, the frequency of the portfolio reconciliation is based on the number of outstanding transactions with the applicable counterparty. In addition, proposed Rule 15Fi-4 would have required SBS Entities to establish, maintain, and follow written policies and procedures related to periodic bilateral and multilateral compression of uncleared security-based swaps, as well as periodic offset of uncleared security-based swaps. Finally, proposed Rule 15Fi-5 would have established certain requirements for SBS Entities related to the use of written trading relationship documentation in connection with their uncleared security-based swap transactions.

The Commission is adopting Rules 15Fi-3 through 15Fi-5, largely as proposed.<sup>23</sup> In developing this

the rights and obligations of the parties are based, and sound collateral and risk management practices may be ineffective if the legal rights of the parties are not clearly set forth.”)

<sup>22</sup> Unless otherwise noted, all references to rules without an accompanying statutory reference are to rules adopted under the Exchange Act.

<sup>23</sup> As described in greater detail below, the Commission is making three changes to the proposal. First, we are adopting a single definition of “material terms” for purposes of the portfolio reconciliation requirements in Rule 15Fi-3 that is generally consistent with the definition used in the corresponding CFTC rule. This is in contrast to the proposed bifurcated definition. See *infra* Section II.A.1. Second, Rule 15Fi-5, unlike in the proposal, does not require an SBS Entity’s written trading relationship documentation to address the allocation of any applicable regulatory reporting obligations. See *infra* Section II.C.1. Both of those changes involve provisions that were included in the proposal as part of a request for comment on how such provisions could potentially help address how a security-based swap data repository (“SDR”) may satisfy its obligation to verify the terms of each security-based swap with both counterparties to the transaction. See Proposing Release at 4633–4635. Finally, the Commission is modifying the scope of the exception for uncleared security-based swaps in each of Rules 15Fi-3, 15Fi-4, and 15Fi-5 to include (1) security-based swaps that are, directly or indirectly, submitted to and cleared by a clearing

rulemaking, both at proposal and adoption, we have consulted and coordinated with the CFTC, the prudential regulators,<sup>24</sup> and foreign regulatory authorities in accordance with the consultation mandate of the Dodd-Frank Act.<sup>25</sup> We also have consulted and coordinated with foreign regulatory authorities through Commission staff participation in numerous bilateral and multilateral discussions with foreign regulatory authorities addressing the regulation of OTC derivatives.<sup>26</sup> Through these multilateral and bilateral discussions, and Commission staff’s participation in various international task forces and working groups, we have gathered

agency (as opposed to limiting it to security-based swaps that have a clearing agency as a direct counterparty) and (2) security-based swaps that are cleared by a clearing agency that the Commission has exempted from registration by rule or order pursuant to Section 17A of the Exchange Act (as opposed to limiting it to security-based swaps cleared at a registered clearing agency). See *infra* Sections II.A.6, II.B.3, and II.C.5.

<sup>24</sup> For purposes of this statement, the term “prudential regulator” is defined in Section 1a(39) of the Commodity Exchange Act (“CEA”), 7 U.S.C. 1a(39), and that definition is incorporated by reference into Section 3(a)(74) of the Exchange Act, 15 U.S.C. 78c(a)(74). Pursuant to that 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 (“FDIC”), the Farm Credit Administration, or the Federal Housing Finance Agency (collectively, the “prudential regulators”) is the “prudential regulator” of an SBS Entity if the entity is directly supervised by that regulator. Separately, we are adopting a definition of “prudential regulator,” to be used for purposes of the new portfolio reconciliation and trading relationship documentation requirements. See *infra* note 73. That new definition also references Section 3(a)(74) of the Exchange Act and includes the same list of agencies as noted above.

<sup>25</sup> Section 712(a)(2) of the Dodd-Frank Act provides in part that the Commission shall “consult and coordinate to the extent possible with the Commodity Futures Trading Commission and the prudential regulators for the purposes of assuring regulatory consistency and comparability, to the extent possible.”

In addition, Section 752(a) of the Dodd-Frank Act provides, in part, that “[i]n order to promote effective and consistent global regulation of swaps and security-based swaps, the Commodity Futures Trading Commission, the Securities and Exchange Commission, and the prudential regulators . . . as appropriate, shall consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards with respect to the regulation (including fees) of swaps.”

<sup>26</sup> Staff participates in a number of international standard-setting bodies and workstreams working on OTC derivatives reforms. For example, Commission staff participated in the International Organization of Securities Commissions’ (“IOSCO”) preparation of a report regarding risk mitigation standards for non-centrally cleared OTC derivatives. See Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives (Jan. 28, 2015), available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD469.pdf>. IOSCO developed those standards in consultation with the Basel Committee on Banking Supervision (“BCBS”) and the Committee on Payments and Market Infrastructures.

information about foreign regulatory reform efforts and their effect on, and relationship with, the U.S. regulatory regime. The Commission has taken, and will continue to take, these discussions into consideration in developing rules, forms, and interpretations for implementing Title VII of the Dodd-Frank Act.

Finally, the Commission continues to recognize that the CFTC rules pertaining to portfolio reconciliation, portfolio compression, and written trading relationship documentation have been in effect since 2012, and that any SBS Entity that also is registered with the CFTC as a Swap Entity will already have incurred systems and compliance costs in connection with the corresponding CFTC requirements. Accordingly, we have endeavored throughout this rulemaking to harmonize the final rules with the existing CFTC rules wherever possible. There are, however, a very limited number of provisions where we continue to believe it is appropriate to diverge from a particular aspect of the CFTC rules. Each of those differences is described below, along with an explanation of the Commission’s reasons for adopting the different approach. To the extent that no such substantive difference is described, it is because we have not identified any such differences or identified only technical differences.

## II. Discussion of Final Rules

### A. Rule 15Fi-3: Portfolio Reconciliation

#### 1. Scope of the Portfolio Reconciliation Requirements

As part of adopting Rule 15Fi-3, we also are amending existing Rule 15Fi-1 to add four new definitions. First, Rule 15Fi-1(l) defines “portfolio reconciliation” to mean any process by which the counterparties to one or more uncleared security-based swaps:

- Exchange the material terms of all security-based swaps in the security-based swap portfolio between the counterparties;
- Exchange each counterparty’s valuation of each security-based swap in the security-based swap 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.<sup>27</sup>

Second, Rule 15Fi-1(o) defines the term “security-based swap portfolio” to mean all security-based swaps currently in effect between a particular SBS Entity

<sup>27</sup> The corresponding CFTC definition is in 17 CFR 23.500(i).

and a particular counterparty.<sup>28</sup> Third, Rule 15Fi-1(q) defines “valuation” to mean the current market value or net present value of a security-based swap.<sup>29</sup> Finally, Rule 15Fi-1(i) defines “material terms” to mean each term that is required to be reported to a registered SDR or the Commission pursuant to 17 CFR 242.901 (Rule 901 under the Exchange Act);<sup>30</sup> provided, however, that such definition does not include any term that is not relevant to the ongoing rights and obligations of the parties and the valuation of the security-based swap.<sup>31</sup>

These definitions are intended to establish the scope of the portfolio reconciliation requirements in Rule 15Fi-3, including by (1) defining “portfolio reconciliation,” (2) defining the two categories of information that must be exchanged during a reconciliation (*i.e.*, the “valuation” and “material terms” of each relevant security-based swap), and (3) identifying the specific transactions that are included in a “security-based swap portfolio” between an SBS Entity and each of its counterparties. Moreover, for consistency with the corresponding CFTC rules applicable to Swap Entities, these four definitions are substantively identical to the CFTC’s corresponding definitions, which we continue to believe are appropriately scoped for purposes of Rule 15Fi-3.<sup>32</sup>

The Commission received no comments on the proposed definitions of “portfolio reconciliation,” “security-based swap portfolio,” and “valuation,” each of which we are adopting as proposed. However, the two comment

letters we received both raised concerns with the proposed definition of “material terms.”<sup>33</sup> That proposed definition was bifurcated, and depended on whether the relevant security-based swap transaction had already been included in a security-based swap portfolio and reconciled pursuant to proposed Rule 15Fi-3.<sup>34</sup> With respect to any security-based swap that had *not* yet been reconciled as part of a security-based swap portfolio, the proposed definition of “material terms” included each term that is required to be reported to a registered SDR pursuant to Rule 901 under the Exchange Act.<sup>35</sup> With respect to all other security-based swaps within a security-based swap portfolio, the proposed definition of “material terms” continued to be based on the reporting requirements in Rule 901, but excluded any term not relevant to the ongoing rights and obligations of the parties and the valuation of the security-based swap.

In contrast to the proposed definition of “material terms,” the CFTC’s corresponding definition is not bifurcated and contains a list of 24 data fields that are excluded from the definition (and therefore excluded from the portfolio reconciliation requirements in CFTC Rule § 23.502) for all purposes. Those excluded fields include, among others: (1) The status of either counterparty as a swap dealer, major swap participant, financial entity, or U.S. person; (2) an indication that the swap will be allocated and certain information regarding the agent and the original swap; (3) an indication that the swap is a multi-asset swap and a further indication of its primary and secondary asset class; (4) an indication that the swap is a mixed swap and the identification of any non-CFTC registered swap data repository to which it is also reported (if applicable); (5) the block trade indicator, execution timestamp, and timestamp for submission to a swap data repository; (6) the clearing indicator and clearing venue; and (7) certain information

regarding the application of the end user exception from mandatory clearing.<sup>36</sup> When the CFTC amended its definition of “material terms” in 2016, it explained that “the removal of these terms from reconciliations would alleviate the burden of resolving discrepancies in terms of a swap that are not relevant to the ongoing rights and obligations of the parties and the valuation of the swap without impairing the [CFTC]’s regulatory mission.”<sup>37</sup>

The Commission continues to believe that the data set submitted to an SDR under Rule 901 is an appropriate starting point for determining which terms should be reconciled pursuant to Rule 15Fi-3. This approach is consistent with the one taken by the CFTC, which also defines “material terms” by reference to the information required to be reported to a swap data repository, and reflects our continued belief that one of the fundamental goals of the portfolio reconciliation process is to help ensure that both counterparties to a security-based swap are in agreement on all of the terms necessary for developing a comprehensive understanding of each of their rights and obligations under the security-based swap, and that they remain in such agreement throughout the life of the transaction.<sup>38</sup> To further that objective, “portfolio reconciliation” has been defined in part to include the exchange of the “material terms” of all security-based swaps in the security-based swap portfolio between the counterparties. Similarly, in adopting Regulation SBSR, the Commission explained that the Title VII regulatory reporting requirement “is designed to allow the Commission and other relevant authorities to have access to comprehensive information about security-based swap activity in registered SDRs.”<sup>39</sup> The Commission therefore remains of the view that the terms that must be reported to an SDR under Regulation SBSR are a good proxy for identifying the “material terms” that should be subject to the portfolio reconciliation requirements.

The Commission also continues to believe that basing the definition of “material terms” on what is required to be reported to an SDR provides certainty for SBS Entities regarding what

<sup>28</sup> The corresponding CFTC definition is in 17 CFR 23.500(k).

<sup>29</sup> The corresponding CFTC definition is in 17 CFR 23.500(m).

<sup>30</sup> Rule 901 is part of Regulation SBSR, which governs the reporting and publication of security-based swap transaction data. See 17 CFR 242.900 to 242.909. Further, Section 3(a)(75) of the Exchange Act defines the term “security-based swap data repository” to mean “any person that collects and maintains information or records with respect to transactions or positions in, or the terms and conditions of, security-based swaps entered into by third parties for the purpose of providing a centralized recordkeeping facility for security-based swaps.” See 15 U.S.C. 78c(a)(75).

<sup>31</sup> The corresponding CFTC definition is in 17 CFR 23.500(g).

<sup>32</sup> Because of differences between the Commission’s and CFTC’s security-based swap and swap data reporting rules, the application of the definition of “material terms” in Rule 15Fi-1(i) may differ from the application of the corresponding CFTC definition. However, in order to make the two definitions as substantively identical in their application as possible, Rule 15Fi-1(i), as adopted, excludes from that definition “any term that is not relevant to the ongoing rights and obligations of the parties and the valuation of the security-based swap.” See *also infra* notes 51–52 (describing the Commission’s recently issued policy statement on compliance with Regulation SBSR).

<sup>33</sup> See Letter dated April 16, 2019, from Steven Kennedy, Global Head of Public Policy, the International Swaps and Derivatives Association (“ISDA”) and Kyle Brandon, Managing Director, Head of Derivatives Policy, the Securities Industry and Financial Markets Association (“SIFMA”) (“ISDA/SIFMA Letter”); see *also* Letter dated April 16, 2019, from Katherine Delp, Executive Director, the Depository Trust & Clearing Corporation (“DTCC”), in conjunction with its swap data repository, and Kara Dutta, General Counsel, ICE Trade Vault (“DTCC/ICE Trade Vault Letter”).

<sup>34</sup> See Proposing Release at 4617–4618.

<sup>35</sup> Rule 901 (17 CFR 242.901) is part of Regulation SBSR, which governs the reporting to registered SDRs of security-based swap data and public dissemination by registered SDRs of a subset of that data. See 17 CFR 242.900 to 242.909.

<sup>36</sup> See 17 CFR 23.500(g).

<sup>37</sup> See Definitions of “Portfolio Reconciliation” and “Material Terms” for Purposes of Swap Portfolio Reconciliation, 81 FR 27309 (May 6, 2016).

<sup>38</sup> See Proposing Release, 84 FR at 4618.

<sup>39</sup> See Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information; Final Rule, Exchange Act Release No. 74244 (Feb. 11, 2015), 80 FR 14563, 14646 (Mar. 19, 2015) (“Regulation SBSR Adopting Release”).

information must be reconciled, which should in turn reduce the burdens on those entities without lessening the benefits of the rule (which are described earlier in this section and in the Economic Analysis section below).<sup>40</sup> Such an approach also is designed to allow affected counterparties to leverage the same systems used for SDR reporting for purposes of the portfolio reconciliation requirements, should such synergies exist.

With respect to the proposed bifurcated definition of “material terms,” such approach was part of a broader request for comment that the Commission included in the Proposing Release to identify ways to potentially resolve an issue previously identified in connection with the rules applicable to the registration and ongoing regulation of SDRs.<sup>41</sup> Specifically, the proposed definition was intended to help establish a basis by which registered SDRs could potentially comply with the requirement in Section 13(n)(5)(B) of the Exchange Act and 17 CFR 240.13n-4(b)(3) (Rule 13n-4(b)(3)) thereunder that they “confirm with both counterparties to the security-based swap the accuracy of the data that was submitted.”<sup>42</sup>

In their joint comment letter, ISDA and SIFMA expressed strong reservations to that proposed definition, noting that portfolio reconciliation and trade reporting are two different processes involving different systems and third party vendors, and that expanding the reconciliation process to include non-economic data fields would require the two associations’ members to incur significant operational and technological development costs and time, with no tangible benefit for an SBS Entity’s risk mitigation activity.<sup>43</sup> Those commenters also posited that requiring reconciliation of non-economic terms for initial, but not subsequent, reconciliations would require further operational and technological

development to manage the portfolio reconciliation process over the course of certain security-based swap life-cycle events, and would impose on SBS Entities the ongoing burden of maintaining three processes for portfolio reconciliation, one to comply with the CFTC’s rules, one for any security-based swap that has not yet been included in a portfolio reconciliation, and one for all other security-based swaps.<sup>44</sup>

The DTCC and ICE Trade Vault expressed general support for leveraging certain aspects of the proposed rules (including the proposed bifurcated definition of “material terms”) as a possible way of resolving, at least in part, the SDR verification issue, but suggested that those provisions would not provide SDRs with the regulatory certainty necessary to rely on an SBS Entity’s submission to satisfy the SDR’s verification obligation under Section 13(n)(5)(B) and Rule 13n-4(b)(3).<sup>45</sup> DTCC and ICE Trade Vault also noted their belief that evaluating an SBS Entity for these purposes goes beyond the SDR’s proper role to store and report data, which would impose a burden on the resources of an SDR outside the statutory requirements.<sup>46</sup> Accordingly, those commenters concluded, reliance on the submissions by or on behalf of an SBS Entity to provide the definitive report of a given security-based swap is not a complete solution to the SDR verification issue, regardless of whether the SBS Entity was subject to a requirement that it initially reconcile with its counterparty all of the terms required to be reported to the SDR.<sup>47</sup>

As an alternative to the approach set out in the Proposing Release, DTCC and ICE Trade Vault requested that the Commission address the issue through interpretive guidance or exemptive relief and make clear that (1) the relief is permanent and (2) the scope of the relief is broad enough to cover all submissions to the SDR not covered under an approach applicable only to SBS Entity submissions.<sup>48</sup> DTCC and ICE Trade Vault did not, however, provide any additional information or potential conditions to support their suggested approach.

After careful review and consideration of the comments received and upon further consideration, the

Commission is adopting a single, non-bifurcated definition of “material terms” that better aligns with the CFTC’s corresponding definition. Specifically, and as described above, Rule 15Fi-1(i) defines “material terms” to include each term that is required to be reported to a registered SDR or the Commission pursuant to Rule 901 under the Exchange Act; provided, however, that such definition does not include any term that is not relevant to the ongoing rights and obligations of the parties and the valuation of the security-based swap. In light of the comments we received, which indicated that the costs and burdens imposed on SBS Entities of implementing the proposed bifurcated approach were not justified in light of what commenters viewed as an incomplete and partial solution to the SDR verification issue (absent the Commission providing interpretive guidance or exemptive relief), the Commission believes that it is appropriate and less burdensome for SBS Entities to harmonize the definition of “material terms” in Rule 15Fi-1(i) with the corresponding CFTC definition by not adopting the proposed bifurcated approach.<sup>49</sup>

In addition to expressing their opposition to the proposed bifurcated approach to the definition of “material terms,” ISDA and SIFMA also requested that the Commission (1) align its trade reporting rules with those of the CFTC and (2) prescribe an enumerated list of the “terms that are not relevant to the ongoing rights and obligations of the parties,” and thus do not need to be reconciled in any portfolio reconciliation process required by Rule 15Fi-3.<sup>50</sup> The Commission has carefully considered these comments and has determined not to make either of the two requested changes to the definition. The Commission believes that the comment about aligning the two agencies’ trade reporting rules is outside the scope of this rulemaking because, although Rule 15Fi-3 references the reporting rules in order to identify the terms that must be reconciled, the purpose of this rulemaking is not to amend the underlying reporting requirements themselves.<sup>51</sup>

<sup>49</sup> As described above, DTCC and ICE requested that the Commission address the issue of SDR verification through interpretive guidance or exemptive relief. This release focuses on specific documentation requirements related to risk mitigation techniques. And while the Commission is not addressing the SDR verification issue in this release, it may do so at a future date.

<sup>50</sup> See ISDA/SIFMA Letter.

<sup>51</sup> In addition, in a separate release adopting rules that address the cross-border application of certain security-based swap requirements the Commission also has issued a policy statement regarding

<sup>40</sup> See also Proposing Release, 84 FR at 4618.

<sup>41</sup> For a more detailed discussion of this issue, including the concerns raised by SDRs as to the difficulty of requiring them to reach out to counterparties who are not their members to verify accuracy of the data, see Proposing Release, 84 FR at 4633-35.

<sup>42</sup> See 15 U.S.C. 78m(n)(5) and Rule 13n-4(b)(3). The Commission also included a provision in proposed Rule 15Fi-5(b)(1) that was intended to serve the same purpose. See *infra* note 110-113 and accompanying text. Further, the Commission requested comment on whether those two aspects of the proposal could provide a sufficient basis, in whole or in part, for an SDR to assess whether it can reasonably rely on a SBS Entity’s verification of transaction data as the basis to meet the verification requirements. See Proposing Release, 84 FR at 4635.

<sup>43</sup> See ISDA/SIFMA Letter.

<sup>44</sup> *Id.* ISDA and SIFMA also questioned “the suitability of this proposed shift in regulatory responsibility” and noted that counterparties that are not members of the SDR may also not be involved in meaningful portfolio reconciliation processes.

<sup>45</sup> See DTCC/ICE Trade Vault Letter.

<sup>46</sup> See *id.*

<sup>47</sup> See *id.*

<sup>48</sup> See *id.*

Moreover, although the Commission understands that there may be benefits of providing an enumerated list of terms that are “not relevant to the ongoing rights and obligations of the parties and the valuation of the security-based swap,” we also note that Rule 901 of Regulation SBSR, unlike the CFTC’s swap data reporting rules, does not contain a list of required data fields, but rather a requirement setting forth broad categories of information that must be reported to an SDR (or the Commission). Because Rule 901 is used to identify the data elements that are considered to be “material terms” for purposes of the portfolio reconciliation requirements in Rule 15Fi–3, the application of the CFTC’s portfolio reconciliation rules may differ from the application of Rule 15Fi–3 due to differences in the operation of the underlying reporting rules, as described above.<sup>52</sup> However, although the Commission is not providing a definitive list of excluded data fields because of the underlying differences between Regulation SBSR and the CFTC’s swap data reporting rules, we would consider the information required to be reported to

compliance with the rules for SDRs and Regulation SBSR (“Regulation SBSR/SDR Policy Statement”). See Rule Amendments and Guidance Addressing Cross-Border Application of Certain Security-Based Swap Requirements. Exchange Act Release No. 87780 (Dec. 18, 2019) (“Cross-Border Amendments Adopting Release”). That policy statement, which will be in effect for four years following the first compliance date for Regulation SBSR, states that certain specified actions with respect to the security-based swap reporting rules will not provide a basis for a Commission enforcement action. For example, one of the identified fact patterns includes a situation where a person with a duty to report a data element of a security-based swap transaction, as required by any provision of Rules 901(c)(2)–(7) and 901(d) of Regulation SBSR, does not report that data element because the CFTC’s swap reporting rules in force at the time of the transaction do not require that data element to be reported. See *id.* During the pendency of the Regulation SBSR/SDR Policy Statement, SBS Entities that elect to follow the CFTC’s swap reporting rules pursuant to the Regulation SBSR/SDR Policy Statement also may look to the CFTC’s reporting requirements with respect to which terms are the “material terms” for purposes of complying with the portfolio reconciliation requirements in Rule 15Fi–3.

<sup>52</sup> However, the Commission’s position in the Regulation SBSR/SDR Policy Statement could, by addressing compliance with certain aspects of the CFTC’s swap reporting rules (in lieu of Regulation SBSR) for a period of four years following the compliance date for SBSR, further alleviate any potential differences between Rule 15Fi–3 and CFTC § 23.502 that may flow from differences between the two agencies’ Title VII data reporting rules. For example, to the extent that an SBS Entity reports security-based swap data to an SDR based on the data fields set forth in CFTC’s swap data reporting rules in 17 CFR part 45, such SBS Entity would be able to identify the exact data fields that may be excluded from the definition of “material terms” in Rule 15Fi–1(i), and therefore not subject to the portfolio reconciliation requirements in Rule 15Fi–3. See *id.*

an SDR pursuant to Rule 901 of Regulation SBSR that corresponds to the 24 excluded fields in CFTC Rule § 23.500(g) to be not relevant to the ongoing rights and obligations of the parties and the valuation of the security-based swap, and therefore such information may appropriately be excluded from the definition of “material terms” in Rule 15Fi–1(i) for purposes of the portfolio reconciliation requirements in Rule 15Fi–3.<sup>53</sup>

## 2. Rule 15Fi–3(a): Portfolio Reconciliation With Other SBS Entities

The particular portfolio reconciliation requirements in Rule 15Fi–3 that apply to a specific security-based swap portfolio will depend on the type of counterparty with which the SBS Entity transacts. For transactions between two SBS Entities, Rule 15Fi–3(a) requires the two sides to engage in portfolio reconciliation at frequencies that are based on the size of the security-based swap portfolio between the two parties, expressed in ranges (or tiers). Under this tiered approach, if the two SBS Entity counterparties maintain a security-based swap portfolio that includes 500 or more security-based swaps, portfolio reconciliation will need to occur once each business day for as long as the portfolio exceeds this threshold. If a security-based swap portfolio between two SBS Entities includes more than 50 but fewer than 500 security-based swaps on any business day during a week, portfolio reconciliation will be required to occur on a weekly basis. For a security-based swap portfolio between two SBS Entities that includes no more than 50 security-based swaps at any time during the calendar quarter, portfolio reconciliation will be required on a quarterly basis.<sup>54</sup>

<sup>53</sup> See *supra* note 37 and accompanying text (explaining that in 2016 when the CFTC adopted amendments to Rule § 23.500(g) to exclude the 24 specific fields from the definition of “material terms,” it described such terms as being “not relevant to the ongoing rights and obligations of the parties and the valuation of the swap.”).

<sup>54</sup> For the avoidance of doubt, if a security-based swap portfolio between two SBS Entity counterparties crosses from one threshold to another, both sides would be required to comply with the relevant frequency requirements of Rule 15Fi–3(a) as of the date the threshold is crossed. For example, if two SBS Entities that have long maintained a portfolio of 50 or fewer security-based swaps (and accordingly reconcile on a quarterly basis) exceed the 50 transaction threshold, the two sides would become subject to the weekly reconciliation requirement as of the first day that the portfolio exceeds 50 security-based swaps (or the daily reconciliation requirement if the portfolio increases to 500 or more security-based swaps). By contrast, if two SBS Entities that maintain a security-based swap portfolio of more than 500 transactions subsequently fall below that threshold, they could begin reconciling on a weekly basis as of the first business day after the date on which

For the reasons noted in the Proposing Release, the Commission continues to believe that the tiering of obligations, whereby the frequency of the portfolio reconciliation is based on the number of outstanding transactions with the applicable counterparty, represents a reasonable attempt to calibrate the costs to the benefits expected from reconciling a person’s security-based swap portfolio at regular intervals.<sup>55</sup> Moreover, the CFTC has adopted rules that utilize identical levels as Rule 15Fi–3(a), and the adoption by the Commission of different thresholds could lead to additional costs and other inefficiencies for SBS Entities that are also registered with the CFTC as Swap Entities.<sup>56</sup>

In addition to the requirements regarding the frequency of the reconciliation, Rule 15Fi–3(a)(1) also requires SBS Entities to agree in writing with each of their counterparties on the terms of the portfolio reconciliation including, if applicable, agreement on the selection of any third party service provider who may be performing the reconciliation.<sup>57</sup> In practice, an SBS

they were able to verify that their security-based swap portfolio has fallen below 500 transactions.

<sup>55</sup> See Proposing Release, 84 FR at 4619.

<sup>56</sup> When it adopted the same numerical thresholds in 2012, the CFTC noted that the requirement to reconcile portfolios with 500 or more swaps on a daily basis was consistent with the commitments made by the OTC Derivatives Steering Group’s 14 major dealers (“G–14 dealers”) in December 2008 as well as international regulatory efforts underway at the time of the CFTC’s release. See *CFTC Risk Mitigation Adopting Release*, 77 FR at 55928, nn. 35 and 36. See also Summary of OTC Commitments, Attachment to the June 2, 2009 letter from G–14 dealers and certain buy-side participants to William C. Dudley, President, FRBNY, available at: <https://www.newyorkfed.org/medialibrary/media/newsevents/news/markets/2009/060209table.pdf> (committing, “[b]y June 30, 2009, [to] execute daily collateralized portfolio reconciliations for collateralized portfolios in excess of 500 trades between [Operations Management Group] dealers as detailed in the December 31, 2008 Collateral Update letter”). See also Attachment to the Mar. 31, 2011 letter from the G–14 dealers and certain buy-side participants to William C. Dudley, President, FRBNY, available at: <https://www.newyorkfed.org/medialibrary/media/newsevents/news/markets/2011/SCL0331.pdf> (“We commit to reduce the threshold for routine portfolio reconciliation of collateralized portfolios from those exceeding 1,000 transactions to those exceeding 500 transactions starting June 30, 2011. These portfolios will be reconciled at least monthly.”) (internal citation omitted).

<sup>57</sup> Rule 15Fi–3(a)(2) provides that portfolio reconciliation may be performed either on a bilateral basis by the counterparties or by a third party selected by the counterparties in accordance with paragraph (a)(1) of the rule. The Commission notes that CFTC Rule § 23.502(a)(2), which is analogous to Rule 15Fi–3(a)(2), uses the term “qualified third party.” When it adopted that provision in 2012, the CFTC explained that it “expects that parties will determine if the third party is qualified based on their own policies.” See

Continued

Entity could satisfy such requirement by including the terms governing the portfolio reconciliation process in the written security-based swap trading relationship documentation that the SBS Entity executes with its counterparty pursuant to Rule 15Fi-5, as opposed to agreeing with the counterparty on the terms of the reconciliation on a transaction-by-transaction basis, which is likely to be significantly more burdensome.<sup>58</sup> This practice should help to ensure that portfolio reconciliation begins without delay after execution of the transaction and is designed to minimize the number of disagreements regarding the portfolio reconciliation process itself.

Finally, the definition of “business day” for purposes of Rule 15Fi-3 (regardless of the status of the counterparty) includes “any day other than a Saturday, Sunday, or legal holiday.” This definition, which the Commission adopted in 2016 in connection with the trade acknowledgement and verification requirements in Rule 15Fi-2, is not being amended in this rulemaking.<sup>59</sup> As explained in the Proposing Release, we believe that the existing definition of “business day” has the benefit of providing market participants with the flexibility to determine the holidays that are “legal holidays” for purposes of the portfolio reconciliation requirements in Rule 15Fi-3, which should be particularly useful given the cross-border nature of the OTC derivatives market.<sup>60</sup>

CFTC Risk Mitigation Release, 77 FR at 55929. In addition, the CFTC’s portfolio reconciliation requirements for transactions between Swap Entities and counterparties that are *not* Swap Entities do not require the relevant third party to be “qualified” and, instead, provide that “[t]he portfolio reconciliation may be performed on a bilateral basis by the counterparties or by one or more third parties *selected by the counterparties.*” See 17 CFR 23.502(b)(2) (emphasis added). Accordingly, the Commission has decided not to refer to a “qualified third party” and, instead, uses the term “third party selected by the counterparties” for purposes of Rule 15Fi-3(a)(2). We believe that it is sufficient for our purposes to refer solely to the fact that a third party has been selected.

<sup>58</sup> Specifically, once the two parties have agreed in writing on the terms of the portfolio reconciliation for the first time, the requirement could then be satisfied in connection with any new security-based swap transaction executed by the two sides merely by agreeing in writing to abide by the existing agreement regarding the reconciliation process.

<sup>59</sup> Upon the effective date of these final rules, the definition of “business day” currently in Rule 15Fi-1(a) will be renumbered as Rule 15Fi-1(b).

<sup>60</sup> See Proposing Release, 84 FR at 4619 (describing the rationale for relying on the existing definition of “business day” in Rule 15Fi-1 (as opposed to proposing a separate definition for purposes of the portfolio reconciliation requirements) and comparing that existing

### 3. Rule 15Fi-3(a): Resolution of Discrepancies With Other SBS Entities

Rule 15Fi-3(a) also requires each SBS Entity to take additional actions in the event of a discrepancy with a counterparty that is an SBS Entity. Specifically, Rule 15Fi-3(a)(4) requires the two SBS Entity counterparties to resolve *immediately* any discrepancy in a material term, whether identified directly as part of the portfolio reconciliation or otherwise. For the reasons discussed in the Proposing Release, we continue to believe that this timeframe is appropriate given the ongoing nature of security-based swap transactions, as well as the potential for disagreements between the counterparties regarding the terms of a transaction to compound over the course of the security-based swap transaction.<sup>61</sup>

Also, and recognizing that *valuation* discrepancies could be particularly difficult to resolve in a short period of time, Rule 15Fi-3(a)(5) requires SBS Entities to have policies and procedures reasonably designed to resolve a valuation discrepancy no later than five business days from the date that it was discovered, which we believe to be both a reasonable and appropriate amount of time to resolve such discrepancies. As a condition to this requirement, however, Rule 15Fi-3(a)(5) requires that each SBS Entity establish, maintain, and follow written policies and procedures reasonably designed to identify how it will comply with any variation margin requirements under Section 15F(e) of the Exchange Act<sup>62</sup> and any related regulations pending resolution of the valuation discrepancy. Although we understand the need to provide counterparties with sufficient time to resolve valuation discrepancies, as reflected in the five business day period provided to resolve them, we also believe it to be important for those counterparties to take reasonable steps during the pendency of the resolution to ensure that they are continuing to manage their credit risk to each other by way of exchanging variation margin.

Further, Rule 15Fi-3(a)(5) provides that for purposes of the requirement to resolve a valuation discrepancy within five business days of it being identified,

definition with the corresponding CFTC definition of “business day” in 17 CFR 1.3). As a reminder, SBS entities are required to agree in writing with each of their counterparties on the terms of the portfolio reconciliation pursuant to Rule 15Fi-3(a)(1) (in the case of security-based swap portfolios with other SBS Entities) and Rule 15Fi-3(b)(1) (in the case of security-based swap portfolios with all other counterparties).

<sup>61</sup> See Proposing Release, 84 FR at 4619–20.

<sup>62</sup> 15 U.S.C. 78o–10(e).

a difference between the lower valuation and the higher valuation of less than 10% of the higher valuation need not be deemed a discrepancy. This 10% threshold would apply on a transaction-by-transaction basis and not on a portfolio level. As discussed in greater detail in the Proposing Release, the Commission believes that this buffer is designed to focus the internal resources of both counterparties on the largest discrepancies.<sup>63</sup> At the same time, however, the Commission believes that, in most cases, prudent risk mitigation of a firm’s security-based swap portfolio and proper governance over an entity’s operations would involve ensuring that, at least to a certain degree, most valuation discrepancies are ultimately resolved.

### 4. Rule 15Fi-3(b): Portfolio Reconciliation With Other Counterparties

Rule 15Fi-3(b) establishes reconciliation requirements for security-based swap portfolios between an SBS Entity and a counterparty that is *not* an SBS Entity. Although there is some broad similarity between Rule 15Fi-3(b) and the rules applicable to security-based swap portfolios between two SBS Entities, we have taken a more streamlined approach with respect to security-based swaps with non-SBS Entity counterparties, similar to the CFTC’s approach.<sup>64</sup>

Pursuant to Rule 15Fi-3(b), each SBS Entity is required to establish, maintain, and follow written policies and procedures reasonably designed to ensure that it engages in portfolio reconciliation with non-SBS Entity counterparties as set forth in the rule.<sup>65</sup> This policies and procedures requirement is in contrast to Rule 15Fi-3(a), which expressly requires portfolio reconciliation with respect to

<sup>63</sup> See Proposing Release, 84 FR at 4620. For the avoidance of doubt, an SBS Entity that identifies a valuation discrepancy in excess of 10% would be in compliance with Rule 15Fi-3(a)(5) if it resolves such discrepancy to a level below 10%, even if the entire discrepancy is not completely eliminated. For example, an SBS Entity would not be required to reduce an 11% valuation discrepancy down to zero. Similarly, an SBS Entity with a 9% valuation discrepancy would already be below the 10% threshold and would have no further obligations under Rule 15Fi-3(a)(5).

<sup>64</sup> For additional discussion of the Commission’s rationale for applying a more streamlined set of requirements in the case of a security-based swap portfolio between an SBS Entity and a non-SBS Entity counterparty, see Proposing Release, 84 FR at 4620.

<sup>65</sup> Rule 15Fi-3(b) contains a slight deviation from corresponding CFTC Rule § 23.502(b) to eliminate language that we believe to be redundant. We do not intend for such clarification to signify any substantive differences between Rule 15Fi-3(b) and CFTC Rule § 23.502(b).

transactions where both counterparties are SBS Entities. The policies and procedures required by Rule 15Fi-3(b) will need to provide that the portfolio reconciliation be performed no less frequently than: (1) Once each calendar quarter for each security-based swap portfolio that includes more than 100 security-based swaps at any time during the calendar quarter and (2) once annually for each security-based swap portfolio that includes no more than 100 security-based swaps at any time during the calendar year. For the reasons noted in the Proposing Release, the Commission continues to believe that basing the required frequency of the portfolio reconciliation on the number of outstanding transactions with the applicable counterparty represents a reasonable attempt to calibrate the costs and benefits of reconciling a person's security-based swap portfolio at regular intervals.<sup>66</sup>

In addition, paragraph (b)(1) of Rule 15Fi-3 requires that the applicable policies and procedures be reasonably designed to ensure that each SBS Entity agrees in writing with each of its non-SBS Entity counterparties on the terms of the portfolio reconciliation including, if applicable, agreement on the selection of any third party service provider who may be performing the reconciliation. Paragraph (b)(2) provides that the portfolio reconciliation may be performed on a bilateral basis by the counterparties or by one or more third parties selected by the counterparties. To the extent that the counterparties elect to use a third party to provide these services, the policies and procedures should be reasonably designed to ensure that the SBS Entity and its counterparty agree on the selection of that third party in writing in accordance with the requirements set forth in Rule 15Fi-3(b)(1).<sup>67</sup>

<sup>66</sup> See Proposing Release, 84 FR at 4620. Also, and similar to the provisions governing portfolio reconciliation between two SBS Entities, the CFTC has adopted rules with identical thresholds and frequencies, and any divergence from those thresholds could lead to additional costs and other inefficiencies for SBS Entities that are also registered with the CFTC as Swap Entities. See *supra* note 56 (discussing how the CFTC arrived at setting the numerical thresholds for the requirement to engage in portfolio reconciliation as between two Swap Entities.).

<sup>67</sup> As noted in the discussion of the corresponding provision in Rule 15Fi-3(a)(1), an SBS Entity could in practice satisfy such requirement by including the terms governing the portfolio reconciliation process in the written security-based swap trading relationship documentation that it executes with its counterparty, which, pursuant to Rule 15Fi-5, will need to be executed prior to, or contemporaneously with, the two parties executing any new security-based swap transaction. In addition, once the two parties have agreed in writing on the terms of the portfolio reconciliation for the first time, the

Finally, Rule 15Fi-3(b)(4) requires each SBS Entity to establish, maintain, and follow written procedures reasonably designed to resolve any discrepancies in the valuation or a material term of each security-based swap identified as part of a portfolio reconciliation or otherwise with a non-SBS Entity counterparty in a timely fashion.<sup>68</sup> We are not providing a fixed definition of "timely fashion" in the context of resolving discrepancies with counterparties who are not SBS Entities because such counterparties may vary considerably in terms of their size, sophistication, and background. Although it may be possible to resolve most valuation discrepancies with large hedge funds and pension funds within the five-business-day period applicable to transactions between two SBS Entities, that timeframe may be much more challenging with respect to transactions with smaller buy-side firms.<sup>69</sup>

#### 5. Reporting of Valuation Disputes

Rule 15Fi-3(c) requires each SBS Entity to promptly notify the Commission of any security-based swap valuation dispute in excess of \$20,000,000 (or its equivalent in any other currency), at either the transaction or portfolio level,<sup>70</sup> if not resolved within: (1) Three business days, if the dispute is with a counterparty that is an SBS Entity; or (2) five business days, if the dispute is with a counterparty that is not an SBS Entity.<sup>71</sup> Such notification

requirement could then be satisfied in connection with any new security-based swap transaction executed by the two sides merely by agreeing in writing to abide by the existing agreement regarding the reconciliation process. See *supra* notes 57 and 58 and accompanying text.

<sup>68</sup> Similar to the requirement for security-based swap portfolios between two SBS Entities, Rule 15Fi-3(b)(4) provides that a difference between the lower valuation and the higher valuation of less than 10% of the higher valuation need not be deemed a discrepancy. See *supra* note 63 and accompanying text (discussing the 10% threshold in the context of Rule 15Fi-3(a)(5)).

<sup>69</sup> See Proposing Release, 84 FR at 4621.

<sup>70</sup> The language "at either the transaction or portfolio level" is not included in CFTC Rule § 23.502(c), which is the corresponding requirement applicable to Swap Entities. The specific requirements as to the operation of CFTC Rule § 23.502(c) are contained in the rules of the National Futures Association ("NFA"), which the CFTC has authorized to, among other things, receive and review notices of reportable swap valuation disputes. See Performance of Certain Functions by the National Futures Association Related to Notices of Swap Valuation Disputes Filed by Swap Dealers and Major Swap Participants, 81 FR 3390 (Jan. 21, 2016).

<sup>71</sup> See Proposing Release, 84 FR at 4621 (discussing the rationale for this notification provision, particularly as it relates to the potential risks to the counterparties of a security-based swap that could result from a lack of agreement on its valuation).

must be in a form and manner acceptable to the Commission,<sup>72</sup> and must be sent to any applicable prudential regulator (*i.e.*, in the case of any SBS Entity that is also a bank).<sup>73</sup>

We also note that the CFTC has adopted a nearly identical requirement with the same \$20,000,000 threshold and timeframes, and that adoption of the Commission of different requirements could lead to additional costs and other inefficiencies for SBS Entities that are also registered with the CFTC as Swap Entities.<sup>74</sup> When the CFTC adopted this requirement, it explained that "the \$20,000,000 materiality threshold for reporting is sufficiently high to eliminate unnecessary 'noise' from over-reporting, but not so high as to eliminate reporting that the [CFTC] may find of regulatory value, such as a large number of relatively small disputes that in aggregate could provide the [CFTC] with information regarding a widespread market disruption."<sup>75</sup> We continue to concur with that justification, and

<sup>72</sup> As explained in the Proposing Release, the requirement that the notice be provided "in a form and manner acceptable to the Commission" is intended to provide SBS Entities with flexibility to determine the most efficient and cost-effective means of making such submissions, so long as it is deemed to be acceptable by the Commission. See Proposing Release, 84 FR at 4621, n. 47 and accompanying text. At the same time, however, we also understand that SBS Entities may prefer to have more specific direction as to how to report these disputes to the Commission (and any applicable prudential regulator). Accordingly, we requested comment on whether we should establish a specific process for how SBS Entities would need to provide notices of valuation disputes to the Commission pursuant to proposed Rule 15Fi-3(c). We received no comments on this aspect of the proposal, which we are adopting without modification.

<sup>73</sup> Additionally, the Commission is amending existing Rule 15Fi-1 to add the term "prudential regulator," which includes the Federal Reserve Board, the Office of the Comptroller of the Currency, the FDIC, the Farm Credit Association, and the Federal Housing Finance Agency, as applicable to the specific type of SBS Entity. This definition, which is numbered as Rule 15Fi-1(m), has the same meaning given to the term in Section 3(a)(74) of the Exchange Act. See 15 U.S.C. 78c(a)(74).

<sup>74</sup> See CFTC Risk Mitigation Adopting Release, 77 FR at 55914.

<sup>75</sup> *Id.* The CFTC has a nearly identical requirement in its Rule § 23.502(c), except that it also requires Swap Entities to send such notices to the Commission when the dispute involves a swap that is also a security-based swap agreement, of which a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein. See 17 CFR 23.502(c) (citing the inclusion of security-based swap agreements in the definition of "swap" in 7 U.S.C. 1a(47)(v)). Because there is no corresponding inclusion of "swap agreements" in the definition of "security-based swap agreement" in Section 3(a)(68) of the Exchange Act (15 U.S.C. 78c(a)), Rule 15Fi-3(c) does not contain a requirement to provide notices of any security-based swap valuation disputes to the CFTC.

believe that these notifications could assist the Commission in identifying potential issues with respect to an SBS Entity's internal valuation methodology.<sup>76</sup>

Finally, in the Proposing Release, the Commission summarized the NFA Interpretive Notice entitled, "NFA Interpretive Notice to Compliance Rule 2-49: Swap Valuation Dispute Filing Requirements" ("NFA Interpretive Notice to Rule 2-49"), and requested comment on whether any aspects of that notice should be incorporated directly into proposed Rule 15Fi-3(c).<sup>77</sup> Among other things, that interpretive notice describes the types of disputes that would trigger a notice requirement as well as requirements related to the timing and frequency for providing notices of valuation disputes.<sup>78</sup> In their letter, ISDA and SIFMA suggested that incorporating NFA Interpretive Notice to Rule 2-49 into Rule 15Fi-3 could become problematic should the NFA update or revise its guidance in the future, such that it would create discrepancies between the two sets of requirements.<sup>79</sup> ISDA and SIFMA instead requested that the Commission put in place a process to ensure that any NFA guidance applicable to Swap Entities with respect to the CFTC's portfolio reconciliation requirements should also automatically apply to SBS Entities with respect to the Commission's requirements in Rule 15Fi-3(c), even when such NFA guidance is updated or changed.<sup>80</sup>

After careful review and consideration, the Commission has determined to incorporate one aspect of NFA Interpretive Guidance to Rule 2-49 into Rule 15Fi-3(c). Specifically, we have modified the rule to provide that SBS Entities are required to notify the Commission, in a form and manner acceptable to the Commission, and any applicable prudential regulator, if the amount of any security-based swap

<sup>76</sup> We are not providing a fixed definition of the term "promptly" in the context of when the SBS Entity would need to provide the Commission of an applicable security-based swap valuation dispute. Although we would expect that SBS Entities would be able to provide these notices to the Commission as soon as the disputes exceed the applicable timeframes (e.g., the beginning of fourth business day in the case of a dispute between two SBS Entities), we also understand that some notices may take longer to prepare, such as in cases when the counterparties are unable to agree even on the size of the dispute.

<sup>77</sup> See Proposing Release, 84 FR at 4621-22 (summarizing the NFA Interpretive Notice to Rule 2-49). The NFA notice is available at: <https://www.nfa.futures.org/rulebook/rules.aspx?Section=9&RuleID=9072>.

<sup>78</sup> See *id.*

<sup>79</sup> See ISDA/SIFMA Letter.

<sup>80</sup> See *id.*

valuation dispute that was the subject of a previous notice increases or decreases by more than \$20,000,000 (or its equivalent in any other currency), at either the transaction or portfolio level. Such amended notice shall be provided to the Commission and any applicable prudential regulator no later than the last business day of the calendar month in which the applicable security-based swap valuation dispute increases or decreases by the applicable dispute amount.<sup>81</sup> This change, which is consistent with NFA Interpretive Guidance to Rule 2-49,<sup>82</sup> is intended to clarify that SBS Entities are not required to file the same notice of a valuation dispute for each day the dispute remains outstanding after the initial three- or five-business day requirement, while also helping to ensure that the Commission is made aware of significant changes to existing valuation disputes using the same increments that Swap Entities are required to use when amending swap valuation dispute notices pursuant to CFTC Rule § 23.502(c) (as administered by the NFA).<sup>83</sup>

<sup>81</sup> The NFA requires amendments from Swap Entities to be filed on the 15th (or the following business day if the 15th is a weekend or holiday) and last business day of each month. To the extent that an SBS Entity that also is registered with the CFTC as a Swap Entity has existing systems in place to send out amendments on both the 15th (or the following business day if the 15th is a weekend or holiday) and last business day of each month, the earlier filing would of course satisfy the requirements of Rule 15Fi-3(c).

<sup>82</sup> Specifically, NFA Interpretive Guidance to Rule 2-49 provides that "[Swap Entities] should not file a daily notice of a previously reported dispute even if the valuation dispute amount changes. [Swap Entities] are required, however, to notify NFA of certain changes to the dispute amount on the 15th (or the following business day if the 15th is a weekend or holiday) and last business day of each month by amending any previously filed notice where the dispute amount has increased in \$20 million incremental bands. For example, if a [Swap Entity] files a notice of a \$30 million dispute, an amended notice updating the dispute amount is required if that dispute increases to \$40 million or more and each subsequent \$20 million increment (i.e., dispute amount increases to \$60 million or more, \$80 million or more, etc.). [Swap Entities] are also required to amend a previously filed notice to update the dispute amount if the amount decreases at these \$20 million increments. The determination of whether an amended notice is required is based on the dispute amount on the reporting date."

<sup>83</sup> Among other things, NFA Interpretive Notice to Rule 2-49 requires Swap Entities to file termination notices of disputes that are no longer reportable under CFTC Rule § 23.502(c) on the 15th (or the following business day if the 15th is a weekend or holiday) and the last business day of the month based on the dispute amount on the reporting date. See Proposing Release, 84 FR at 4621-22 (summarizing NFA Interpretive Notice to Rule 2-49). In addition, the NFA issued another notice, entitled "Effective date of Interpretive Notice to NFA Compliance Rule 2-49: Swap Valuation Dispute Filing Requirement" which, among other things, requires that all swap valuation disputes include: (1) The swap dealer's NFA ID and legal

The Commission has not incorporated any other provision of NFA Interpretive Guidance to Rule 2-49 into Rule 15Fi-3(c) in order to provide SBS Entities with the flexibility to submit the required information to the Commission in a manner that is most efficient for each SBS Entity.<sup>84</sup> Finally, the Commission is not including in Rule 15Fi-3(c) a process to ensure that the NFA's guidance for Swap Entities would also apply to the requirements in Rule 15Fi-3(c) for SBS Entities, as requested by commenters. The Commission recognizes that subsequent revisions to the NFA's guidance could potentially result in divergences between the application of the Commission's requirements regarding notices of valuation disputes and the corresponding CFTC requirements (as administered by NFA). However, to the extent that future changes to the NFA's requirements create divergences between Rule 15Fi-3(c) and application of CFTC Rule § 23.502(c), market participants are encouraged to contact Commission staff to discuss such divergences.

## 6. Application of Rule 15Fi-3 to Cleared Security-Based Swaps

As proposed, the portfolio reconciliation requirements in Rule 15Fi-3 would not have applied to a "clearing transaction" which, pursuant to existing Rule 15Fi-1(c), is defined as a security-based swap that has a clearing agency as a direct counterparty.<sup>85</sup> As the

entity identifier ("LEI"), (2) the dispute reportable date, (3) the dispute type, (4) the dispute termination date, (5) the receiver/payer, (6) the disputed amount, in U.S. Dollars ("USD"), (7) the counterparty name, and (8) counterparty LEI or Privacy Law Identifier. For initial and variation margin disputes, the swap dealer is also required to provide (1) the unique swap identifier, (2) the base currency notional amount, (3) the base currency code, (4) the notional value USD equivalent, (5) the asset type, and (6) the product type. For disputes where no collateral is exchange, NFA Interpretive Notice to Rule 2-49 also requires Swap Entities to include in the notice the credit support annex/netting agreement ID. See Proposing Release, 84 FR at 4622, n. 57 (describing NFA Notice to Members I-17-30, which incorporates NFA Notice to Members I-17-30).

<sup>84</sup> As a general matter, we believe it likely that a notice provided to the Commission with respect to a security-based swap valuation dispute that is compliant with NFA Interpretive Guidance to Rule 2-49 (but for the fact that such notice pertains to a security-based swap) would also be compliant with 17 CFR 240.15F-5(c) (Rule 15F-5(c)). SBS Entities that have questions about using a system designed to accommodate the NFA guidance to comply with Rule 15Fi-5(c) are encouraged to contact Commission staff to discuss such questions.

<sup>85</sup> Under existing Rule 15Fi-1(b) (which is renumbered as Rule 15Fi-1(c) under these final rules), the term "clearing agency" means a clearing agency registered with the Commission pursuant to Section 17A of the Exchange Act and that provides central counterparty services for security-based swap transactions.

Commission explained in the Proposing Release, the exception reflected the Commission's belief that the function of reconciling the terms of cleared trades is more appropriately addressed by the rules governing a clearing agency's risk management practices, as well as by the documentation governing the relationship between a clearing agency and its members.

We did, however, request comment on whether the scope of the exception for cleared security-based swaps should be modified, such as by including transactions that are cleared at a clearing agency that is not registered with the Commission pursuant to Section 17A of the Exchange Act, whether because of an applicable exemption from registration or because the Exchange Act does not cover the activities of the clearing agency. For example, security-based swaps cleared at a foreign clearing agency that is not registered with the Commission would not be deemed to be "cleared" for these purposes, and would therefore be subject to Rule 15Fi-3. In their comment letter, ISDA and SIFMA expressed broad general support for expanding the scope of the transactions considered to be cleared for purposes of this exception, and stated that they would consider such a change to be a clarification, and not a deviation from the corresponding CFTC rules.<sup>86</sup>

After careful review and consideration of the comments received and upon further consideration, the Commission is making two changes to Rule 15Fi-3(d). First, we are expanding the exception to include not only security-based swaps that have a clearing agency as a direct counterparty, but also those that are, directly or indirectly, submitted to and cleared by a clearing agency. As the Commission explained when it adopted the trade acknowledgment and verification requirements, under the agency model of clearing, cleared security-based swap transactions are new transactions created to replace a bilateral transaction that was submitted to, and has been accepted for clearing by, a clearing agency. Upon acceptance for clearing, the clearing agency becomes the new direct counterparty to each of the counterparties of the original bilateral

<sup>86</sup> See ISDA/SIFMA Letter. Although ISDA and SIFMA made this comment solely in connection with the portfolio compression requirements in Rule 15Fi-4, we view this issue as applying equally to the portfolio reconciliation requirements in Rule 15Fi-3 and the trading relationship documentation requirements in Rule 15Fi-5. As a result, the discussion that follows, including the change we are making to the scope of the clearing transactions subject to the clearing exception, applies to all three new rules.

transaction. Therefore, these transactions (known colloquially as the "beta" and "gamma") effectively mirror the original bilateral transaction (known as the "alpha") that was extinguished in the process of acceptance for clearing.<sup>87</sup>

By virtue of relying on the current definition of "clearing transaction," which applies to the trade acknowledgment and verification requirements in existing Rule 15Fi-2, the proposed exception in Rule 15Fi-3(d) would have applied only to the "beta" and "gamma" transactions, and not to the original bilateral transaction (*i.e.*, the "alpha"). Although the obligation to reconcile the original bilateral security-based swap transaction would no longer exist as soon as the transaction is novated to the clearing agency, the Commission nevertheless believes that requiring the initial transaction to be reconciled during the period between trade execution and novation would be inconsistent with the approach taken by both the CFTC in its portfolio reconciliation rules and by the Commission in 17 CFR 240.18a-3 (Rule 18a-3), which sets forth the uncleared security-based swap margin requirements for non-bank SBS Entities, and in 17 CFR 240.18a-4 (Rule 18a-4), which sets forth the segregation requirements for certain SBS dealers.<sup>88</sup>

<sup>87</sup> See Trade Acknowledgement and Verification Adopting Release, 81 FR at 39820-21. In that release, the Commission also noted that if both direct counterparties to the alpha transaction are members of the clearing agency, the direct counterparties would submit the transaction to the clearing agency directly and the resulting beta transaction would be between the clearing agency and one clearing member, and the gamma transaction would be between the clearing agency and the other clearing member. However, if the direct counterparties to the alpha transaction are a clearing member and a non-clearing member (a "customer"), the customer's side of the trade would be submitted for clearing by a clearing member acting on behalf of the customer. When the clearing agency accepts the alpha transaction for clearing, one of the resulting transactions—in this case, assume the beta transaction—would be between the clearing agency and the customer, with the customer's clearing member acting as guarantor for the customer's trade. The other resulting transaction—the gamma transaction—would be between the clearing agency and the clearing member that was a direct counterparty to the alpha transaction. See *id.* (citing Regulation SBSR Adopting Release, 80 FR 14563 at n. 292).

<sup>88</sup> Rule 18a-3(b)(5) defines "non-cleared security-based swap" as a security-based swap that is not, directly or indirectly, submitted to and cleared by a clearing agency registered pursuant to section 17A of the [Exchange] Act (15 U.S.C. 78q-1) or by a clearing agency that the Commission has exempted from registration by rule or order pursuant to section 17A of the [Exchange] Act (15 U.S.C. 78q1). See 17 CFR 240.18a-3(b)(5). Similarly, Rule 18a-4(a)(1) defines "cleared security-based swap" as "a security-based swap that is, directly or indirectly, submitted to and cleared by a clearing agency registered with the Commission pursuant to section

For the reasons set forth above, the Commission is revising the exception in Rule 15Fi-3(d) such that it includes those original "alpha" security-based swap transactions. This modification is reflective of the fact that the original transaction, once submitted to and cleared by a clearing agency, no longer exists. In addition, the exception also will apply to security-based swap transactions cleared by a clearing agency that the Commission has exempted from registration by rule or order pursuant to Section 17A of the Exchange Act (in addition to transactions cleared by a registered clearing agency). We are making this change in response to commenters, as well as to better align the operation of Rule 15Fi-3 with CFTC Rule § 23.502 and the Commission's security-based swap margin requirements in Rule 18a-3.<sup>89</sup> Accordingly, Rule 15Fi-3(d) provides an exception from the portfolio reconciliation requirements for any security-based swap that is, directly or indirectly, submitted to and cleared by a clearing agency registered pursuant to Section 17A of the Exchange Act or by a clearing agency that the Commission has exempted from registration by rule or order pursuant to Section 17A of the Exchange Act.<sup>90</sup> Finally, the Commission believes that the justifications for modifying the clearing exception in Rule 15Fi-3 apply equally to the portfolio compression requirements in Rule 15Fi-4 and to the trading relationship documentation requirements in Rule 15Fi-5, and we

17A of the Act (15 U.S.C. 78q-1)." See 17 CFR 240.18a-4(a)(1).

<sup>89</sup> See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital and Segregation Requirements for Broker-Dealers, Exchange Act Release No. 86175 (June 21, 2019), 84 FR 43872, 43919 (Aug. 22, 2019) ("Capital, Margin, and Segregation Adopting Release") ("[t]he language regarding exemption from registration was added to the final rule to align the definition more closely with the definitions used in the margin rules of the CFTC and prudential regulators.').

<sup>90</sup> These revisions have been incorporated directly into the operative exception in Rule 15Fi-3(d), which no longer cross-references to the existing definition of "clearing transaction" in Rule 15Fi-1(d) (re-numbered from paragraph (c)). In addition, we have amended the existing definition of "clearing agency" in Rule 15Fi-1(c) (re-numbered from paragraph (b)) to provide that it applies only to the trade acknowledgment and verification requirements in Rule 15Fi-2. That modification was necessary because the trade acknowledgment and verification requirements in Rule 15Fi-2 contain an exception only for security-based swap transactions cleared by a registered clearing agency, and not for those transactions cleared by an exempted clearing agency (in contrast to the clearing exceptions from the requirements in Rules 15Fi-3, 15Fi-4, and 15Fi-5).

have made corresponding revisions to both of those rules.<sup>91</sup>

### B. Rule 15Fi-4: Portfolio Compression

#### 1. Scope of Rule 15Fi-4—Portfolio Compression Exercises

For purposes of Rule 15Fi-4, the phrase “portfolio compression exercise” generally refers to an exercise by which security-based swap counterparties wholly terminate or change the notional value of some or all of the security-based swaps submitted by the counterparties for inclusion in the portfolio compression exercise and, depending on the methodology employed, replace the terminated security-based swaps with other security-based swaps whose combined notional value (or some other measure of risk) is less than the combined notional value (or some other measure of risk) of the terminated security-based swaps in the exercise.<sup>92</sup> In order to incorporate that concept into these final rules, we are amending existing Rule 15Fi-1 to incorporate definitions for both “bilateral portfolio compression exercise”<sup>93</sup> and “multilateral portfolio compression exercise.”<sup>94</sup> These two definitions are nearly identical, with the sole difference being that the former applies to a portfolio compression exercise that includes only two security-based swap counterparties, while the latter applies to a portfolio compression exercise that includes more than two security-based swap counterparties.<sup>95</sup>

Pursuant to Rule 15Fi-4(a)(2) and (3), SBS Entities are required to establish, maintain, and follow written policies and procedures for periodically engaging in both bilateral portfolio compression exercises 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 a counterparty that is *not* an SBS Entity, Rule 15Fi-4(b) provides that the policies and procedures required under the rule will need to provide that portfolio compression exercises occur when appropriate and only to the extent requested by any such counterparty.<sup>96</sup>

The definitions of “bilateral portfolio compression exercise” and “multilateral portfolio compression exercise” are designed to be sufficiently broad as to provide market participants with maximum flexibility when complying with Rule 15Fi-4, while also retaining the key elements necessary to achieve the important risk-reducing benefits discussed throughout this release—namely the reduction of counterparty and operational risk achieved by terminating offsetting security-based swap transactions. Accordingly, with one exception, the rule does not include specific requirements as to the contents of the policies and procedures created to comply with these rules.<sup>97</sup> In addition, for consistency with the rules applicable to Swap Entities, these definitions are substantively identical to the CFTC’s corresponding definitions, which we continue to believe are appropriately scoped for purposes of Rule 15Fi-4.

The Commission recognizes that a decision to engage in a process that could ultimately result in the termination or modification of existing contracts, and the potential entry into new ones, should be made in accordance with policies and procedures that are tailored to the specific risks and operations of the relevant SBS Entity. Such policies and procedures should, in the Commission’s view, be permitted to take into account the specific risk tolerances of the regulated entity, including with respect to such areas as operational, funding, liquidity, and credit risk, and also reflect the possibility that firms may have legitimate business reasons for maintaining certain offsetting security-based swap positions, even if in theory they could be compressed.

For example, the Commission understands that an SBS Entity might be unable to participate in a particular portfolio compression exercise that could result in it transacting with

prescriptive requirements in cases where both entities are subject to the SEC’s requirements for registered entities.

<sup>97</sup> The one exception to this statement is the requirement in Rules 15Fi-4(a)(2) and (a)(3) that such policies and procedures address the evaluation of portfolio compression exercises that are initiated, offered, or sponsored by any third party. The Commission believes that the decision of which party to use (or not use) to conduct a compression exercise is of critical importance to the overall determination of whether to participate in compression. Although the Commission takes no position with respect to the type or identity of the party used to conduct a compression exercise, we recognize that a number of parties are currently offering such services, including third-party vendors and some self-regulatory organizations (e.g., clearing agencies). The Commission also understands that there may be some instances where compression could be performed without the use of a third-party service provider.

certain counterparties (e.g., because a counterparty poses an unacceptable level of credit risk), or in certain types of transactions. To the extent that such limitations exist and are reflected in the policies and procedures required pursuant to Rules 15Fi-4(a) and (b), an SBS Entity will be in compliance with those rules so long as it follows those policies and procedures, even if it determines not to engage in a particular compression exercise.

Further, in comparing Rules 15Fi-4(a) and (b) with the analogous rules adopted by the CFTC, we note three main differences, the first two of which we believe to be minor and technical in nature. First, CFTC Rule § 23.503(a)(3)(i) requires that any policies and procedures related to multilateral portfolio compression address, among other things, participation in all multilateral portfolio compression exercises required by CFTC regulation or order. Although the Commission would expect that any comprehensive policy or procedure would, as a matter of course, reflect any applicable laws and regulations expressly mandating participation in certain types of portfolio compression exercises, there is no comparable requirement in Rule 15Fi-4(a)(3).

Second, CFTC Rule § 23.503(a)(3)(ii) requires 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.<sup>98</sup> The CFTC did not, however, include such a requirement in the corresponding provision related to policies and procedures addressing *bilateral* portfolio compression exercises.<sup>99</sup> Although the inclusion of a specific requirement in the rule should not be interpreted as creating an exhaustive list of what we would expect SBS Entities to include in their policies and procedures, we understand that bilateral portfolio compression services are currently being offered by third-party vendors. Evaluating those services would seem to be a natural part of the process of broadly analyzing the applicability of bilateral compression in general. Therefore, we have included a similar requirement in *both* Rules 15Fi-4(a)(2) (policies and procedures regarding bilateral compression) and 15Fi-4(a)(3) (policies and procedures regarding multilateral compression).<sup>100</sup>

<sup>98</sup> See 17 CFR 23.503(a)(3)(ii).

<sup>99</sup> See 17 CFR 23.503(a)(2).

<sup>100</sup> The Commission received no comments on this particular issue.

<sup>91</sup> See *infra* Sections II.B.3 and II.C.5.

<sup>92</sup> The corresponding CFTC rule is 17 CFR 23.503. The structure of the CFTC rule, including the subsections, mirrors the structure of Rule 15Fi-4.

<sup>93</sup> The corresponding CFTC definition is in 17 CFR 23.500(b).

<sup>94</sup> The corresponding CFTC definition is in 17 CFR 23.500(h).

<sup>95</sup> As noted below in Section I.C.4, Rule 15Fi-4 is applicable only to uncleared security-based swaps.

<sup>96</sup> As we noted in discussing the portfolio reconciliation requirements in Rule 15Fi-3, the Commission believes it appropriate to impose more

Third, CFTC Rule § 23.503(b), which is the corresponding CFTC compression rule applicable to transactions with counterparties that are *not* Swap Entities, does not contain the caveat that the compression or offset covered by the applicable policies and procedures would only need to occur “when appropriate.” By contrast, Rule 15Fi-4(b) does contain such qualifier. In their comment letter, ISDA and SIFMA expressed support for this approach, which we are adopting today as proposed, and also requested that the Commission clarify in the final rule that SBS Entities can always determine whether it is appropriate to engage in such activity.<sup>101</sup> Despite this divergence from the approach previously adopted by the CFTC, we continue to believe it prudent to allow an SBS Entity to engage in bilateral offset or compression exercises (to the extent requested by its non-SBS Entity counterparty) only in circumstances when doing so was appropriate for the SBS Entity in light of the particular facts and circumstances involved. However, as we stated in the Proposing Release, the discretion we intended to provide SBS Entities in connection with this requirement should not be used by an SBS Entity arbitrarily not to honor the request by its counterparty to engage in portfolio compression.<sup>102</sup>

Finally, ISDA and SIFMA raised questions about the impact of Rule 15Fi-4 on existing counterparty documentation, noting that “the industry has a strong interest in not having to address any deviations regarding the portfolio compression process (or other substantive areas covered by industry standard documentation intended to achieve compliance with CFTC swap rules) as this may trigger more detailed review, explanation and negotiation between relevant counterparties, which will be challenging, costly and time consuming without commensurate benefit to regulatory oversight.” Those commenters further requested that, to the extent any differences remain between the Commission’s and CFTC’s portfolio compression rules, the Commission should allow, on an ongoing basis, firms that qualify as both SBS Entities and Swap Entities to comply with Rule 15Fi-4 by complying with CFTC Rule § 23.503 without any further conditions. The Commission has carefully considered this comment and has concluded that such action should not be necessary as we believe that any SBS Entity that is in compliance with

CFTC Rule § 23.503 as it exists at this time also will be in compliance with Rule 15Fi-4. As the Commission previously stated, we believe that any differences between Rule 15Fi-4 and CFTC § 23.503 are either technical in nature or provide SBS Entities with greater flexibility as compared to Swap Entities (e.g., the inclusion of the phrase “when appropriate” in Rule 15Fi-4(b)).

## 2. Scope of Rule 15Fi-4—Bilateral Offset

As we previously noted, the Commission does not believe it prudent to suggest a preference as to the use of any particular type of compression, or as to the type or identity of the party conducting the exercise. Instead, we have crafted broad definitions of the terms “bilateral portfolio compression exercise” and “multilateral portfolio compression exercise” in Rules 15Fi-1(a) and 15Fi-1(j), respectively. In addition, the Commission recognizes that there may be other ways for market participants to reduce the size of their derivatives portfolios that may not be considered to be “portfolio compression exercises” for purposes of those two definitions.

In light of those considerations, Rule 15Fi-4(a)(1) requires each SBS Entity to establish, maintain, and follow written policies and procedures for terminating each “fully offsetting security-based swap” that it maintains with another SBS Entity in a timely fashion, when appropriate.<sup>103</sup> To the extent that an SBS Entity transacts with a counterparty that is *not* an SBS Entity, the requirements of Rule 15Fi-4(b) are identical to those in Rule 15Fi-4(a)(1), except that the required policies and procedures only need to address engaging in bilateral offset when appropriate and to the extent requested by the counterparty. The Commission believes that by not adopting prescriptive requirements as to the form of bilateral offset that would need to be reflected in an SBS Entity’s policies and procedures, the rules regarding bilateral offset allow the counterparties flexibility in the manner in which they undertake to reduce the size of their security-based swap portfolios in light

of each counterparty’s unique risks and operations.

The rules regarding bilateral offset also have been designed to reflect the Commission’s understanding that firms may have legitimate business reasons for maintaining fully offsetting security-based swap transactions that otherwise could be terminated. As such, Rules 15Fi-4(a)(1) and (b) require a firm’s policies and procedures to address the termination of fully offsetting security-based swaps only “when appropriate.”

Finally, for purposes of Rule 15Fi-4(a)(1), the Commission expects to generally consider an SBS Entity to have terminated each fully offsetting security-based swap in a “timely fashion” so long as (1) termination of the offsetting security-based swaps occurs within a period that is reasonable in light of the circumstances of each particular transaction and (2) the relevant SBS Entity is otherwise in compliance with its policies and procedures regarding bilateral offset.

## 3. Application of Rule 15Fi-4 to Cleared Security-Based Swaps

As proposed, the portfolio compression requirements in Rule 15Fi-4 would not have applied to a “clearing transaction” which, pursuant to existing Rule 15Fi-1(c), is defined as a security-based swap that has a clearing agency as a direct counterparty.<sup>104</sup> Notwithstanding this provision, the Commission understands that portfolio compression is not limited to uncleared swaps and that compression services may be offered either by a clearing agency itself or by a third-party vendor that works collaboratively with the clearing agency.<sup>105</sup> Although the Commission recognizes the risk-reducing benefits that could be realized through the compression of cleared security-based swaps, we nonetheless believe that the issue of whether and when compression should occur within a clearing agency is best addressed by the rules governing the clearing agency’s risk management practices, as well as by the documentation governing the

<sup>104</sup> See *supra* note 85 and accompanying text.

<sup>105</sup> Notwithstanding the applicability of the requirements of Rule 15Fi-4, the Commission reminds any third parties performing compression or offset services to keep in mind any potential requirements under other provisions of the securities laws. For example, the Commission has stated that the provision of tear-up and compression services for security-based swaps would qualify these participants as clearing agencies and therefore trigger the statutory requirement to register as clearing agencies pursuant to Section 17A of the Exchange Act, absent exemptive relief (which the Commission provided on a conditional temporary basis in July 2011). See Clearing Services Exemptive Order, 76 FR at 39964.

<sup>101</sup> See ISDA/SIFMA Letter.

<sup>102</sup> See Proposing Release, 84 FR at 4625, n.70.

<sup>103</sup> The Commission also is amending existing Rule 15Fi-1 to add, as paragraph (h), the term “fully offsetting security-based swaps,” which is defined as “security-based swaps of equivalent terms where no net cash flow would be owed to either counterparty after the offset of payment obligations thereunder.” For consistency with the rules applicable to Swap Entities, this definition is substantively identical to the CFTC’s corresponding definition in 17 CFR 23.500(f), which we continue to believe is appropriately scoped for purposes of Rule 15Fi-4.

relationship between the clearing agency and its members.<sup>106</sup>

Accordingly, Rule 15Fi-4(c) provides an exception from the portfolio compression requirements for any security-based swap that is, directly or indirectly, submitted to and cleared by a clearing agency registered pursuant to Section 17A of the Exchange Act or by a clearing agency that the Commission has exempted from registration by rule or order pursuant to Section 17A of the Exchange Act. This exception has been modified from the proposal, as described in detail in Section II.A.6.

### C. Rule 15Fi-5: Trading Relationship Documentation

#### 1. Scope of Rule 15Fi-5

In light of the important risk mitigating factors described in Section I of this release, the Commission is adopting Rule 15Fi-5, which establishes certain requirements for SBS Entities related to the use of written trading relationship documentation in connection with their security-based swap transactions.<sup>107</sup> Specifically, Rule 15Fi-5(a)(2) requires each SBS Entity to establish, maintain, and follow written policies and procedures reasonably designed to ensure that it executes written security-based swap trading relationship documentation with each of its counterparties prior to, or contemporaneously with, executing a security-based swap with any counterparty.<sup>108</sup> The rule further requires that the policies and procedures required thereunder be approved in writing by a senior officer of the SBS Entity, and that a record of the approval be retained.<sup>109</sup>

<sup>106</sup> The corresponding CFTC rule is 17 CFR 23.503(c).

<sup>107</sup> The corresponding CFTC rule is 17 CFR 23.504. The structure of the CFTC rule, including the subsections, mirrors the structure of Rule 15Fi-5.

<sup>108</sup> Among other exceptions discussed below in Section II.C.5, Rule 15Fi-5 does not apply to security-based swap that is directly or indirectly, submitted to and cleared by a clearing agency registered pursuant to Section 17A of the Exchange Act or by a clearing agency that the Commission has exempted from registration by rule or order pursuant to Section 17A of the Exchange Act.

<sup>109</sup> For purposes of this requirement, the Commission views the term “senior officer” as covering only the most senior executives in the organization, such as a firm’s chief executive officer, chief financial officer, chief legal officer, chief compliance officer, president, or other person at a similar level. This approach is similar to how the Commission has previously interpreted the term in the context of other requirements applicable to SBS Entities. See Registration Process for Security-Based Swap Dealers and Major Security-Based Swap Participants, Exchange Act Release No. 75611 (Aug. 5, 2015), 80 FR 48964, 48968 n. 29 (Aug. 14, 2015) (“SBS Entity Registration Adopting Release”). By contrast, CFTC Rule § 23.504 uses the term “senior management,” which is not further defined

Pursuant to Rule 15Fi-5(b)(1), the security-based swap trading relationship documentation subject to the policies and procedures requirement in Rule 15Fi-5(a)(2) must be in writing. Such documentation also must include all terms governing the trading relationship between the SBS Entity and its counterparty, 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, governing law, valuation, and dispute resolution.

As proposed, Rule 15Fi-5(b)(1) also would have required that the applicable policies and procedures provide that the trading relationship documentation include terms governing “applicable regulatory reporting obligations (including pursuant to Regulation SBSR).” CFTC Rule § 23.504 does not contain a comparable provision. Nevertheless, the Commission included this requirement in the proposal as a means to potentially help address the SDR verification issue that is discussed in detail in Section II.A.1 above and Section I.E. of the Proposing Release.<sup>110</sup>

In their comment letter, ISDA and SIFMA expressed their view that trading relationship documentation, such as ISDA Master Agreements, including amendments effectuated by protocol or otherwise, are not the appropriate place to memorialize regulatory reporting obligations and should not address reporting obligations that go beyond what is required under Regulation SBSR.<sup>111</sup> ISDA and SIFMA also stated that the proposed documentation requirement would have essentially mirrored the reporting requirements in Regulation SBSR, including the reporting hierarchy established by that rule, which would be duplicative, burdensome and impose additional costs on SBS Entities, and that such requirement also may not address the underlying SDR verification issue.<sup>112</sup>

in either CFTC Rules § 23.500 or § 23.504. We view this difference as a clarification and do not believe that it represents a substantive difference between the two sets of rules.

<sup>110</sup> See Proposing Release, 84 FR at 4633–35. The Commission stated its view that clarifying the counterparties’ reporting arrangements in advance of a transaction generally should prove beneficial to the OTC derivatives market due to the importance of ensuring that a security-based swap transaction is reported accurately and in a timely manner.

<sup>111</sup> See ISDA/SIFMA Letter.

<sup>112</sup> See *id.* In particular, ISDA and SIFMA noted that the proposed requirement could force institutions to “re-paper” or enter into new documentation with clients, where there is potential for security-based swap reporting obligations to arise.

The Commission has carefully considered these comments and has modified Rule 15Fi-5(b)(1), such that the required policies and procedures no longer need to be reasonably designed to ensure that the trading relationship documentation include terms governing applicable regulatory reporting obligations. In particular, the comments we received indicated that the inclusion of the proposed requirement would not serve as a basis for potentially addressing the SDR verification issue, and that such requirement would introduce additional burdens on SBS Entities, which commenters asserted were not justified in light of the fact that the expected benefits the Commission referred to in the Proposing Release were already addressed by other requirements, namely in certain aspects of Regulation SBSR.<sup>113</sup>

In addition, pursuant to Rule 15Fi-5(b)(2), all trade acknowledgements and verifications of security-based swap transactions required under Rule 15Fi-2 will be deemed to be security-based swap trading relationship documentation, as they often may contain one or more terms contemplated by the policies and procedures required by Rule 15Fi-5. Further, the Commission understands that in some transactions, the parties may choose to document their trading relationship by using a stand-alone “long-form confirmation” that includes all of the terms governing the relationship. Rule 15Fi-5 is not intended to interfere with this practice. Accordingly, we believe that the use of a “long-form confirmation” would comply with Rule 15Fi-5 so long as such document is: (1) In written form and includes all of the elements of the trading relationship required under the rule (whether by incorporating them by reference from a standard master agreement or by expressly restating them in the confirmation) and (2) executed prior to, or contemporaneously with, the execution of each relevant security-based swap.

Pursuant to Rule 15Fi-5(b)(3), the policies and procedures required by Rule 15Fi-5(a)(2) also need to provide that the security-based swap trading relationship documentation include credit support arrangements. Such credit support arrangements must

<sup>113</sup> See *id.* For example, ISDA and SIFMA stated that “Regulation SBSR establishes which parties to the trade have a reporting obligation without the need for any further contractual agreement among the parties.” As such, requiring that an SBS Entity’s trading relationship documentation include terms governing applicable regulatory reporting obligations would be both redundant with, and an expansion of, the requirements in Regulation SBSR.

contain, in accordance with applicable requirements under regulations adopted by the Commission or any prudential regulators,<sup>114</sup> and without limitation, the following:

- 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 security-based swaps, if any; and
- custodial arrangements for margin assets, including whether margin assets are to be segregated with an independent third party, in accordance with the notice requirement in Section 3E(f)(1)(A) of the Exchange Act (and either 17 CFR 240.15c3-3(p)(4)(i) (Rule 15c3-3(p)(4)(i)) or Rule 18a-4(d)(1) thereunder, as applicable), if any.<sup>115</sup>

As the Commission has previously explained, ensuring that uncleared OTC derivatives transactions are appropriately collateralized was one of the key elements of the Title VII reforms.<sup>116</sup> Accordingly, requiring that an SBS Entity's policies and procedures be reasonably designed to ensure that the counterparties clearly document the applicable processes and requirements for calculating and exchanging margin in connection with a security-based swap transaction is an important step in achieving this broader regulatory objective.<sup>117</sup>

<sup>114</sup> See *supra* note 73.

<sup>115</sup> See 15 U.S.C. 78c-5(f). Consistent with the Commission's goal of ensuring that these final rules are harmonized with the corresponding CFTC requirements wherever possible, the requirements in Rule 15Fi-5(b)(3) are identical to CFTC Rule § 23.504(b)(3), other than a cross-reference in the latter to CFTC Rule part 701 which, among other things, requires that a Swap Entity notify its counterparty to an uncleared swap transaction that the counterparty has the right to require that any initial margin the counterparty provides in connection with such transaction be segregated in accordance with the CFTC's segregation requirements. On March 28, 2019, the CFTC amended certain parts of Rule part 701, including by modifying the timing requirements applicable to the required notices. See Segregation of Assets Held as Collateral in Uncleared Swap Transactions, 84 FR 12894 (Apr. 3, 2019). In addition, the Commission has made technical edits to Rule 15Fi-5(b)(3) to incorporate the applicable pinpoint citation in Section 3E(f)(1)(a) of the Exchange Act and to reference the specific rules the Commission recently adopted pursuant to that statutory authority.

<sup>116</sup> See *supra* Section I.

<sup>117</sup> Also in furtherance of harmonizing these final rules with the corresponding CFTC requirements, we note that in adopting Title VII capital, margin, and segregation requirements in June 2019, the Commission crafted certain margin requirements, including rules regarding third-party custodian and netting or collateral agreements, such that existing agreements with counterparties entered into for purposes of the corresponding CFTC

At the same time, however, the Commission notes that the requirement in Rule 15Fi-5(b)(3) is intended to be complementary to, and not conflict with, our existing margin requirements, particularly Rule 18a-3. That rule, which the Commission adopted in June 2019, prescribes margin requirements for non-bank SBS Entities with respect to uncleared security-based swaps. Although Rule 18a-3 does not contain specific margin documentation requirements, paragraphs (c)(4) and (5) contain requirements related to the use of collateral and netting agreements.<sup>118</sup> Rule 18a-3 also contains an exception to the requirement to collect initial margin when the initial margin amount plus all other credit exposures resulting from uncleared swaps and security-based swaps of the SBS Entity and its affiliates with the counterparty and its affiliates does not exceed \$50 million. Recognizing that counterparties may need time after breaching that \$50 million threshold to execute agreements to address the posting of initial margin, the rule also permits an SBS Entity to defer collecting initial margin from a counterparty for two months after the month in which the counterparty does not qualify for the \$50 million threshold exception for the first time.<sup>119</sup> Accordingly, the Commission is confirming that an SBS Entity that is not collecting initial margin from a counterparty pursuant to the exception in Rule 18a-3(c)(1)(iii)(H) (including the one-time two-month deferral period after breaching the \$50 million threshold) would not be required to have a collateral agreement or a netting agreement in place, solely with respect to the collection of initial margin, for purposes of both Rule 18a-3 and Rule 15Fi-5(b)(3).<sup>120</sup>

documentation rules will be sufficient for purposes of the Commission's margin rules, if the agreements meet the requirements of the applicable Commission rules. See Capital, Margin, and Segregation Adopting Release, 84 FR at 43894, 43909, and 43928, n. 570. Nevertheless, the Commission encourages registrants or potential registrants who have concerns regarding the need to revise their existing documentation solely due to the operation of Rule 15Fi-5 to consult with the staff of the Commission.

<sup>118</sup> See 17 CFR 240.18a-3(c)(4) and (5). See also Capital, Margin, and Segregation Adopting Release, 84 FR at 43909, n. 334.

<sup>119</sup> See Capital, Margin, and Segregation Adopting Release, 84 FR at 43926.

<sup>120</sup> By contrast, the uncleared swap margin rules adopted by the CFTC and the prudential regulators do contain specific margin documentation requirements. See Capital, Margin, and Segregation Adopting Release, 84 FR at 43909, n. 335. However, CFTC staff issued an advisory on July 9, 2019 clarifying that the CFTC's margin rules do not require documentation governing the posting, collection and custody of initial margin until the initial margin threshold amount exceeds \$50

## 2. Rule 15Fi-5(b)(4): Documenting Valuation Methodologies

As discussed in Section I, ensuring that security-based swaps are accurately valued throughout the duration of a contract should play an important role in protecting the integrity of the OTC derivatives market, both at the level of an individual participant and systemically across the broader financial market.<sup>121</sup> Accordingly, Rule 15Fi-5(b)(4) requires that the 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 security-based swap at any time from execution to the termination, maturity, or expiration of such security-based swap for the purposes of complying with the margin requirements under Section 15F(e) of the Exchange Act (and applicable regulations),<sup>122</sup> and the risk management requirements under Section 15F(j) of the Exchange Act (and applicable regulations).<sup>123</sup> To the maximum extent practicable, such valuations need to be based on recently executed transactions, valuations

million. See CFTC Letter No. 19-16 (Jul. 9, 2019), available at: <https://www.cftc.gov/PressRoom/PressReleases/7960-19>. Similarly, the prudential regulators recently proposed amendments to their margin rules for uncleared swaps and security-based swaps that, among other things, would clarify that covered entities subject to those rules are not required to execute initial margin trading documentation with a counterparty prior to the time they are required to collect or post initial margin pursuant to the rule. See Margin and Capital Requirements for Covered Swap Entities, 84 FR 59970, 59977 (Nov. 7, 2019). Finally, BCBS and IOSCO issued a statement on March 5, 2019, also clarifying their recommended view that documentation should not be required if the bilateral initial margin amount does not exceed €50 million, and further noting that "[i]t is expected, however, that covered entities will act diligently when their exposures approach the threshold to ensure that the relevant arrangements needed are in place if the threshold is exceeded." See BCBS/IOSCO statement on the final implementation phases of the Margin requirements for non-centrally cleared derivatives (Mar. 5, 2019), available at: <https://www.bis.org/press/p190305a.htm>.

<sup>121</sup> See *id.*

<sup>122</sup> See 15 U.S.C. 78o-10(e). For the avoidance of doubt, the requirements in Rule 15Fi-5(b)(4) are intended to facilitate agreement between an SBS Entity and its counterparty as to how they will determine the value of a security-based swap in order to, among other things, comply with the margin requirements promulgated by either the Commission or, with respect to an SBS Entity that is a bank, the applicable prudential regulator. These requirements are not intended in any way to supersede those underlying margin requirements.

<sup>123</sup> See 15 U.S.C. 78o-10(j).

provided by independent third parties, or other objective criteria.

The requirements in Rule 15Fi-5(b)(4) regarding valuation methodology apply to security-based swap trading relationship documentation entered into between: (1) Two SBS Entities; (2) an SBS Entity and a “financial counterparty;” and (3) an SBS Entity and any other counterparty, if requested by such counterparty. Accordingly, we are also revising proposed Rule 15Fi-1 to add, as paragraph (g), a definition of “financial counterparty,” which includes any counterparty that is not an SBS Entity *and* that is one of the following:

- A swap dealer;
- a major swap participant;
- a commodity pool as defined in Section 1a(10) of the Commodity Exchange Act (7 U.S.C. 1a(10));
- a private fund as defined in Section 202(a)(29) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a));
- an employee benefit plan as defined in paragraphs (3) and (32) of Section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002); and
- a person predominantly engaged in activities that are in the business of banking or, in activities that are financial in nature, as defined in Section 4(k) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843k).<sup>124</sup>

Further, Rule 15Fi-5(b)(4)(ii) is intended to help ensure that the required valuation documentation between SBS Entities and their counterparties contains sufficient guidance and information in the event of a problem with determining the value of a security-based swap. Specifically, the documentation required by the applicable policies and procedures must include *either*: (1) Alternative methods for determining the value of the security-based swap for the purposes of complying with Rule 15Fi-5(b)(4) in the event of the unavailability or other

<sup>124</sup> The corresponding definition in CFTC Rule § 23.500(e) is referred to as a “financial entity.” We replaced the word “entity” with “counterparty” to avoid any confusion due to the fact that there are other definitions of “financial entity” within the Exchange Act and its implementing regulations. For example, term “financial entity” is used in Section 3C(g) of the Exchange Act for purposes of the statutory exception to the mandatory clearing requirement in Title VII. *See* 15 U.S.C. 78c-3(g)(3). Similarly, there is a definition of “financial entity” in Rule 3a67-6 under the Exchange Act, which is used for one of the tests for determining a person’s status under the definition of “major security-based swap participant” in Section 3(a)(67) of the Exchange Act. *See* 15 U.S.C. 78. Other than the different titles, we do not believe that there are any substantive differences between the CFTC’s definition of “financial entity” and the definition of “financial counterparty” in Rule 15Fi-1(g).

failure of any input required to value the security-based swap for such purposes; or (2) a valuation dispute resolution process by which the value of the security-based swap shall be determined for the purposes of complying with the rule.

To the extent that the prescribed valuation documentation needs to be updated, revised, or otherwise modified, Rule 15Fi-5(b)(4)(iv) provides that the parties may agree on changes or procedures for modifying or amending such documentation at any time.<sup>125</sup> Finally, because valuation data and methodologies often include, or may be based on, private information, Rule 15Fi-5(b)(4)(iii) makes clear that an SBS Entity is not required to disclose to the counterparty confidential, proprietary information about any model it may use to value a security-based swap.

### 3. Rule 15Fi-5(b)(5) and (6): Other Disclosure Requirements

Rule 15Fi-5 also requires that the policies and procedures governing the applicable trading relationship documentation require an SBS Entity and its counterparty to disclose to each other certain information regarding their legal and bankruptcy status, and to include a statement regarding the status of a security-based swap if accepted for clearing by a central counterparty (“CCP”). The first requirement relates to whether the SBS Entity or its counterparty is subject to a particular legal regime in the event of its failure, such as FDIC receivership for banks or orderly liquidation for certain financial companies that meet the requirements set forth in Title II of the Dodd-Frank Act.<sup>126</sup> As background, Title II of the Dodd-Frank Act provides for an alternative insolvency regime for the “orderly liquidation” of large financial companies,<sup>127</sup> including broker-dealers,

<sup>125</sup> The text of CFTC Rule § 23.504(b)(4)(iv), which is the corresponding subsection under CFTC rules, provides that “[t]he parties may agree on changes or procedures for modifying or amending the documentation required by this paragraph at any time.” Rule 15Fi-5(b)(4)(iv) does not contain the phrase “required by this paragraph.” We view this to be solely a technical change and do not intend for it to represent a substantive deviation from the corresponding CFTC rule. Rather, the difference is intended to avoid any suggestion that the parties could amend the underlying requirements contained in Rule 15Fi-5(b)(4).

<sup>126</sup> *See* 12 U.S.C. 5382; 12 U.S.C. 5383.

<sup>127</sup> The term “financial company” is defined in 12 U.S.C. 5381(a)(11) to include any company (as defined in 12 U.S.C. 5381(a)(5)) that—

(A) is incorporated or organized under any provision of Federal law or the laws of any State;

(B) is—

(i) a bank holding company (as defined in 12 U.S.C. 1841(a));

(ii) a nonbank financial company supervised by the Federal Reserve Board;

that meet specified criteria (each a “covered financial company”) as set forth in Title II of the Dodd-Frank Act.<sup>128</sup> If the covered financial company is (1) a broker or dealer and (2) a member of the Securities Investor Protection Corporation (“SIPC”), such “covered broker or dealer” would be placed into an orderly liquidation proceeding with the FDIC appointed as receiver.<sup>129</sup> Because this orderly liquidation process, which was modeled on the receivership process used for failed banks, is different from the liquidation regimes established under the Securities Investor Protection Act of 1970<sup>130</sup> or by the U.S. Bankruptcy Code,<sup>131</sup> the Commission believes it to be appropriate to require counterparties to a security-based swap transaction to disclose to each other whether this alternative regime may potentially apply in the event of an insolvency.

Accordingly, Rule 15Fi-5(b)(5) sets out that each SBS Entity’s policies and procedures must require that security-based swap trading relationship documentation contain a statement as to whether it or its counterparty is an

(iii) any company that is predominantly engaged in activities that the Federal Reserve Board has determined are financial in nature or incidental thereto for purposes of 12 U.S.C. 1843(k) (other than a company described in clause (i) or (ii)); or

(iv) any subsidiary of any company described in any of clauses (i) through (iii) that is predominantly engaged in activities that the Federal Reserve Board has determined are financial in nature or incidental thereto for purposes of 12 U.S.C. 1843(k) (other than a subsidiary that is an insured depository institution or an insurance company); and

(C) is not a Farm Credit System institution chartered under and subject to the provisions of the Farm Credit Act of 1971, as amended (12 U.S.C. 2001 *et seq.*), a governmental entity, or a regulated entity, as defined under 12 U.S.C. 4502(20).

<sup>128</sup> Section 203 of the Dodd-Frank Act sets forth the process for designating a financial company as a “covered financial company.” In the case of a broker-dealer, or when a financial company’s largest U.S. subsidiary is a broker-dealer, Section 203(a)(1)(B) provides that the Federal Reserve Board and the Commission (in each case subject to the approval of a two-thirds majority of each agency’s members), in consultation with the FDIC, may, either on their own initiative or at the request of the Secretary of the U.S. Treasury (“Secretary”), issue a written orderly liquidation recommendation to the Secretary. *See* 12 U.S.C. 5383(a). Section 203(b) requires the Secretary (after consultation with the President) to take action on the recommendation upon an affirmative determination that, among other things, the failure of a financial company would have serious adverse effects on financial stability in the United States and that taking action under the orderly liquidation authority with respect to that company would avoid or mitigate such adverse effects. *See* 12 U.S.C. 5383(b).

<sup>129</sup> *See* 12 U.S.C. 5384. Section 205(a) of the Dodd-Frank Act requires the FDIC, as the appointed receiver for any covered broker or dealer, to appoint SIPC as trustee for the liquidation. *See* 12 U.S.C. 5385(a).

<sup>130</sup> 15 U.S.C. 78aaa *et seq.*

<sup>131</sup> 11 U.S.C. 101 *et seq.*

insured depository institution or financial company. Further, the documentation also must contain a statement that the orderly liquidation provisions of the Dodd-Frank Act and the Federal Deposit Insurance Act<sup>132</sup> 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 a receiver. The documentation further needs to state that such limitations relate to the right of the non-covered party to terminate, liquidate, or net any security-based swap by reason of the appointment of the FDIC as receiver, notwithstanding the agreement of the parties in the security-based swap trading relationship documentation, and that the FDIC may have certain rights to transfer security-based swaps of the covered party. Finally, the policies and procedures must require that the trading relationship documentation contain an agreement between the SBS Entity and its counterparty to provide notice if either it or its counterparty becomes or ceases to be an insured depository institution or a financial company.<sup>133</sup>

Second, pursuant to Rule 15Fi-5(b)(6), the security-based swap trading relationship documentation subject to the policies and procedures requirement in Rule 15Fi-5(a)(2) must include certain information regarding the status of a security-based swap accepted for clearing by a clearing agency.

<sup>132</sup> 12 U.S.C. 1811 *et seq.*

<sup>133</sup> Specifically, Rule 15Fi-5(b)(5) requires that an SBS Entity’s policies and procedures require that the applicable security-based swap trading relationship documentation contain:

- A statement of whether the SBS Entity is an insured depository institution (as defined in 12 U.S.C. 1813) or a financial company (as defined in Section 201(a)(11) of the Dodd-Frank Act, 12 U.S.C. 5381(a)(11));

- A statement of whether the counterparty is an insured depository institution or financial company;

- A statement that in the event either the SBS Entity or its counterparty becomes a covered financial company (as defined in 12 U.S.C. 5381(a)(8)) or is an insured depository institution for which the FDIC has been appointed as a receiver (the “covered party”), certain limitations under Title II of the Dodd-Frank Act or the Federal Deposit Insurance Act may apply to the right of the non-covered party to terminate, liquidate, or net any security-based swap by reason of the appointment of the FDIC as receiver, notwithstanding the agreement of the parties in the security-based swap trading relationship documentation, and that the FDIC may have certain rights to transfer security-based swaps of the covered party under Section 210(c)(9)(A) of the Dodd-Frank Act, 12 U.S.C. 5390(c)(9)(A), or 12 U.S.C. 1821(e)(9)(A); and

- An agreement between the SBS Entity and its counterparty to provide notice if either it or its counterparty becomes or ceases to be an insured depository institution or a financial company.

Specifically, such documentation must contain a notice that, upon acceptance of a security-based swap by a clearing agency:

- The original security-based swap is extinguished;
- The original security-based swap is replaced by equal and opposite security-based swaps with the clearing agency; and
- All terms of the security-based swap shall conform to the product specifications of the cleared security-based swap established under the clearing agency’s rules.

The Commission believes that such disclosure provides important information to counterparties regarding the effects of clearing a trade at a clearing agency and clarifies the status of the contract following its acceptance and novation at the clearing agency.

#### 4. Rule 15Fi-5(c): Audit of Security-Based Swap Trading Relationship Documentation

Rule 15Fi-5(c) requires 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 the rule. In addition, a record of the results of each audit must be retained for a period of three years after the conclusion of the audit.<sup>134</sup> The Commission believes that requiring periodic audits of a firm’s security-based swap trading relationship documentation is consistent with sound risk mitigation practices and is designed to reduce the prevalence of discrepancies during the course of these transactions. This requirement differs slightly from CFTC Rule § 23.504(c), which references an independent “internal or external” auditor.<sup>135</sup>

In their comment letter, ISDA and SIFMA asked the Commission to clarify that the required auditor can be “internal or external” as is the case in the CFTC rule.<sup>136</sup> As we stated in the Proposing Release, the Commission has experience overseeing accounting and auditing standards in other contexts, particularly as related to certain disclosure requirements under the federal securities laws.<sup>137</sup> We also explained in the Proposing Release that, in those contexts, an internal auditor

<sup>134</sup> The three year holding period for these records is contained in the applicable recordkeeping, reporting, and notification requirements for SBS Entities, as opposed to in Rule 15Fi-5(c) itself.

<sup>135</sup> See 17 CFR 23.504(c).

<sup>136</sup> See ISDA/SIFMA Letter.

<sup>137</sup> See Proposing Release, 84 at 4630 (referencing See 17 CFR 210.2-01(c)(2) (Rule 2-01(c)(2) of Regulation S-X) (Employment Relationships)).

typically reports to the management of the applicable entity, which would be inconsistent with the Commission’s auditor independence rules.<sup>138</sup>

Accordingly, we have determined not to modify Rule 15Fi-5(c) in the manner requested by the commenters because it appears that an internal auditor would not typically be independent as contemplated in the Commission’s auditor independence rules. However, and as noted in the Proposing Release, we also are not necessarily foreclosing the possibility that there could be alternative structures to the typical “internal” auditor employment relationship that, if structured properly, could be consistent with the Commission’s auditor independence rules.<sup>139</sup>

#### 5. Exceptions to the Trading Relationship Documentation Requirements

Rule 15Fi-5(a)(1) contains three different exceptions from the basic requirement that each SBS Entity establish, maintain, and follow written policies and procedures reasonably designed to ensure that it executes written security-based swap trading relationship documentation with each of its counterparties prior to, or contemporaneously with, executing a security-based swap with any counterparty. First, Rule 15Fi-5(a)(1)(i) provides an exception for security-based swaps executed prior to the date on which an SBS Entity is required to be in compliance with the documentation rule. Although the Commission recognizes the significant risk mitigation benefits associated with ensuring that all transactions are supported by comprehensive and accurate documentation, we also understand that it may be impractical to require SBS Entities to have policies and procedures to bring existing transactions into compliance with these rules, particularly when weighing any potential benefits of doing so against the potential costs.<sup>140</sup> Accordingly, we believe that those transactions should be

<sup>138</sup> See *id.*

<sup>139</sup> See Proposing Release, 84 at 4630 n. 105. In the request for comment on this issue, we also asked commenters to identify and describe such potential structures. We did not receive any information responsive to that request.

<sup>140</sup> When the CFTC adopted a similar exception in 2012, it acknowledged the views of commenters that applying CFTC Rule § 23.504 retroactively to existing swaps would be time consuming and costly for Swap Entities due to them needing to make amendments to existing documentation. See CFTC Risk Mitigation Adopting Release, 77 FR at 55950.

excepted from the documentation requirements.<sup>141</sup>

To the extent that an SBS Entity maintains an existing security-based swap portfolio with a counterparty that pre-dates the compliance date, Rule 15Fi-5(a)(1)(i) provides an exception from the documentation requirements only with respect to those *existing* transactions. This means that the SBS Entity would not be in violation of Rule 15Fi-5 solely as a result of having policies and procedures that do not require such SBS Entity to have executed written security-based swap trading relationship documentation with any counterparty with respect to those existing transactions, or if the existing documentation that it maintains with the counterparty does not otherwise comply with the requirements of the rule. However, if the SBS Entity enters into *new* security-based swap transactions with that same counterparty, the exception would not apply to those new transactions, even if noncompliant trading relationship documentation already existed. Under those circumstances, the SBS Entity's policies and procedures will need to be reasonably designed to ensure that the existing documentation complies with the rule before using it as the basis to enter into any new security-based swaps with that counterparty.

Second, Rule 15Fi-5(a)(1)(ii) provides an exception for any security-based swap that is, directly or indirectly, submitted to and cleared by a clearing agency registered pursuant to Section 17A of the Exchange Act or by a clearing agency that the Commission has exempted from registration by rule or order pursuant to Section 17A of the Exchange Act.<sup>142</sup> We included this exception in recognition of the fact that, once a security-based swap is cleared, the transaction is governed primarily by the terms of the agreements in effect between the clearing member and the clearing agency (as well as between the clearing member and its customer, if applicable). This exception has been modified from the proposal, as described in detail in Section II.A.6.

<sup>141</sup> As discussed in detail in Section II.F.1 of this release, the Commission also is amending Rules 17a-4 and 18a-6 under the Exchange Act to, among other things, require SBS Entities to retain all security-based swap trading relationship documentation with counterparties required to be created under Rule 15Fi-5. Because security-based swaps executed prior to the compliance date for Rule 15Fi-5 would be exempt from the underlying documentation requirement, any trading relationship documentation voluntarily entered into in respect of those transactions would not be deemed to have been created pursuant to Rule 15Fi-5.

<sup>142</sup> See *supra* note 85 and accompanying text.

Finally, Rule 15Fi-5(a)(1)(iii) provides an exception for security-based swaps executed anonymously on a national securities exchange or a security-based swap execution facility ("SB SEF"), provided that:

- Such security-based swaps are intended to be cleared and are actually submitted for clearing to a clearing agency;
- All terms of such security-based swaps conform to the rules of the clearing agency; and
- Upon acceptance of such security-based swap by the clearing agency: (1) The original security-based swap is extinguished; (2) the original security-based swap is replaced by equal and opposite security-based swaps with the clearing agency; and (3) all terms of the security-based swap shall conform to the product specifications of the cleared security-based swap established under the clearing agency's rules.

The exception in Rule 15Fi-5(a)(1)(iii) is intended to recognize the fact that the documentation requirements may be largely impossible to comply with in the context of cleared anonymous transactions because, by definition, the parties to these transactions would not know the identity their counterparties. Therefore, trading relationship documentation with any such counterparty would be unnecessary and impractical.

The exception provided for in Rule 15Fi-5(a)(1)(iii) is limited—and therefore distinguishable from the exception for cleared security-based swap transactions—in one important respect to account for instances where a transaction is not accepted for clearing following its submission. For example, an SBS Entity may enter into a security-based swap transaction on an anonymous basis on a national securities exchange or an SB SEF, fully intending for the transaction to be submitted to, and cleared by, a clearing agency. In some cases, the transaction may be rejected by the clearing agency for reasons which the SBS Entity did not know prior to its submission, such as possible operational or clerical errors or if one of the clearing members unintentionally exceeded its clearing limits. If a bilateral transaction continues to exist between the two counterparties (who would no longer be unknown to each other), written trading relationship documentation governing that transaction might not exist between them.

The Commission believes that under those circumstances the objectives of Rule 15Fi-5 would not be satisfied if the SBS Entity and its counterparty did not ultimately have written agreement on

the terms of the remaining security-based swap transaction. At the same time, however, because the transaction was initially entered into on an anonymous basis, the two sides might need additional time to agree to the terms of the trading relationship documentation, particularly if they previously had not engaged in any other transactions. Accordingly, if an SBS Entity that is relying on the exception in Rule 15Fi-5(a)(1)(iii) subsequently receives notice that the relevant security-based swap transaction has not been accepted for clearing by a clearing agency, the rule requires that the SBS Entity be in compliance with the requirements of Rule 15Fi-5 in all respects promptly after receipt of such notice (if a security-based swap continues to exist between the two counterparties after it has been rejected by the clearing agency).<sup>143</sup>

Whether a contract that has not been accepted for clearing by a clearing agency continues to exist may depend on the rules of the particular SB SEF, national securities exchange, or clearing agency, or the agreement of the counterparties. If the end result is that a security-based swap continues to exist despite being rejected by the clearing agency, then the policies and procedures would need to require that the SBS Entity be in compliance with the requirements of Rule 15Fi-5 with respect to that transaction. If the rejection from clearing results in a termination or voiding of the original security-based swap, then there is no security-based swap for which it is necessary to comply with Rule 15Fi-5.

Similarly, ISDA and SIFMA requested that the exception in Rule 15Fi-5(a)(1)(iii) be expanded to include all "intended to be cleared" ("ITBC") security-based swaps, consistent with CFTC Staff Letter 13-70, issued in 2013.<sup>144</sup> That no-action letter addresses the treatment of trading relationship documentation requirements in CFTC Rule § 23.504 and a number of specified provisions of the CFTC's business conduct standards in the context of ITBC swaps, which CFTC staff defined as swaps that (i) are of a type accepted for clearing by a derivatives clearing organizations ("DCO"), and (ii) are

<sup>143</sup> The provisions in Rule 15Fi-5(a)(iii) to account for cleared anonymous transactions that are submitted for clearing, but ultimately not accepted, are not included in CFTC Rule § 23.504. We have included this provision to account for situations when an SBS Entity could be otherwise deemed to be not in compliance with Rule 15Fi-5 due to a transaction being rejected for clearing for reasons which the SBS Entity did not know prior to when the transaction was submitted to the clearing agency.

<sup>144</sup> See ISDA/SIFMA Letter.

intended to be submitted for clearing contemporaneously with execution.<sup>145</sup>

After careful review and consideration of these comments, the Commission has determined not to modify Rule 15Fi-5(a)(1)(iii) to take into account CFTC Staff Letter 13-70. Because a number of variables included in CFTC Staff Letter 13-70 relate to aspects of Title VII that the Commission has not yet addressed, we believe that it would be premature to incorporate the exceptions contained in that letter into Rule 15Fi-5 at this time. For example, and as described above, certain of the fact patterns identified in the CFTC letter depend on whether the relevant swap is subject to a CFTC mandatory clearing determination. As the Commission has not yet made any such mandatory clearing determinations, we do not yet have a factual basis for assessing whether and to what extent a comparable condition should be reflected in Rule 15Fi-5.

Finally, the Commission recognizes that because the definition of “security-based swap execution facility” in Rule 15Fi-1(n) only includes an SB SEF that is registered with the Commission pursuant to section 3D of the Exchange Act, the exemption provided in Rule 15Fi-5(a)(1)(iii) will not be available to SBS Entities until such time as the Commission has finalized its SB SEF registration rules.<sup>146</sup> The Commission also has granted temporary exemptions

<sup>145</sup> See Swaps Intended to be Cleared CFTC Letter No. 13-70, No-Action Relief: Swaps Intended to be Cleared (Nov. 15, 2013), available at: <https://www.cftc.gov/sites/default/files/idc/groups/public/@lrllettergeneral/documents/letter/13-70.pdf>. The position in CFTC Staff Letter 13-70 applies to four specific fact patterns set forth in the letter. Those fact patterns differ based on certain variables, including, among other things, (1) whether the Swap Entity knows the identity of its counterparty prior to execution of the swap, (2) whether the ITBC swap is executed on or subject to the rules of a swap execution facility or a designated contract market, (3) whether the ITBC swap is of a type that was not being accepted for clearing by a DCO as of the date of the letter, (4) whether the ITBC swap is subject to a mandatory trading determination, and (5) whether the Swap Entity ensures that both parties submit the ITBC swap for clearing as quickly after execution as would be technologically practicable if fully automated systems were used. CFTC Staff Letter 13-70 also requires as conditions to all four scenarios that (i) the Swap Entity is either a clearing member of the DCO to which the ITBC swap will be submitted, or has entered into an agreement with a clearing member of such DCO for clearing of swaps of the same type as the ITBC swap; and (ii) the Swap Entity does not require the counterparty or its clearing FCM to enter into a breakage agreement or similar agreement as a condition to executing the ITBC swap.

<sup>146</sup> In February 2011, the Commission proposed rules providing for the registration and other requirements applicable to SB SEFs. See Registration and Regulation of Security-Based Swap Execution Facilities, Exchange Act Release No. 63825 (Feb. 2, 2011), 76 FR 10948 (Feb. 28, 2011). The Commission has not yet adopted these rules.

from the registration requirements for SB SEFs and from certain disclosure requirements in Section 3D(c) of the Exchange Act (“SB SEF Exemptions”).<sup>147</sup> The SB SEF Exemptions will expire on the earliest compliance date set forth in any of the final rules regarding registration of SB SEFs.<sup>148</sup> Accordingly, the Commission is taking the position that until such time as an SB SEF is required to register with the Commission, an SBS Entity may comply with the exemption from the trading relationship documentation requirements, as provided for in Rule 15Fi-5(a)(1)(iii), by executing a security-based swap on a trading platform that would be required to be registered with the Commission as an SB SEF, but for the relief provided by the SBS Exemptions.<sup>149</sup>

#### D. Amendments to Recordkeeping Rules

The Commission also is amending the recordkeeping, reporting, and notification requirements applicable to SBS Entities. With these amendments, SBS Entities will be required to make and keep current information relevant to each portfolio reconciliation and portfolio compression exercise in which it participates, and to retain a record of each valuation dispute notification required pursuant to Rule 15Fi-3(c), all security-based swap trading relationship documentation required to be created under Rule 15Fi-5, a record of the results of each audit of the SBS Entity’s security-based swap trading relationship documentation policies and procedures, as required pursuant to Rule 15Fi-5(c), and each policy and procedure created pursuant to Rules 15Fi-3 through 15Fi-5.

Specifically, the Commission is amending: (1) Existing Rule 17a-3 under the Exchange Act, which applies to SBS Entities that are also registered with the Commission as broker-dealers under Section 15(b) of the Exchange Act (“broker-dealer SBS Entities”), and (2) Rule 18a-5 under the Exchange Act, which applies to SBS Entities that are *not* also registered with the Commission as broker-dealers under Section 15(b) of

<sup>147</sup> See Temporary Exemptions and Other Temporary Relief, Together with Information on Compliance Dates for New Provisions of the Securities Exchange Act of 1934 Applicable to Security-Based Swaps, Exchange Act Release No. 64678 (June 15, 2011), 76 FR 36287, 36292-93, 36306 (June 22, 2011).

<sup>148</sup> See *id.*

<sup>149</sup> Of course, to rely on this Commission position, the SBS Entity also would need to ensure that it remains in compliance with the other requirements of Rule 15Fi-5(a)(1)(iii), such as the requirement that the transaction be executed anonymously and that it be intended to be cleared and actually submitted for clearing.

the Exchange Act (“stand-alone and bank SBS Entities”). As amended, these rules require each SBS Entity to make and keep current records of each security-based swap portfolio reconciliation, whether conducted pursuant to Rule 15Fi-3 or otherwise,<sup>150</sup> a copy of each valuation dispute notification required to be provided to the Commission pursuant to Rule 15Fi-3(c),<sup>151</sup> and a record of each bilateral offset and each bilateral portfolio compression exercise or multilateral portfolio compression exercise in which it participates, whether conducted pursuant to Rule 15Fi-4 or otherwise.<sup>152</sup>

With respect to the reconciliation requirement, the amendments require that these records include the dates of the security-based swap portfolio reconciliation, the number of portfolio reconciliation discrepancies, the number of security-based swap valuation disputes (including the time-to-resolution of each valuation dispute and the age of outstanding valuation disputes, categorized by transaction and counterparty), and the name of the third-party entity performing the security-based swap portfolio reconciliation, if any.<sup>153</sup> With respect to the valuation notification requirement, the amended rules require the retention of each notification required to be provided to the Commission pursuant to Rule 15Fi-3(c).<sup>154</sup> With respect to compression, the rules will now require that these records include the dates of the offset or compression, the security-based swaps included in the offset or compression, the identity of the counterparties participating in the offset or compression, the results of the compression, and the name of the third-party entity performing the offset or compression, if any.<sup>155</sup> The Commission believes that requiring SBS Entities to make and retain such records will, among other things, promote compliance with Rules 15Fi-3 and 15Fi-4, assist SBS Entities in the event that they need to resolve problems that relate to a previous reconciliation or compression, and assist Commission examiners in reviewing compliance with those rules.

<sup>150</sup> See Rules 17a-3(a)(31)(i), 18a-5(a)(18)(i), and 18a-5(b)(14)(i).

<sup>151</sup> See Rules 17a-3(a)(31)(ii), 18a-5(a)(18)(ii), and 18a-5(b)(14)(ii).

<sup>152</sup> See Rules 17a-3(a)(31)(iii), 18a-5(a)(18)(iii), and 18a-5(b)(14)(iii).

<sup>153</sup> See Rules 17a-3(a)(31)(i) and 18a-5(a)(18)(i) and (b)(14)(i).

<sup>154</sup> See Rules 17a-3(a)(31)(ii) and 18a-5(a)(18)(ii) and (b)(14)(ii).

<sup>155</sup> See Rules 17a-3(a)(31)(iii) and 18a-5(a)(18)(iii) and (b)(14)(iii).

In addition, the Commission is amending (1) Rule 17a-4 under the Exchange Act, which requires each applicable broker-dealer, including broker-dealer SBS Entities, to preserve certain records if the broker-dealer makes or receives the type of record and (2) Rule 18a-6 under the Exchange Act, which imposes parallel preservation requirements on stand-alone and bank SBS Entities. In particular, the amendments to Rules 17a-4 and 18a-6 require SBS Entities to retain certain of the records required to be made and kept under Rules 17a-3 and 18a-5, as amended, for at least three years, the first two years in an easily accessible place.<sup>156</sup> Those amended rules also require each SBS Entity to retain the following:

- The written policies and procedures required pursuant to Rules 15Fi-3, 15Fi-4, and 15Fi-5 until three years after termination of the use of the policies and procedures;<sup>157</sup>
- each written agreement with counterparties on the terms of portfolio reconciliation with those counterparties, as required to be created under Rules 15Fi-3(a)(1) and (b)(1) until three years after the termination of the agreement and all transactions governed thereby;<sup>158</sup>
- security-based swap trading relationship documentation with counterparties required to be created under Rule 15Fi-5, until three years after the termination of such documentation and all transactions governed thereby;<sup>159</sup> and
- a record of the results of each audit required to be performed pursuant to Rule 15Fi-5(c) until three years after the completion of the audit.<sup>160</sup>

The Commission believes that requiring the retention of the above records in accordance with the applicable rules will help ensure that those records are retained in a manner that would allow them to be readily accessible for Commission examiners.

Finally, in June 2019, the Commission adopted 17 CFR 240.18a-10 (Rule 18a-10), which established an alternative compliance mechanism for certain SBS dealers.<sup>161</sup> As originally adopted, Rule

18a-10 permits SBS dealers to elect to comply with the CFTC's capital, margin, and segregation requirements in lieu of complying with the Commission's capital, margin, and segregation requirements of 17 CFR 240.18a-1 (Rule 18a-1) and Rules 18a-3 and 18a-4, subject to certain conditions. The Commission recently amended Rule 18a-10 to permit firms that will operate under Rule 18a-10 to elect to also comply with the CFTC's recordkeeping and reporting requirements in lieu of complying with Rules 18a-5 and 18a-6 and 17 CFR 240.18a-7, 240.18a-8, and 240.18a-9 (Rules 18a-7, 18a-8, and 18a-9).<sup>162</sup> Accordingly, SBS dealers that satisfy the conditions of Rule 18a-10 and that elect to comply with the CFTC's recordkeeping and reporting requirements will be able to comply with Rules 18a-5 and 18a-6, as amended by the final rules to incorporate records related to Rules 15Fi-3, 15Fi-4, and 15Fi-5.

### III. Cross-Border Application of Rules 15Fi-3, 15Fi-4, and 15Fi-5

#### A. Background on the Cross-Border Application of Title VII Requirements

In 2013, the Commission proposed rules and interpretive guidance to address the cross-border application of Title VII, including requirements applicable to SBS Entities.<sup>163</sup> In that proposal, the Commission preliminarily interpreted the Title VII requirements associated with registration to apply generally to the activities of registered entities.<sup>164</sup> In reaching that preliminary conclusion, the Commission did not concur with the views of certain commenters that the Title VII requirements should not apply to the foreign security-based swap activities of registered entities, stating that such a

thresholds are designed to limit the availability of the alternative compliance mechanism to firms whose security-based swaps business is not a significant part of the security-based swap market and that are predominately engaged in a swaps business as compared to a security-based swaps business. See *Capital, Margin, and Segregation Adopting Release*, 84 FR at 43943-46.

<sup>162</sup> See *Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers*, Exchange Act Release No. 87005 (Sept. 19, 2019), 84 FR 68550 (Dec. 16, 2019) (“*Recordkeeping and Reporting Adopting Release*”).

<sup>163</sup> See *Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants*, Exchange Act Release No. 69490 (May 1, 2013), 78 FR 30968 (May 23, 2013) (“*Cross-Border Proposing Release*”) (discussing joint rulemaking to further define various Title VII terms).

<sup>164</sup> See *Trade Acknowledgment and Verification Adopting Release*, 81 FR at 39825, n.191 (citing *Cross-Border Proposing Release*, 78 FR at 30986).

view could be difficult to reconcile with, among other things, the statutory language describing the requirements applicable to SBSDs.<sup>165</sup>

Although the Cross-Border Proposing Release preliminarily identified the trade acknowledgment and verification rules as entity-level requirements, it did not propose a cross-border interpretation with respect to the portfolio reconciliation, portfolio compression, and trading relationship documentation requirements.<sup>166</sup> Consequently, and consistent with the approach in both the Cross-Border Proposing Release and the Trade Acknowledgment and Verification Adopting Release, the Commission proposed that the portfolio reconciliation, portfolio compression, and trading relationship documentation requirements in Rules 15Fi-3 through 15Fi-5 should be treated as entity-level requirements.<sup>167</sup>

#### B. Final Cross-Border Interpretation

The Commission received no comments on its proposed cross-border interpretation in the Proposing Release. Accordingly, the Commission concludes that it is treating the portfolio reconciliation, portfolio compression, and trading relationship documentation requirements in Rules 15Fi-3 through 15Fi-5 as entity-level requirements that apply to an SBS Entity's entire security-based swap business without exception, including in connection with any security-based swap business it conducts with foreign counterparties.

As we explained in the Proposing Release, the requirements referenced above play an important role in addressing risks to the SBS Entity as a whole, including risks related to the entity's safety and soundness. As we have noted throughout this release in connection with describing each of the new rules, requiring SBS Entities and their counterparties to identify and resolve discrepancies involving key terms of their security-based swap transactions is a key consideration

<sup>165</sup> See *Cross-Border Proposing Release*, 78 FR at 30986. The Proposing Release also contains a more detailed background discussion of the Commission's taxonomy for classifying requirements under Section 15F of the Exchange Act as applying at either the transaction-level or at the entity-level. See *Proposing Release*, 84 FR at 4636-4637 (citing *Cross-Border Proposing Release*, 78 FR at 31009-10).

<sup>166</sup> See *Cross-Border Proposing Release*, 78 FR at 31013. The Commission subsequently adopted its proposed cross-border interpretation of the trade acknowledgment and verification rules as entity-level requirements in connection with adopting those underlying rules in 2016. See *Trade Acknowledgment and Verification Adopting Release*, 81 FR at 39826.

<sup>167</sup> See *Proposing Release*, 84 FR at 4637.

<sup>156</sup> See Rules 17a-4(b)(1) and 18a-6(b)(1)(i) and (b)(2)(i).

<sup>157</sup> See Rules 17a-4(e)(11) and 18a-6(d)(4).

<sup>158</sup> See Rules 17a-4(e)(12)(i) and 18a-6(d)(5)(i).

<sup>159</sup> See Rules 17a-4(e)(12)(ii) and 18a-6(d)(5)(ii).

<sup>160</sup> See Rules 17a-4(e)(12)(iii) and 18a-6(d)(5)(iii).

<sup>161</sup> See 17 CFR 240.18a-10. Among other things, the SBS dealer must (1) be registered with the Commission as a stand-alone SBS dealer (*i.e.*, not also registered with the Commission as a broker-dealer or an OTC derivatives dealer), (2) be registered with the CFTC as a swap dealer, and (3) not exceed certain thresholds with respect to its outstanding security-based swap positions. Those

underpinning both the portfolio reconciliation and trading relationship documentation requirements, and serves as an important mechanism for encouraging SBS Entities and their counterparties to better manage their internal risks.<sup>168</sup> Similarly, portfolio compression is intended to help SBS Entities and their counterparties and their counterparties manage their post-trade risks associated with security-based swap transactions in a number of important ways, including by eliminating redundant uncleared transactions (as measured both by the number of contracts and total notional value) and potentially reducing a market participant's credit risk to its direct counterparties, including by eliminating all outstanding transactions with some counterparties, without affecting the market participant's overall economic position.<sup>169</sup>

In the alternative, not requiring an SBS Entity to take steps to manage its internal risk using portfolio reconciliation, compression, or standards governing trading relationship documentation could be expected to contribute to operational risk and legal uncertainty throughout the firm's entire security-based swap business, affecting the entity's business as a whole, and not merely specific security-based swap transactions. For example, as we have previously noted, inaccurate or incomplete trading relationship documentation could lead to, among other things, a collateral dispute between the counterparties to a security-based swap transaction. The larger the dispute, even if confined to a single counterparty, the greater the risk that an SBS Entity could experience liquidity problems on a firmwide basis.

Moreover, to the extent that these risks affect the safety and soundness of the SBS Entity, they also may affect the firm's counterparties and the functioning of the broader security-based swap market. Continuing with the previous example, if a collateral dispute with a foreign counterparty creates liquidity issues throughout an SBS Entity, the firm could experience difficulty making payments or posting collateral to its other counterparties, which may include U.S. persons. Accordingly, the Commission concludes that it is appropriate to apply the requirements in Rules 15Fi-3, 15Fi-4, and 15Fi-5 to the entirety of an SBS Entity's security-based swap business.<sup>170</sup>

#### IV. Availability of Substituted Compliance for Rules 15Fi-3 Through 15Fi-5

##### A. Existing Substituted Compliance Rule

In 2013, the Commission proposed to make substituted compliance potentially available in connection with the requirements applicable to foreign SBS dealers pursuant to Section 15F of the Exchange Act, other than the registration requirements applicable to dealers.<sup>171</sup> Because the portfolio reconciliation, portfolio compression, and trading relationship documentation requirements being adopted are grounded in Section 15F, substituted compliance generally would have been available for those requirements pursuant to the 2013 proposal.

The Commission subsequently adopted Rule 3a71-6, which provides that substituted compliance is available with respect to the Commission's business conduct requirements, and (rather than addressing all requirements under Section 15F of the Exchange Act) reserved the issue as to whether substituted compliance also would be available in connection with other requirements under that section.<sup>172</sup> Rule 3a71-6 was subsequently amended to provide SBS Entities with the potential to avail themselves of substituted compliance with respect to the following Title VII requirements: (1) Trade acknowledgment and verification,<sup>173</sup> (2) capital and margin,<sup>174</sup> and (3) recordkeeping and reporting.<sup>175</sup>

##### B. Amendments to Rule 3a71-6

In the Proposing Release, the Commission proposed to further amend Rule 3a71-6 to provide SBS Entities that are not U.S. persons (as defined in 17 CFR 240.3a71-3(a)(4) (Rule 3a71-3(a)(4) of the Exchange Act)) with the potential to avail themselves of substituted

requirements pursuant to the CEA, classifying them as what the CFTC has termed "Category A" transaction-level requirements. See CFTC Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations, 78 FR 45292, 45334 (Jul. 26, 2013).

<sup>171</sup> See Cross-Border Proposing Release, 78 FR at 30968, 31085.

<sup>172</sup> See Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, Release No. 77617 (Apr. 14, 2016), 81 FR 29960 ("Business Conduct Standards Adopting Release"). See also Cross-Border Proposing Release, 78 FR at 31088, 31207-08 (Rule 3a71-6 was proposed as Rule 3a71-5).

<sup>173</sup> See Trade Acknowledgment and Verification Adopting Release, 81 FR at 39827-28.

<sup>174</sup> See Capital, Margin, and Segregation Adopting Release, 84 FR at 43948-57.

<sup>175</sup> See Recordkeeping and Reporting Adopting Release, 84 FR at 68597-99.

compliance to satisfy the Title VII portfolio reconciliation, portfolio compression, and trading relationship documentation requirements.<sup>176</sup> In their comment letter, ISDA and SIFMA agreed with the proposed outcomes-based approach to substituted compliance, as opposed to issuing comparability determinations based on a line-by-line review of the foreign requirements.<sup>177</sup> ISDA and SIFMA also suggested that the Commission should, in essence, not diverge from any comparability determination previously made by the CFTC with respect to the portfolio reconciliation, portfolio compression, and trading relationship documentation requirements.<sup>178</sup> As noted previously, the Commission has endeavored to harmonize these rules with the corresponding CFTC rules wherever possible, which should make divergence with respect to an outcomes-based comparability analysis of the rules highly unlikely. Substituted compliance, however, involves additional considerations and arrangements, particularly with respect to supervisory and enforcement cooperation.<sup>179</sup> We are therefore adopting the amendments to Rule 3a71-6, as proposed. Accordingly, Rule 3a71-6(d)(7) provides foreign SBS Entities<sup>180</sup>

<sup>176</sup> See Proposing Release, 84 FR at 4638. We did not propose rules making substituted compliance available specifically with respect to the amendments to Rules 18a-5 and 18a-6, which specify the recordkeeping and reporting requirements applicable to SBS Entities. This is because the Commission has also adopted amendments to Rule 3a71-6 with respect to Title VII recordkeeping and reporting requirements in connection with adopting those underlying provisions. See Recordkeeping and Reporting Adopting Release, 84 FR 68597-99. Accordingly, to the extent that substituted compliance is made available with respect to those rules, we would anticipate that any determination made with respect to the comparability of the foreign financial regulatory system would address all aspects of the Commission recordkeeping and reporting requirements for SBS Entities including the amendments we are adopting with respect to the portfolio reconciliation, portfolio compression, and trading relationship document requirements.

<sup>177</sup> See ISDA/SIFMA Letter.

<sup>178</sup> See *id.*

<sup>179</sup> See 17 CFR 240.3a71-6(a)(2)(i) and (ii).

<sup>180</sup> In the Business Conduct Standards Adopting Release, the Commission stated that Rule 3a71-6 provides that substituted compliance is potentially available in connection with the business conduct requirements for registered major SBS participants as well as for registered SBS dealers. The Commission further explained that such decision reflects the fact that the business conduct standards apply to registered major SBS participants as well as to registered SBS dealers, and recognizes that the market efficiency goals that underpin substituted compliance also can apply when substituted compliance is granted to registered major SBS participants. See Business Conduct Standards Adopting Release, 81 FR at 30076. This same reasoning applies with respect to the Commission's portfolio reconciliation, portfolio compression, and

Continued

<sup>168</sup> See *supra* note 11 and accompanying text.

<sup>169</sup> See *supra* notes 16-18 and accompanying text.

<sup>170</sup> We recognize that the CFTC has taken a different position with regard to corresponding

with the potential to utilize substituted compliance with comparable foreign requirements to satisfy Section 15F(i) of the Exchange Act and Rules 15Fi-3, 15Fi-4, and 15Fi-5 thereunder.<sup>181</sup>

In amending Rule 3a71-6, the Commission concludes that the principles associated with substituted compliance for the business conduct, trade acknowledgment and verification, capital and margin, and recordkeeping and reporting requirements in large part similarly apply to the portfolio reconciliation, portfolio compression, and trading relationship documentation requirements.<sup>182</sup> Accordingly, except as discussed below, the revised substituted compliance rule applies to Section 15F(i) of the Exchange Act and Rules 15Fi-3, 15Fi-4, and 15Fi-5 thereunder in the same manner as it applies to the business conduct, trade acknowledgment and verification, capital and margin, and recordkeeping and reporting requirements.

#### 1. Basis for Substituted Compliance in Connection With the Portfolio Reconciliation, Portfolio Compression, and Trading Relationship Documentation Requirements

In light of the global nature of the security-based swap market and the prevalence of cross-border transactions within that market, there is the potential that the application of the Title VII portfolio reconciliation, portfolio compression, and trading relationship documentation requirements may lead to requirements that are duplicative of, or in conflict with, applicable foreign requirements, even when the two sets of requirements implement similar goals and lead to similar results. Those results have the potential to disrupt existing business relationships and, more

trading relationship documentation requirements and Rule 3a71-6, as amended, provides that substituted compliance is also potentially available to foreign major SBS participants (in addition to foreign SBS dealers) with respect to Section 15F(i) of the Exchange Act and Rules 15Fi-3, 15Fi-4, and 15Fi-5, as applicable.

<sup>181</sup> In the Proposing Release, these requirements would have been designated as paragraph (d)(3) of Rule 3a71-6. Because of subsequent amendments to that rule, however, the provision applicable to the portfolio reconciliation, portfolio compression, and trading relationship documentation requirements is now being adopted as paragraph (d)(7).

<sup>182</sup> The discussions in the Business Conduct Standards Adopting Release, including those regarding consideration of supervisory and enforcement practices (see Business Conduct Standards Adopting Release, 81 FR at 30079), regarding certain multi-jurisdictional issues (see *id.* at 30079-80), and regarding application procedures (see *id.* at 30080-81) are applicable to the portfolio reconciliation, portfolio compression, and trading relationship documentation requirements.

generally, to reduce competition and market efficiency.<sup>183</sup>

To address those effects, the Commission concludes that under certain circumstances it is appropriate to allow the possibility of substituted compliance, whereby foreign SBS Entities may satisfy Section 15F of the Exchange Act and the portfolio reconciliation, portfolio compression, and trading relationship documentation requirements in Rules 15Fi-3, 15Fi-4, and 15Fi-5, respectively, by complying with the comparable foreign requirements. Allowing for the possibility of substituted compliance in this manner may be expected to help achieve the benefits of those particular risk mitigation requirements—helping to curb legal uncertainty and reduce credit and operational risk for participants in security-based swap transactions and in the broader market—in a way that helps avoid regulatory conflict and minimizes duplication, thereby promoting market efficiency, enhancing competition, and contributing to the overall functioning of the global security-based swap market. Accordingly, Rule 3a71-6 is amended to identify the portfolio reconciliation, portfolio compression, and trading relationship documentation requirements of Section 15F(i) of the Exchange Act and Rules 15Fi-3, 15Fi-4, and 15Fi-5 thereunder as being eligible for substituted compliance.<sup>184</sup>

#### 2. Comparability Criteria, and Consideration of Related Requirements

The Commission will endeavor to take a holistic approach in determining the comparability of foreign requirements for substituted compliance purposes, focusing on regulatory outcomes as a whole, rather than on requirement-by-requirement similarity.<sup>185</sup> The Commission's comparability assessments associated with Section 15F(i) and Rules 15Fi-3, 15Fi-4, and 15Fi-5 thereunder

<sup>183</sup> See generally Business Conduct Standards Adopting Release, 81 FR at 30073-74 (addressing the basis for making substituted compliance available in the context of the business conduct requirements).

<sup>184</sup> See paragraph (d) of Rule 3a71-6, as adopted. Paragraph (a)(1) of the rule provides that the Commission may, conditionally or unconditionally, by order, make a determination with respect to a foreign financial regulatory system that compliance with specified requirements under the foreign financial system by an SBS dealer and/or by a registered major SBS swap participant, or class thereof, may satisfy the corresponding requirements identified in paragraph (d) of the rule that would otherwise apply.

<sup>185</sup> See Business Conduct Standards Adopting Release, 81 FR at 30078-79. See also Trade Acknowledgment and Verification Adopting Release, 81 FR at 39828.

accordingly will consider whether, in the Commission's view, the foreign regulatory system achieves regulatory outcomes that are comparable to the regulatory outcomes associated with those Exchange Act requirements. However, paragraph (a)(2)(i) of Rule 3a71-6 provides that the Commission's substituted compliance determination will take into account factors that the Commission determines appropriate, such as, for example, the scope and objectives of the relevant foreign regulatory requirements (taking into account the applicable criteria set forth in paragraph (d) of the rule, which sets forth the list of requirements eligible for substituted compliance), as well as the effectiveness of the supervisory compliance program administered, and the enforcement authority exercised, by a foreign financial regulatory authority or authorities in such system to support its oversight of such foreign security-based swap entity (or class thereof) or of the activities of such security-based swap entity (or class thereof).

In light of these considerations, paragraph (d)(7) of Rule 3a71-6 states that prior to making a substituted compliance determination in connection with the portfolio reconciliation, portfolio compression, and trading relationship documentation requirements, the Commission intends to consider whether the requirements of the foreign financial regulatory system, the duties imposed by the foreign financial regulatory system, and the information that is required to be provided to counterparties pursuant to the requirements of the foreign financial regulatory system, are comparable to those required pursuant to the applicable provisions under the Exchange Act.

In reviewing applications, the Commission may determine to conduct its comparability analyses regarding the portfolio reconciliation, portfolio compression, and trading relationship documentation requirements in conjunction with comparability analyses regarding other Exchange Act requirements that, like the requirements in these final rules, promote risk mitigation in connection with SBS Entities. Accordingly, depending on the applicable facts and circumstances, the comparability assessment associated with the portfolio reconciliation, portfolio compression, and trading relationship documentation requirements may constitute part of a broader assessment of Exchange Act risk mitigation requirements, and the applicable comparability decisions may be made at the level of those risk mitigation requirements as a whole.

## V. Explanation of Dates

### A. Effective Date

These final rules will be effective 60 days after the date of this release's publication in the **Federal Register**.

### B. Compliance Date

The compliance date for the final rules, other than the amendments to Rule 3a71-6 (as discussed below), will be the same as the compliance date for the registration of SBS Entities (the "Registration Compliance Date").<sup>186</sup> Specifically, the Registration Compliance Date will be 18 months after the effective date of the final rules set forth in the Cross-Border Amendments Adopting Release.<sup>187</sup> The Commission believes that this compliance date should allow sufficient time for SBS Entities to prepare for and come into compliance with the new portfolio reconciliation, portfolio compression, and trading relationship documentation requirements.

In addition, these final rules are in many respects intended to complement and work in coordination with other Title VII requirements for which compliance will also be required as of the Registration Compliance Date. For example, Rules 15Fi-3 (portfolio reconciliation) and 15Fi-5 (written trading relationship documentation) both contain requirements that are intended to help ensure that the counterparties to a security-based swap agree on the methodology for determining the valuation of the security-based swap and for detecting and resolving any discrepancies with respect to that valuation, if necessary. As we noted in Section I, the valuation of an uncleared security-based swap is critical for determining, among other things, the amount of margin that would be required to be collected from the security-based swap counterparty and

<sup>186</sup> See Cross-Border Amendments Adopting Release, *supra* note 51. Moreover, the Registration Compliance Date also will be the compliance date for: (1) Nonbank SBS Entity capital and margin requirements; (2) SBS Entity participant segregation requirements; (3) SBS Entity participant business conduct and chief compliance officer requirements; (4) SBS Entity trade acknowledgment and verification requirements; and SBS Entity recordkeeping and reporting requirements. See Capital, Margin, and Segregation Adopting Release, 84 FR at 43954; Business Conduct Standards Adopting Release, 81 FR at 30081-82; Trade Acknowledgment and Verification Adopting Release, 81 FR at 39828-29; and Recordkeeping and Reporting Adopting Release, 84 FR at 68600-01.

<sup>187</sup> As explained in the Cross-Border Amendments Adopting Release, the effective date of those final rules will be the later of March 1, 2020, or 60 days following publication of the Cross-Border Amendments Adopting Release in the **Federal Register**. See Cross-Border Amendments Adopting Release, *supra* note 51.

for calculating potential capital charges applicable to the SBS Entity. We also discussed in Section I the relationship between the Title VII trade acknowledgment and verification process and the portfolio reconciliation process. Further, these final rules supplement the recordkeeping and reporting requirements for security-based swaps that the Commission adopted in September 2019, which also use the Registration Compliance Date. Accordingly, the Commission believes it to be both practical and efficient to require SBS Entities to begin complying with the rules we are adopting in this release on the same date on which compliance with those other rules will be required.

### C. Application to Substituted Compliance

For the amendments to Rule 3a71-6, the Commission is adopting an effective date of 60 days following publication in the **Federal Register**.<sup>188</sup> There will be no separate compliance date in connection with that rule amendment, as the rule does not impose obligations upon Swap Entities. Rather, those amendments provide foreign SBS Entities with the potential to utilize substituted compliance with comparable foreign requirements to satisfy Section 15F(i) of the Exchange Act and new Rules 15Fi-3, 15Fi-4, and 15Fi-5 thereunder.

SBS Entities will not be required to comply with the portfolio reconciliation, portfolio compression, and trading relationship documentation requirements until they are registered, and the registration requirement for those entities will not be triggered until a number of regulatory benchmarks have been met. In practice, the Commission recognizes that if the requirements of a foreign regime are comparable to the corresponding Title VII requirements, and the other prerequisites to substituted compliance also have been satisfied, then it may be appropriate to permit an SBS Entity to rely on substituted compliance commencing at the time that entity is registered with the Commission. Accordingly, and to alleviate any concerns that the compliance date could be before substituted compliance determinations are made, the Commission would consider substituted compliance requests that are submitted prior to the compliance date for the portfolio reconciliation, portfolio

<sup>188</sup> The Commission has taken a similar approach in connection with other recent amendments to Rule 3a71-6. See, e.g., Recordkeeping and Reporting Adopting Release, 84 FR at 68602.

compression, and trading relationship documentation requirements.

## VI. Paperwork Reduction Act

Certain provisions of the final rules and rule amendments being adopted in this release contain new or modified "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").<sup>189</sup> The Commission submitted these collections of information to OMB for review in accordance with the PRA.<sup>190</sup> The Commission did not receive any comments on the PRA estimates included in the Proposing Release. However, the Commission's earlier PRA assessments have been revised solely with respect to the number of respondents that we expect to be registered with both the Commission and the CFTC, as discussed below. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.

Specifically, Rules 15Fi-3, 15Fi-4, and 15Fi-5 impose new collection of information requirements. The title of these new collections of information is, collectively, "Rules 15Fi-3—15Fi-5—Risk Mitigation Techniques for Uncleared Security-Based Swaps." OMB has not yet assigned a control number to these new collections of information. In addition, the amendments to Rules 3a71-6, 17a-3, 17a-4, 18a-5, and 18a-6 modify already-existing collection of information requirements. The titles and control numbers for these collections of information are as follows:

(1) Rule 17a-3—Records to be made by certain brokers and dealers (OMB control number 3235-0033);

(2) Rule 17a-4—Records to be preserved by certain brokers and dealers (OMB control number 3235-0279);

(3) Rule 18a-5—Records to be made by certain security-based swap dealers and major security-based swap participants (OMB control number 3235-0745);

(4) Rule 18a-6—Records to be preserved by certain security-based swap dealers and major security-based swap participants (OMB control number 3235-0751); and

(5) Rule 3a71-6—Substituted Compliance for Foreign Security-Based Swap Dealers (OMB control number 3235-0715).

<sup>189</sup> 44 U.S.C. 3501 *et seq.*

<sup>190</sup> See 44 U.S.C. 3507(d); see also 5 CFR 1320.11.

### A. Summary of Collections of Information

#### 1. Rule 15Fi-3: Portfolio Reconciliation

Rule 15Fi-3 generally requires SBS Entities to (1) engage in periodic portfolio reconciliation activities with counterparties who are also SBS Entities, and (2) establish, maintain, and follow written policies and procedures reasonably designed to ensure that they engage in periodic portfolio reconciliation with counterparties who are not SBS Entities.<sup>191</sup> Among other things, Rule 15Fi-3 specifies the requirements applicable to an SBS Entity for purposes of engaging in portfolio reconciliation with either type of counterparty (as well as the applicable definitions), with regard to (1) the information that the two sides are required to exchange as part of the reconciliation process,<sup>192</sup> (2) the frequency by which an SBS Entity is required to reconcile its security-based swap portfolios with its counterparties,<sup>193</sup> (3) the required policies and procedures specifying the means and timeframes by which an SBS Entity is required to resolve discrepancies with respect to either the valuation or a material term of a security-based swap,<sup>194</sup> and (4) the requirement that an SBS Entity agree in writing with each of its counterparties on the terms of the portfolio reconciliation, including agreement of the selection of any third-party service provider.<sup>195</sup> Finally, Rule 15Fi-3(c) requires an SBS Entity to promptly notify the Commission of any security-based swap valuation dispute in excess of \$20,000,000 (or its equivalent in any other currency) if not resolved within: (1) Three business days, if the dispute is with a counterparty that is an SBS Entity; or (2) five business days, if the dispute is with a counterparty that is not an SBS Entity.<sup>196</sup>

<sup>191</sup> Rule 15Fi-3 does not apply to any security-based swap that has a clearing agency as a direct counterparty.

<sup>192</sup> See *supra* Section II.B.1.

<sup>193</sup> See *supra* Sections II.B.2 and II.B.4.

<sup>194</sup> See *supra* Sections II.B.3 and II.B.4.

<sup>195</sup> See *supra* Sections II.B.2 and II.B.4.

<sup>196</sup> See *supra* Section II.B.5. Rule 15Fi-3(c) also requires SBS Entities to notify the Commission, in a form and manner acceptable to the Commission, and any applicable prudential regulator, if the amount of any security-based swap valuation dispute that was the subject of a previous notice increases or decreases by more than \$20,000,000 (or its equivalent in any other currency), at either the transaction or portfolio level. Each amended notice is required to be provided to the Commission and any applicable prudential regulator no later than the last business day of the calendar month in which the applicable security-based swap valuation dispute increases or decreases by the applicable dispute amount.

#### 2. Rule 15Fi-4: Portfolio Compression

Rule 15Fi-4 requires SBS Entities to establish, maintain, and follow written policies and procedures related to bilateral offsetting of security-based swaps, and periodic bilateral and multilateral compression exercises. Specifically, Rules 15Fi-4(a)(2) and (3) requires each SBS Entity to establish, maintain, and follow written policies and procedures for periodically engaging in both bilateral portfolio compression exercises and multilateral portfolio compression exercises, in each case when appropriate, with each counterparty that is an SBS Entity.<sup>197</sup> Similarly, Rule 15Fi-4(a)(1) requires each SBS Entity to establish, maintain, and follow written policies and procedures for terminating each “fully offsetting security-based swap” that it maintains with another SBS Entity in a timely fashion, when appropriate.<sup>198</sup> To the extent that an SBS Entity transacts with a counterparty that is *not* an SBS Entity, Rule 15Fi-4(b) provides that such policies and procedures will only need to address terminating each “fully offsetting security-based swap” or engaging in a bilateral or multilateral portfolio compression exercise, when appropriate and to the extent requested by any such counterparty.<sup>199</sup>

#### 3. Rule 15Fi-5: Written Trading Relationship Documentation

Rule 15Fi-5 requires that each SBS Entity to establish, maintain, and follow written policies and procedures reasonably designed to ensure that it executes written trading relationship documentation with each of its counterparties, subject to certain exceptions, prior to, or contemporaneously with, executing a security-based swap transaction, in each case in the manner as provided for in the rule.<sup>200</sup> The rule also requires that the trading relationship documentation include (1) credit support arrangements addressing certain specified items related to, among other things, margin haircuts, and custody of margin assets<sup>201</sup> and (2) agreements regarding the means by which the counterparties would determine the value of each

<sup>197</sup> See *supra* Section II.C.1.

<sup>198</sup> See *supra* Section II.C.2.

<sup>199</sup> See *supra* Section II.C.1 and II.C.2.

<sup>200</sup> See *supra* Section II.C.1. Rule 15Fi-5 also requires that the security-based swap trading relationship documentation address, among other things, 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, governing law, valuation and dispute resolution.

<sup>201</sup> See *id.*

security-based swap.<sup>202</sup> Rule 15Fi-5 also contains requirements for SBS Entities and their counterparties to disclose to each other certain information regarding their legal and bankruptcy status, and to include a statement regarding the status of a security-based swap if accepted for clearing by a CCP.<sup>203</sup> Finally, the rule requires 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 the rule.<sup>204</sup>

#### 4. Amendments to Rules 17a-3, 17a-4, 18a-5, and 18a-6: Books and Records Requirements

Rule 17a-3 requires a broker-dealer to make and keep current certain records and Rule 17a-4 requires a broker-dealer to preserve certain records if it makes or receives them.<sup>205</sup> The Commission is amending these existing rules to account for the security-based swap risk mitigation activities of broker-dealers, including broker-dealer SBS Entities, by requiring the making and preserving of any required records regarding portfolio reconciliation, bilateral offsets, bilateral or multilateral portfolio compression, valuation disputes, and written trading relationship documentation. With respect to stand-alone SBS Entities, the Commission is amending Rules 18a-5 and 18a-6—which the Commission adopted in September of this year and are themselves modeled on Rules 17a-3 and 17a-4—to account for these same risk mitigation requirements.<sup>206</sup>

#### 5. Amendment to Rule 3a71-6: Substituted Compliance

The amendment to Rule 3a71-6 permits non-U.S. SBS Entities to comply with the portfolio reconciliation, portfolio compression, and written trading relationship documentation requirements by following the comparable regulatory requirements of a foreign financial regulatory system. Specifically, the amendment adds Rules 15Fi-3, 15Fi-4, and 15Fi-5 to the list of Commission requirements eligible for a substituted compliance determination and sets forth the standard by which the Commission would make such a determination.<sup>207</sup>

<sup>202</sup> See *supra* Section II.C.2.

<sup>203</sup> See *supra* Section II.C.3.

<sup>204</sup> See *supra* Section I.D.5.

<sup>205</sup> 17 CFR 240.17a-3; 17 CFR 240.17a-4.

<sup>206</sup> See *supra* Section I.F.1.

<sup>207</sup> See *supra* Sections IV.B.1 and IV.B.2.

## B. Use of Information

### 1. Rule 15Fi-3: Portfolio Reconciliation

As previously noted, the Commission believes that the information shared by counterparties to a security-based swap transaction periodically during the portfolio reconciliation process, as contemplated by Rule 15Fi-3, will play an important role in assisting those counterparties in identifying and resolving discrepancies involving key terms of their transactions on an ongoing basis. This information also should allow those counterparties to improve their management of internal risks related to the enforcement of their rights and the performance of their obligations under a security-based swap. For example, the information obtained and provided in the course of portfolio reconciliation should help ensure that the counterparties to a security-based swap are and remain in agreement with respect to all material terms throughout the life of the transaction, thereby mitigating the possibility that a discrepancy could unexpectedly affect either side's ability to perform any or all of its obligations under the contract, including those obligations related to the posting of collateral. Moreover, requiring SBS Entities to agree in writing with each of their counterparties on the terms of the portfolio reconciliation (including, if applicable, agreement on the selection of any third party service provider who may be performing the reconciliation) should help to minimize any discrepancies regarding the portfolio reconciliation process itself, thereby ensuring that it operates in as efficient and cost-effective means possible. Finally, the requirement to report certain unresolved valuation disputes to the Commission should assist the Commission in identifying potential issues with respect to an SBS Entity's internal valuation methodology and also could serve as an indication of a widespread market disruption in cases where the Commission receives a large number of such notices from multiple firms.

### 2. Rule 15Fi-4: Portfolio Compression

As previously discussed, the Commission believes that Rule 15Fi-4 will help market participants by eliminating redundant uncleared derivatives contracts, thereby potentially reducing a market participant's credit risk to its direct counterparties, including by eliminating all outstanding contracts with some counterparties, without affecting the market participant's overall economic position. In addition, we believe that the collection of information should lead to

processing improvements for market participants, as envisioned by Section 15F(i) of the Exchange Act, by virtue of the fact that both SBS Entities and their counterparties should ultimately have fewer trades to manage, maintain, and settle, resulting in fewer opportunities for processing errors, failures, or other problems that could develop throughout the lifecycle of a transaction.

### 3. Rule 15Fi-5: Written Trading Relationship Documentation

The Commission believes that the information required to be contained in the written trading relationship documentation pursuant to Rule 15Fi-5 should help ensure that each SBS Entity mitigates risk with respect to its security-based swap portfolio by, among other things, enhancing clarity and legal certainty from the outset of a transaction regarding each party's rights and obligations. This outcome should help to reduce exposure to, among other things, counterparty credit risk and promote agreement regarding the proper valuation and other material terms of a security-based swap.

### 4. Amendments to Rules 17a-3, 17a-4, 18a-5, and 18a-6: Books and Records Requirements

The Commission expects that the information contained in the records required to be made and kept pursuant to the amendments to Rules 17a-3, 17a-4, 18a-5, and 18a-6 would be used to assist the Commission in its oversight of SBS Entities. In addition, records regarding portfolio reconciliation, bilateral offsets, bilateral or multilateral portfolio compression, valuation disputes, and written trading relationship documentation should help to provide SBS Entities and their counterparties to security-based swaps with an ability to identify and resolve discrepancies involving key terms of their transactions on an ongoing basis, allowing for better management of internal risks related to performance of obligations, valuation, margin obligations, internal valuation systems and models, or internal controls.

### 5. Amendment to Rule 3a71-6: Substituted Compliance

Under the amendment to Rule 3a71-6 under the Exchange Act, the Commission would use the information collected to evaluate requests for substituted compliance with respect to the portfolio reconciliation, portfolio compression, and written trading relationship documentation requirements applicable to SBS Entities.

## C. Respondents

The Commission estimated the number of respondents in the Proposing Release. The Commission received no comment on these estimates. However, the Commission is updating the number of SBS Entities that we estimate to be dually-registered with the CFTC as Swap Entities in order to be consistent with the most recent estimates used in other Commission rulemakings.<sup>208</sup> Rules 15Fi-3, 15Fi-4, and 15Fi-5, and the amendments to Rules 17a-3, 17a-4, 18a-5, and 18a-6 apply only to SBS Entities, each of which will be registered with the Commission. Consistent with prior releases, the Commission estimates that 50 or fewer entities ultimately may be required to register with the Commission as SBS dealers.<sup>209</sup> We also previously estimated that the number of major SBS participants likely will be five or fewer and, in actuality, may be zero.<sup>210</sup> The Commission continues to believe that these estimates are appropriate. Thus, the Commission believes that approximately 55 entities will be required to register with the Commission under either category, and will therefore be subject to Rules 15Fi-3 through 15Fi-5.

In the Proposing Release, the Commission estimated that of the 55 entities that may register with the Commission as SBS Entities, approximately 35 will be dually-registered with the CFTC as Swap Entities.<sup>211</sup> In a more recent release, however, the Commission updated that estimate, such that we now believe that approximately 20 SBS Entities will also be registered with the CFTC as Swap Entities.<sup>212</sup> Accordingly, we are using the updated number for calculating the burdens pursuant to Rule 15Fi-3, 15Fi-4, and 15Fi-5.

With regard to the requirements under Rule 3a71-6, as amended, requests for a substituted compliance determination with respect to the portfolio reconciliation, portfolio compression, and written trading relationship documentation requirements may be filed by foreign financial regulatory authorities, or by non-U.S. SBS Entities. Consistent with prior estimates, the

<sup>208</sup> See Recordkeeping and Reporting Adopting Release, 84 FR at 68607-09.

<sup>209</sup> See *id.* See also Capital, Margin, and Segregation Adopting Release, 84 FR at 43960; Trade Acknowledgement and Verification Adopting Release, 81 FR at 39830; and SBS Entity Registration Adopting Release, 80 FR at 48990.

<sup>210</sup> See *id.*

<sup>211</sup> See Proposing Release, 84 FR at 4643.

<sup>212</sup> See Recordkeeping and Reporting Adopting Release, 84 FR at 68607-09. This figure includes 19 SBS dealers and one major SBS participant.

Commission expects that there are approximately 22 non-U.S. entities that may register with the Commission as SBS dealers, out of approximately 50 total entities that may register as SBS dealers.<sup>213</sup>

Potentially, all such non-U.S. SBS dealers, or some subset thereof, may seek to rely on a substituted compliance determination in connection with these portfolio reconciliation, portfolio compression, and written trading relationship documentation requirements.<sup>214</sup> In practice, however, the Commission expects that the greater portion of any such requests will be submitted by foreign financial regulatory authorities, given their expertise in connection with the relevant substantive requirements, especially in connection with their supervisory and enforcement oversight with regard to SBS dealers and their activities.

*D. Total Annual Recordkeeping Burden*

1. Portfolio Reconciliation Activities Generally

Pursuant to Rule 15Fi-3(a), the approximately 55 respondent SBS Entities will be required to reconcile security-based swap portfolios with other SBS Entities on a daily, weekly, or quarterly basis, depending upon the size of the portfolio. For purposes of this requirement, the Commission estimates that each SBS Entity will engage in security-based swap transactions with approximately one-third of the other 54 SBS Entities, meaning that an SBS Entity will maintain security-based swap portfolios with approximately 18 SBS Entities. Of this total, we believe that, on average, two SBS Entity counterparty portfolios will require daily reconciliation (*i.e.*, a portfolio consisting of 500 or more uncleared security-based swaps), four SBS Entity counterparty portfolios will require weekly reconciliation (*i.e.*, a portfolio of more than 50 but fewer than 500 uncleared security-based swaps), and the remaining 12 SBS Entity counterparty portfolios will require

quarterly reconciliation (*i.e.*, a portfolio of no more than 50 uncleared security-based swaps).<sup>215</sup> The Commission therefore estimates that each SBS Entity will engage in an average of 760 portfolio reconciliations with other SBS Entities per year.<sup>216</sup>

The Commission believes that each portfolio reconciliation is likely to be conducted through an automated process.<sup>217</sup> As a result, we believe that each reconciliation will require an average of 30 minutes to complete in total (which is the combined estimate for both counterparties), regardless of the size of the security-based swap portfolio with the applicable counterparty.<sup>218</sup> Using these figures, the Commission estimates that compliance with Rule 15Fi-3(a), as it relates to engaging in portfolio reconciliation with other SBS Entities, will impose an average annual burden of approximately 190 hours per year on each of the respondent 55 SBS Entities, for an estimated average annual burden of 10,450 hours in the aggregate. These calculations are summarized in PRA Table 1, below.

PRA TABLE 1—RULE 15i-3(a): PORTFOLIO RECONCILIATIONS WITH OTHER SBS ENTITIES

Number of counterparties per respondent	Number of annual reconciliations	Hourly burden per reconciliation	Total annual burden (hours)
2 (≥500 transactions) .....	252 (daily) .....	.25	126
4 (>50<500 transactions) .....	52 (weekly) .....	.25	52
12 (≤50 transactions) .....	4 (quarterly) .....	.25	12
Total per respondent .....	.....	.....	190
Total Aggregate Annual Burden for all 55 respondents .....	.....	.....	10,450

In addition, Rule 15Fi-3(b) requires each SBS Entity to establish, maintain, and follow written policies and procedures reasonably designed to ensure that it engages in portfolio reconciliation for all security-based swaps (other than security-based swaps

that will be cleared by a clearing agency) in which its counterparty is not an SBS Entity.<sup>219</sup> In calculating the burden of performing the portfolio reconciliations required by these policies and procedures, the Commission estimates that (1) there are

currently 13,082 market participants in security-based swaps who will not be required to register as SBS Entities,<sup>220</sup> and (2) each SBS Entity will have an average of approximately 350 of these non-SBS Entity market participants as

<sup>213</sup> See Cross-Border Application Proposing Release, 84 FR at 24253. See also Recordkeeping and Reporting Adopting Release, 84 FR at 68607-09; and Capital, Margin, and Segregation Adopting Release, 84 FR at 43960-61.

<sup>214</sup> As previously noted, the Commission further believes that there may up to five major SBS participants. See *supra* note 210 and accompanying text. It is possible that some subset of those entities will be non-U.S. major SBS participants that will seek to rely on substituted compliance in connection with the applicable portfolio reconciliation, portfolio compression, and written trading relationship documentation requirements.

<sup>215</sup> These estimates are consistent with those used by the CFTC in connection with its portfolio reconciliation rule. See Confirmation, Portfolio Reconciliation, and Portfolio Compression

Requirements for Swap Dealers and Major Swap Participants, 75 FR 81519, 81528 (Dec. 28, 2010).

<sup>216</sup> This estimate uses 252 business days for purposes of the daily portfolio reconciliation requirement, which is consistent with the definition of “business day” in Rule 15Fi-1(b).

<sup>217</sup> The Commission recognizes that some respondents may choose to engage a third-party vendor to conduct portfolio reconciliations. For simplicity, however, the Commission’s burden estimate is based upon SBS Entities conducting these activities internally, without the use of third-party vendors. The Commission requested, but did not receive, comment on this approach, including regarding the likelihood and cost of using third-party providers. Accordingly, we are using the same estimates as included in the proposal. See Proposing Release, 84 FR at 4642, n. 176.

<sup>218</sup> Because the 30 minute estimate is for the entire reconciliation process, without respect to how that time is allocated between the two parties, to avoid double-counting we have divided it by one-half in the context of security-based swap portfolios between two SBS Entities, resulting in an estimate of 15 minutes per reconciliation per counterparty for those portfolios.

<sup>219</sup> The Commission’s estimate for the hourly burden for preparing these policies and procedures is discussed below.

<sup>220</sup> In the Economic Analysis, the Commission estimates that there are approximately 13,137 market participants in the security-based swap market. See *infra* Section VI.B.1.c (Table 2). Subtracting the estimated 55 SBS Entities from this figure results in an estimated 13,082 non-SBS Entities.

counterparties.<sup>221</sup> Further, the Commission believes that reconciliations with these parties will be conducted on a quarterly basis for 10% of these portfolios (*i.e.*, portfolios with more than 100 uncleared security-based swaps), and on an annual basis for the remaining 90% of these portfolios (*i.e.*, portfolios that do not

involve 100 or more uncleared security-based swaps).<sup>222</sup>

The Commission further estimates that each portfolio reconciliation between an SBS Entity and a non-SBS Entity will require an average of 30 minutes to complete (which is the combined estimate for both counterparties).<sup>223</sup> Using these figures, the Commission estimates that

compliance with Rule 15Fi-3(b), as it relates to conducting portfolio reconciliations with non-SBS Entities, will impose an annual hourly burden of approximately 227.5 hours per SBS Entity, for an estimated average annual burden of approximately 12,512.5 hours in the aggregate for all 55 SBS Entity respondents. These calculations are summarized in PRA Table 2, below.

TABLE 2 –RULE 15i-3(b): PORTFOLIO RECONCILIATIONS WITH NON-SBS ENTITIES

Number of counterparties per respondent	Number of annual reconciliations	Hourly burden per reconciliation	Total annual burden (hours)
35 (≤100 transactions) .....	4 (quarterly) .....	.5	70
315 (≤100 transactions) .....	1 (annual) .....	.5	157.5
Total per respondent .....	.....	.....	227.5
Total Aggregate Annual Burden for all 55 respondents .....	.....	.....	12,512.5

2. Establishing, Maintaining, and Enforcing Written Policies and Procedures

Rule 15Fi-3 also contains policies and procedures requirements applicable to SBS Entities in connection with engaging in portfolio reconciliation with both SBS Entities and other counterparties. As previously noted, the Commission estimates that of the estimated 55 persons that may register with the Commission as SBS Entities, approximately 20 will be dually-registered with the CFTC as Swap Entities.<sup>224</sup> In addition, the CFTC’s adopted final rules on portfolio reconciliation written policies and procedures are substantively identical to those in Rule 15Fi-3. Accordingly, these 20 dually-registered entities are already required to establish, maintain, and follow written policies and procedures as they relate to the reconciliation of their swap portfolios, and these policies and procedures would be expected to be largely consistent with those that would be required with respect to their security-based swap portfolios. Assuming that these existing policies

and procedures would simply need to be amended to apply to security-based swap transactions pursuant to Rule 15Fi-3, we estimate that the initial burden of revising these policies and procedures would be one hour per respondent, for an estimated one-time initial burden of 20 hours in the aggregate. With respect to the remaining 35 SBS Entities that will not be dually-registered with the CFTC, the Commission estimates, based on prior estimates in earlier Dodd-Frank rulemakings, that these policies and procedures would require an average of 80 hours per non-dually-registered respondent to initially prepare and implement, for an estimated one-time initial burden of 2,800 hours in the aggregate.<sup>225</sup> Once these policies and procedures are established, the Commission estimates that it will take an average of 40 hours annually to revise and maintain these policies and procedures per respondent (including both dually-registered and non-dually-registered SBS Entities),<sup>226</sup> for an estimated average annual burden of

2,200 hours in the aggregate for all 55 respondents.<sup>227</sup>

3. Reporting of Certain Valuation Disputes

Rule 15Fi-3(c) requires each SBS Entity to promptly notify the Commission (and any applicable prudential regulator for an SBS Entity that is also a bank), in a form and manner acceptable to the Commission, of any security-based swap valuation dispute in excess of \$20,000,000 (or its equivalent in any other currency) if not resolved within a prescribed time period. As previously noted, we crafted the rule in this way to provide SBS Entities with flexibility to determine the most efficient and cost-effective form and manner of making such submissions, so long as it is deemed to be acceptable by the Commission.<sup>228</sup> Accordingly, we would expect there to be only a minimal, if any, initial burden of designing a system for submitting these notices. We also believe that the associated ongoing hourly burden of preparing and submitting such notices would be minimal. In addition, until

<sup>221</sup> This estimate is based upon the assumption that each non-SBS Entity market participant will do business with, on average, between one or two SBS Entities and is calculated as follows: ((13,082 non-SBS Entity market participants/55 SBS Entities) × 1.5 SBS Entities per non-SBS market participants) = approximately 350 non-SBS Entity counterparties per SBS Entity.

<sup>222</sup> Accordingly, of the estimated 350 security-based swap portfolios that an SBS Entity maintains with non-SBS Entities, 90% (or 315) will require only one portfolio reconciliation each year, and 10% (or 35) will require quarterly portfolio reconciliations, resulting in a total of 455 portfolio reconciliations per SBS Entity per year.

<sup>223</sup> This figure is identical to the estimate used for reconciliations between two SBS Entities (before

dividing by one-half to avoid double-counting) and is consistent with the estimate used by the CFTC, which used an estimate of six minutes (or .10 hours) in connection with its portfolio reconciliation requirements. See *supra* notes 215 and 218 and accompanying text.

<sup>224</sup> See *supra* note 212 and accompanying text.

<sup>225</sup> This estimate is based on Commission staff discussions with market participants and is calculated as follows: (((Compliance Attorney at 40 hours) + (Director of Compliance at 20 hours) + (Deputy General Counsel at 20 hours))) = 80 hours per SBS Entity. See Trade Acknowledgment and Verification Adopting Release, 81 FR at 39831, n. 242.

<sup>226</sup> Although dually-registered SBS Entities would technically need to revise and maintain their policies and procedures to ensure compliance with both the Commission’s and CFTC’s rules, we have decided to conservatively assume that all of the estimated hours would be incurred in connection with compliance with the collection of information associated with Rule 15Fi-3.

<sup>227</sup> This estimate is based on Commission staff discussions with market participants and is calculated as follows: (((Compliance Attorney at 20 hours) + (Director of Compliance at 10 hours) + (General Counsel at 10 hours))) = 40 hours per SBS Entity. See Trade Acknowledgment and Verification Adopting Release, 81 FR at 39831, n. 243.

<sup>228</sup> See *supra* note 72.

SBS Entities are registered with the Commission, it is difficult for us to determine the typical number of valuation disputes meeting the applicable thresholds that SBS Entities would be required to submit on an annual basis.

Rule 15Fi-3(c) also requires SBS Entities to notify the Commission, in a form and manner acceptable to the Commission, and any applicable prudential regulator, if the amount of any security-based swap valuation dispute that was the subject of a previous notice increases or decreases by more than \$20,000,000 (or its equivalent in any other currency), at either the transaction or portfolio level. Such amended notice shall be provided to the Commission, and any applicable prudential regulator, no later than the last business day of the calendar month in which the applicable security-based swap valuation dispute increases or decreases by the applicable dispute

amount. Although the Commission believes that the time required to submit amendments to existing notices will be minimal, and likely included in the 24 hour estimate that we used in the Proposing Release (which was used by the CFTC when it first proposed a similar requirement),<sup>229</sup> we are conservatively increasing that estimate by 25% to account for the submission of amended notices. As such, we estimate that each SBS Entities will spend on average of 30 hours each year complying with this requirement, for an estimated average annual burden of 1,650 hours in the aggregate for all 55 respondents.

Combining all of the estimated burdens described above, the Commission estimates that Rule 15Fi-3 will impose an estimated one-time initial burden of 2,899 hours in the aggregate for all SBS Entities to prepare new written policies and procedures or to bring existing ones into compliance. The Commission also estimates that

Rule 15Fi-3 will impose an estimated ongoing burden of 26,812.5 hours each year in the aggregate for all SBS Entities, which is composed of (1) an estimated annual burden of 10,450 hours in the aggregate for all SBS Entities to engage in portfolio reconciliation with SBS Entities; (2) an estimated annual burden of 12,512.5 hours in the aggregate for all SBS Entities to engage in portfolio reconciliation with non-SBS Entities; (3) an estimated annual burden of 2,200 hours in the aggregate for all SBS Entities to revise and maintain the written policies and procedures required pursuant to the rule; and (4) an estimated annual burden of 1,650 hours for all SBS Entities to report certain large valuation disputes to the Commission and any applicable prudential regulator.<sup>230</sup> These calculations are summarized in PRA Tables 3 and 4, below.

PRA TABLE 3—RULE 15Fi-3: TOTAL ESTIMATED INITIAL BURDENS

Requirement	Hourly burden	Total one-time burden (hours)
Preparation of New Written Policies and Procedures (20 dual SEC-CFTC registrants) .....	1	20
Preparation of New Written Policies and Procedures (35 SEC-only registrants) .....	80	2,800
<b>Total Aggregate One-Time Burden for all 55 respondents .....</b>		<b>2,820 hours</b>

PRA TABLE 4—RULE 15Fi-3: SUMMARY OF ANNUAL BURDENS

Requirement	Aggregate hourly burden (all 55 respondents)
Portfolio Reconciliations with Other SBS Entities .....	10,450
Portfolio Reconciliations with Non-SBS Entities .....	12,512.5
Revise and Maintain Written Policies and Procedures ...	2,200
Prepare and Submit Notices of Valuation Disputes >\$20 million .....	1,650
<b>Total Aggregate Annual Burden for all 55 respondents .....</b>	<b>26,812.5</b>

registered with the CFTC as Swap Entities. In addition, and as we previously noted, the requirements in CFTC Rule § 23.503 are, other than as expressly described above in Section II.B, substantively identical to Rule 15Fi-4. Accordingly, these 20 entities are already required to establish, maintain, and follow relevant written policies and procedures related to bilateral offsets and portfolio compression exercises involving their swap portfolios, and these policies and procedures would be expected to be largely consistent with those that would be required with respect to their security-based swap portfolios. Assuming that these existing policies and procedures would need to be amended to apply to security-based swap transactions, we estimate that the initial burden of revising these policies and procedures would be one hour per respondent, for an estimated one-time initial burden of 20 hours in the aggregate.

With respect to the remaining 35 SBS Entities that are not dually-registered with the CFTC, the Commission estimates, based on prior estimates in earlier Dodd-Frank rulemakings, that these policies and procedures would require an average of 80 hours per non-dually-registered respondent to initially prepare and implement, for an estimated average annual burden of 2,800 hours in the aggregate.<sup>231</sup> Once these policies and procedures are established, the Commission estimates that it will take an average of 40 hours annually to revise and maintain these policies and procedures per respondent (including both dually-registered and non-dually-registered SBS Entities), for an estimated average annual burden of 2,200 hours in the aggregate for all 55 respondents.

In addition, the respondents will incur additional hourly burdens as they undertake bilateral offsets and portfolio compression exercises consistent with these written policies and procedures.

4. Rule 15Fi-4: Portfolio Compression

As noted above, the Commission continues to believe that of the estimated 55 persons that may register with the Commission as SBS Entities, approximately 20 will be dually-

<sup>229</sup> See Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 76 FR 6715, 6723 (Feb. 8, 2011).

<sup>230</sup> Rule 15Fi-3(a)(1) and (b)(1) also require an SBS Entity to agree in writing with each of its

counterparties on the terms of the portfolio reconciliation including, if applicable, agreement on the selection of any third party service provider who may be performing the reconciliation. The Commission expects SBS Entities to undertake this agreement as part of the written trading relationship

documentation each is required to enter into with its counterparties as a result of Rule 15Fi-5. Thus, the estimate here does not account for this burden, which is instead assumed to form part of the burden of complying with Rule 15Fi-5.

<sup>231</sup> See *supra* note 225.

As noted above the Commission estimates that each of the 55 estimated SBS Entities will be counterparty to an average of 18 other SBS Entities and 350 non-SBS Entities, for a total of 368 counterparties. For purposes of conducting bilateral offsets and portfolio compression exercises, the Commission estimates that (1) each SBS Entity will have an average of one set of security-based swaps that are eligible for annual bilateral offset with each of these 368 counterparties, (2) each SBS Entity will conduct an annual bilateral compression exercise with one-third, or six of its 18 SBS Entity counterparties, (3) each SBS Entity will conduct an annual bilateral compression exercise with each of its 350 non-SBS Entity

counterparties, and (4) each SBS Entity will engage in multilateral compression exercises at an average rate of 12 exercises per year.

The Commission believes that each bilateral offset and portfolio compression exercise is likely to be conducted through an automated process. As a result, we believe that (1) each bilateral offset will require on average five minutes of respondent time to complete with each of the 350 non-SBS Entity counterparties, (2) each bilateral offset will require on average 2.5 minutes of respondent time to complete with each of the 18 SBS Entity counterparties,<sup>232</sup> (3) each bilateral compression will require an average of 15 minutes of respondent time to

complete with each of the 350 non-SBS Entity counterparties, (4) each bilateral compression will require an average of 7.5 minutes with each of the six SBS Entity counterparties,<sup>233</sup> and (5) each multilateral compression exercise will require an average of 30 minutes of respondent time to complete 12 times annually. In each of those hourly burdens, the figure used is the combined estimate for both counterparties. Based on these estimates, the Commission estimates the average annual hourly burden for these activities at 124.16 hours per respondent, an estimated average annual burden of 6,828.8 hours in the aggregate. These calculations are summarized in PRA Table 5, below.

PRA TABLE 5—PORTFOLIO COMPRESSION WITH ALL ENTITIES

Type of exercise	Number of counterparties	Number of annual exercises	Hourly burden per exercise	Total annual burden
Bilateral Offset (w/non-SBS Entities) .....	350	1	.0833	29.16
Bilateral Offset (w/SBS Entities) .....	18	1	.0417	.75
Bilateral Compression (w/non SBS-Entities) .....	350	1	.25	87.5
Bilateral Compression (w/SBS Entities) .....	6	1	.125	.75
Multilateral Compression .....	N/A	12	.5	6
Total per respondent .....				124.16
Total Aggregate Annual Burden for all 55 respondents .....				6,828.8

Combining all of the estimated burdens described above, the Commission estimates that Rule 15Fi-4 will impose an estimated one-time initial burden of 2,899 hours in the aggregate for all SBS Entities to prepare new written policies and procedures or to bring existing ones into compliance. The Commission also estimates that Rule 15Fi-4 will impose an estimated ongoing burden of 9,028.8 hours each year in the aggregate for all SBS Entities,

which is composed of (1) an estimated annual burden of 1,603.8 hours in the aggregate to conduct bilateral offsets with non-SBS Entities; (2) an estimated annual burden of 41.25 hours in the aggregate to conduct bilateral offsets with SBS Entities; (3) an estimated annual burden of 4,812.5 hours in the aggregate to participate in bilateral compression exercises with non-SBS Entities; (4) an estimated annual burden of 41.25 hours in the aggregate to

participate in bilateral compression exercises with SBS Entities; (5) an estimated annual burden of 330 hours in the aggregate to participate in multilateral compression exercises; and (6) an estimated annual burden of 2,200 hours in the aggregate for all SBS Entities to revise and maintain written policies and procedures. These calculations are summarized in PRA Tables 6 and 7, below.

PRA TABLE 6—RULE 15Fi-4: TOTAL ESTIMATED INITIAL BURDEN

Activity	Hourly burden	Total one-time burden (hours)
Preparation of New Written Policies and Procedures (20 dual SEC-CFTC registrants) .....	1	20
Preparation of New Written Policies and Procedures (35 SEC-only registrants) .....	80	2,800
Total Aggregate One-Time Burden for all 55 respondents .....		2,820

<sup>232</sup> Similar to our estimates in the context of the portfolio reconciliation requirements, because the five minute estimate is for the entire bilateral offset process, without respect to how that time is allocated between the two parties, to avoid double-counting we have divided it by one-half in the

context of security-based swap portfolios between two SBS Entities, resulting in an estimate of 2.5 minutes per bilateral offset for those portfolios.

<sup>233</sup> Again, we have divided the 15 minute estimate to complete the bilateral compression

exercise by one-half in the context of security-based swap portfolios between two SBS Entities, resulting in an estimate of 7.5 minutes per bilateral compression for those portfolios.

PRA TABLE 7—RULE 15Fi-3:  
SUMMARY OF ANNUAL BURDENS

Requirement	Aggregate hourly burden (all 55 respondents)
Bilateral Offsets with non-SBS Entities .....	1603.8
Bilateral Offsets with SBS Entities .....	41.25
Bilateral Compression with non-SBS Entities .....	4,812.5
Bilateral Compression with SBS Entities .....	41.25
Multilateral Compression .....	330
Revise and Maintain Written Policies and Procedures ...	2,200
<b>Total Aggregate Annual Burden for all 55 respondents</b>	<b>9028.8</b>

#### 5. Rule 15Fi-5: Written Trading Relationship Documentation

As previously noted, the Commission estimates that each SBS Entity will have 18 SBS Entity counterparties and 350 non-SBS Entity counterparties, for a total of 368 counterparties per SBS Entity. For the purposes of the underlying documentation requirements, and based on staff discussions with market participants, the Commission understands that many SBS Entities already have in place industry-standard written trading relationship documentation that is likely to contain many of the elements required by Rule 15Fi-5. With this in mind, the Commission estimates that (1) the initial burden per respondent to negotiate and draft written trading relationship documentation with non-SBS Entities that is compliant with Rule 15Fi-5 will be approximately 30 hours (which is the combined estimate for both counterparties), and (2) the initial burden per respondent to negotiate and draft written trading relationship documentation with SBS Entities that is compliant with Rule 15Fi-5 will be approximately 15 hours.<sup>234</sup> These estimates are averages, and both account for the fact that some SBS Entities may lack appropriate documentation in

<sup>234</sup> As was the case in calculating the PRA estimates for the portfolio reconciliation and portfolio compression requirements, because the 30 hours estimate is for the entire process of negotiating and executing written trading relationship documentation, without respect to how that time is allocated between the two parties, to avoid double-counting we have divided it by one-half in the context of counterparties that are also SBS Entities, resulting in an estimate of 15 hours to negotiate and execute such documentation.

certain respects and will need to enter into new documentation with counterparties, while in other cases existing documentation will need only to be modified to be brought into compliance. The Commission's estimates are further based on an assumption that, in each case, the written documentation will always include the valuation agreements set forth in Rule 15Fi-5(b)(4), notwithstanding the fact that the rule only requires this information in certain circumstances.

Based on these estimates and assumptions, the Commission believes that the requirement to prepare written relationship documentation in accordance with Rule 15Fi-5 will result in an estimated one-time initial burden of 9,540 hours for each of the 55 SBS Entity respondents, for an estimated average one-time burden of 524,700 hours in the aggregate. The Commission also believes that there will be little need to modify the written trading relationship documentation on an ongoing basis once it is in place, and therefore is not estimating any additional annual hourly burden for ongoing modifications.

As noted above, the Commission continues to believe that of the estimated 55 persons that may register with the Commission as SBS Entities, approximately 20 will be dually-registered with the CFTC as Swap Entities. In addition, and as we previously noted, the requirements in CFTC Rule § 23.504 are, other than as expressly described above in Section I.C, substantively identical to those contained in Rule 15Fi-5. Accordingly, these 20 entities are already required to establish, maintain, and follow relevant written policies as they relate to the execution of written trading relationship documentation involving their swap portfolios, and these policies and procedures would be expected to be largely consistent with those that would be required with respect to their security-based swap portfolios. Assuming that these existing policies and procedures would simply need to be amended to apply to security-based swap transactions, we estimate that the average initial burden of revising these policies and procedures would be one hour per respondent, for an estimated one-time burden of 20 hours in the aggregate.

With respect to the remaining 35 SBS Entities that are not dually-registered

with the CFTC, the Commission estimates, based on prior estimates in earlier Dodd-Frank rulemakings, that these policies and procedures would require an average of 80 hours per non-dually-registered respondent to initially prepare and implement, for an estimated average annual burden of 2,800 hours in the aggregate.<sup>235</sup> Once these policies and procedures are established, the Commission estimates that it will take an average of 40 hours annually to revise and maintain these policies and procedures per respondent (including both dually-registered and non-dually-registered SBS Entities), for an estimated average annual burden of 2,200 hours in the aggregate for all 55 respondents.

With regard to having an independent auditor conduct the required periodic audit of written trading relationship documentation and the requirement to retain a record of each such audit, the Commission estimates that it will take an average of 10 hours to audit an SBS Entity's documentation with each of its 368 counterparties, for a total of 3,680 hours per SBS Entity, or 202,400 hours for all 55 SBS Entity respondents.

Combining all of the estimated burdens described above, the Commission estimates that Rule 15Fi-5 will impose an estimated one-time initial burden of 595,170 hours in the aggregate for all SBS Entities, which consists of (1) 2,820 hours in the aggregate for all SBS Entities to prepare new written policies and procedures or to bring existing ones into compliance, (2) 577,500 hours in the aggregate for SBS Entities to negotiate and execute trading relationship documentation with 350 non-SBS Entity counterparties, and (3) 14,850 hours in the aggregate for SBS Entities to negotiate and execute trading relationship documentation with 18 SBS Entity counterparties. The Commission also estimates that Rule 15Fi-5 will impose an estimated ongoing burden of 204,600 hours each year in the aggregate for all SBS Entities, which is composed of: (1) An estimated annual burden of 2,200 hours in the aggregate for all SBS Entities to revise and maintain written policies and procedures and (2) an estimated annual burden of 202,400 hours in the aggregate for all SBS Entities to conduct the required periodic audits. These calculations are summarized in PRA Tables 8 and 9, below.

<sup>235</sup> See *supra* note 225.

PRA TABLE 8—RULE 15Fi-5: TOTAL ESTIMATED INITIAL BURDENS

Activity	Hourly burden	Total one-time burden (hours)
Preparation of New Written Policies and Procedures (20 dual SEC-CFTC registrants) .....	1	20
Preparation of New Written Policies and Procedures (35 SEC-only registrants) .....	80	2,800
Negotiate and Execute Trading Relationship Documentation with 350 non-SBS Entities (all 55 respondents) ....	30	577,500
Negotiate and Execute Trading Relationship Documentation with 18 SBS Entities (all 55 respondents) .....	15	14,850
Total Aggregate One-Time Burden for all 55 respondents .....		595,170

PRA TABLE 9—RULE 15Fi-3: SUMMARY OF ANNUAL BURDENS

Requirement	Aggregate hourly burden (all 55 respondents)
Audit of Written Trading Relationship Documentation ..	202,400
Revise and Maintain Written Policies and Procedures ...	2,200
Total Aggregate Annual Burden for all 55 respondents .....	204,600

6. Amendments to Rules 17a-3, 17a-4, 18a-5, and 18a-6: Books and Records Requirements

The amendments to Rules 17a-3, 17a-4, 18a-5, and 18a-6 will impose collection of information requirements that result in initial and annual time burdens for SBS Entities. The amendments to Rules 17a-3 and 18a-5 require three additional types of records to be made and kept current by SBS Entities—records regarding portfolio reconciliations, valuation disputes, and portfolio compressions. Because the burden to make these records is accounted for in the PRA estimates for Rules 15Fi-3 and 15Fi-4, the burden imposed by these new requirements relates only to the requirement in Rules 17a-4 and 18a-6 to maintain and preserve a written record of these tasks, as well as the additional requirements in those provisions to maintain and preserve records of policies and procedures required by Rules 15Fi-3, 15Fi-4, and 15Fi-5, and written agreements with counterparties regarding the terms of portfolio reconciliation. The Commission estimates that these recordkeeping requirements will impose an initial burden of 60 hours per firm for updating the applicable policies and systems required to account for capturing the additional records made pursuant to Rule 15Fi-3 through 15Fi-5, and an ongoing annual burden of 75 hours per firm for maintaining such records as well as to make additional updates to the applicable recordkeeping policies

and systems to account for the new rules. As noted previously, the Commission estimates that there are 55 SBS Entity respondents, for a total average initial annual burden for all respondents of 3,300 hours and a total ongoing average annual burden of 4,125 hours.

7. Amendment to Rule 3a71-6: Substituted Compliance

The amendment to Rule 3a71-6 requires the submission of certain information to the Commission to the extent SBS Entities elect to request a substituted compliance determination with respect to the proposed portfolio reconciliation, portfolio compression, and written trading relationship documentation requirements. The Commission expects that registered SBS Entities will seek to rely on substituted compliance upon registration, and that it is likely that the majority of such requests will be made during the first year following the effective date. Requests will not be necessary with regard to applicable rules and regulations of a foreign financial regulatory system that have previously been the subject of a substituted compliance determination in connection with the applicable rules.

The Commission expects that the great majority of substituted compliance applications will be submitted by foreign authorities, and that very few substituted compliance requests will come from SBS Entities. For purposes of this assessment, the Commission estimates that three such SBS Entities will submit such an application.<sup>236</sup> The Commission has previously estimated that the paperwork burden associated with making each such substituted compliance request would be approximately 80 hours of in-house counsel time, plus \$80,000 for the services of outside professionals (based on 200 hours of outside time × \$400 per hour).<sup>237</sup> The Commission is currently of the belief that this prior estimate is

<sup>236</sup> See Business Conduct Standards Adopting Release, 81 FR at 30097, n. 1582.

<sup>237</sup> See Business Conduct Standards Adopting Release, 81 FR at 30097, n. 1583.

sufficient to cover a combined substituted compliance request that also seeks a determination for the portfolio reconciliation, portfolio compression, and written trading relationship documentation requirements. This estimate results in an aggregate total of 240 internal hours, plus \$240,000 for outside services. Therefore, the Commission estimates that the total paperwork burden incurred by such entities associated with preparing and submitting a request for a substituted compliance determination in connection with the portfolio reconciliation, portfolio compression, and written trading relationship documentation requirements will be approximately 240 hours per applicant, plus \$240,000 for the services of outside professionals for all three requests.

E. Collection of Information Is Mandatory

Each collection of information for Rules 15Fi-3, 15Fi-4, and 15Fi-5, and for the amendments to Rules 17a-3, 17a-4, 18a-5, and 18a-6 is a mandatory collection of information. With respect to the amendment to Rule 3a71-6, the application for substituted compliance is mandatory for all foreign financial regulatory authorities or SBS Entities that seek a substituted compliance determination.

F. Confidentiality

Rule 15Fi-3(c) requires an SBS Entity to promptly notify the Commission of any security-based swap valuation dispute in excess of \$20,000,000 (or its equivalent in any other currency) if not resolved within: (1) Three business days, if the dispute is with a counterparty that is an SBS Entity; or (2) five business days, if the dispute is with a counterparty that is not an SBS Entity. The rule also requires SBS Entities to notify the Commission, in a form and manner acceptable to the Commission, and any applicable prudential regulator, if the amount of any security-based swap valuation dispute that was the subject of a previous notice increases or decreases by more than \$20,000,000 (or its equivalent in any other currency), at either the transaction or portfolio level.

These amendments are required to be provided to the Commission, and any applicable prudential regulator, no later than the last business day of the calendar month in which the applicable security-based swap valuation dispute increases or decreases by the applicable dispute amount. We requested comment as to whether the initial notices should be submitted to the Commission on a confidential basis, but did not receive any comments in response to this request. Accordingly, the Commission has not modified Rule 15Fi-3(c) to provide for these notices (either the initial notice or any amendments) to be submitted on a confidential basis. No other information is required to be submitted directly to the Commission under Rules 15Fi-3, 15Fi-4, and 15Fi-5, or under the amendments to Rules 17a-3, 17a-4, 18a-5, and 18a-6. To the extent that the Commission receives confidential information pursuant to this collection of information that is otherwise not publicly available, including in connection with examinations or investigations, the SBS Entity can request the confidential treatment of the information.<sup>238</sup> If such a confidential treatment request is made, the Commission anticipates that it will keep the information confidential, subject to the provisions of applicable law.<sup>239</sup>

With regard to the amendments to Rule 3a71-6, the Commission generally will make requests for a substituted compliance determination public, subject to requests for confidential treatment being submitted pursuant to any applicable provisions governing confidentiality under the Exchange Act.<sup>240</sup>

## VII. Economic Analysis

The Commission is sensitive to the economic effects of its rules, including the costs and benefits and the effects of its rules on efficiency, competition, and capital formation. Section 3(f)<sup>241</sup> of the Exchange Act requires the Commission, whenever it engages in rulemaking pursuant to the Exchange Act and is required to consider or determine whether an action is necessary or appropriate in the public interest, also to consider, in addition to the protection

of investors, whether the action would promote efficiency, competition, and capital formation. In addition, Section 23(a)(2)<sup>242</sup> of the Exchange Act requires the Commission, when promulgating rules under the Exchange Act, to consider the impact such rules would have on competition. Section 23(a)(2) also provides that the Commission shall not adopt any rule which would impose a burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act.<sup>243</sup>

### A. Broad Economic Considerations

Unlike some other types of securities transactions, a security-based swap typically gives rise to ongoing obligations between transaction counterparties during the life of the transaction, including payments contingent on specific events, such as a corporate default or a change in the price of an underlying reference asset (e.g., changes in price to the floating leg of a total return swap). Consequently, certain risk mitigation techniques, such as engaging in portfolio reconciliation at periodic intervals, exercising opportunities for portfolio compression, and ensuring that the terms of a transaction are fully documented, are important practices for assisting SBS Entities in effectively measuring and managing market and credit risk.

Credit risk refers to the probability of a financial loss due to a counterparty to a transaction failing to fulfill its financial obligations. In order to manage credit risk in the security-based swap context properly, a market participant should know the identity of each of its counterparties, the details of the obligations of each counterparty in each transaction into which the two have entered, and the value of those obligations (including for purposes of calculating margin or measuring outstanding exposure for risk management). The greater the number of counterparties and transactions, the complexity of those transactions, and the value of the outstanding obligations, the more important it becomes for each counterparty to have well-documented credit risk management policies.

The risks of the counterparties' failure to manage credit risk adequately may not become apparent until the onset of a financial crisis. Such a crisis occurred in the fall of 2008, when certain events threatened to freeze U.S. and global credit markets. The severity of that crisis has been partially attributed to poor risk management practices of financial firms and flawed supervisory

oversight for certain financial institutions.<sup>244</sup>

Shortcomings in credit risk management and documentation may be unobservable to counterparties and other market participants until a crisis occurs as it did in 2008; thus some benefits of compliance will accrue to the financial system as a whole while the ongoing direct costs are borne by the institution. If firms do not fully internalize the benefits of risk management, then they may underinvest. For example, shortcomings in documentation were reported to have created significant problems during the financial crisis that immediately preceded passage of the Dodd-Frank Act in connection with efforts by Barclays PLC to take over a portion of Lehman Brothers Holdings Inc.'s derivatives trades.<sup>245</sup> Shortcomings in the documentation of portfolio valuation methods and reconciliation of portfolio values were also exposed when, during bankruptcy proceedings, counterparties' valuations differed by hundreds of millions of dollars from the value of those same positions on the bankrupt entity's books.<sup>246</sup>

Among other things, effective risk management requires the existence of sound documentation, periodic reconciliation of portfolios, rigorously tested valuation methodologies, and sound collateralization practices.<sup>247</sup> More broadly, the President's Working Group on Financial Policy ("PWG") noted shortcomings in the OTC derivatives market as a whole during the financial crisis that immediately preceded passage of the Dodd-Frank Act. The PWG identified the need for an improved integrated operational structure supporting OTC derivatives, specifically highlighting the need for an

<sup>244</sup> See *Lessons of the Financial Crisis for Future Regulation of Financial Institutions*, at 3-4, IMF Policy Paper (Feb. 4, 2009), available at: <http://www.imf.org/external/np/pp/eng/2009/020409.pdf>; see also Sewall Chan, *Financial Crisis Was Avoidable, Inquiry Finds*, N.Y. Times (Jan. 25, 2011), available at: [http://www.nytimes.com/2011/01/26/business/economy/26inquiry.html?\\_r=1](http://www.nytimes.com/2011/01/26/business/economy/26inquiry.html?_r=1).

<sup>245</sup> See Linda Sandler, *Lehman Derivatives Records a 'Mess,' Barclays Executive Says*, Bloomberg (Aug. 30, 2010), available at: <http://www.bloomberg.com/news/articles/2010-08-30/lehman-derivatives-records-a-mess-barclays-executive-says>.

<sup>246</sup> See Satyajit Das, *In the Matter of Lehman Brothers*, 59 Wilmott 20-29 (May 2012). Disagreement over CDO valuation between AIG and its counterparties was also an issue around the same time. See *supra* note 14 and accompanying text.

<sup>247</sup> See PriceWaterhouseCoopers, *Lehman Brothers' Bankruptcy: Lessons learned for the survivors*, Informational presentation for clients, (Aug. 2009), at 12-24, available at: <https://www.pwc.com/jg/en/events/lessons-learned-for-the-survivors.pdf>.

<sup>238</sup> See 17 CFR 200.83.

<sup>239</sup> See, e.g., 5 U.S.C. 552 *et seq.*; 15 U.S.C. 78x (governing the public availability of information obtained by the Commission).

<sup>240</sup> See 17 CFR 200.83; 17 CFR 240.24b-2; see also Application of "Security-Based Swap Dealer" and "Major Security-Based Swap Participant" Definitions to Cross-Border Security-Based Swap Activities, Exchange Act Release No. 72472 (June 25, 2014), 79 FR 47278, 47359 (Aug. 12, 2014) ("Cross-Border Adopting Release").

<sup>241</sup> 15 U.S.C. 78c(f).

<sup>242</sup> 15 U.S.C. 78w(a)(2).

<sup>243</sup> See *id.*

enhanced ability to manage counterparty risk through “netting and collateral agreements by promoting portfolio reconciliation and accurate valuation of trades.”<sup>248</sup>

The final rules are designed to ensure that SBS Entities implement certain risk mitigation techniques by engaging in periodic portfolio reconciliation, maintaining policies and procedures for engaging in certain forms of portfolio compression exercises with each of their counterparties, and maintaining policies and procedures reasonably designed to ensure that they execute written trading relationship documentation with each of their counterparties prior to executing a security-based swap transaction. These rules also will set minimum standards with respect to identifying the matters that must be addressed in the security-based swap trading documentation, and outline certain requirements related to the resolution of discrepancies, particularly those involving differences in the valuation of security-based swaps.<sup>249</sup> In adopting these rules, the Commission believes that they will promote effective risk management practices by security-based swap market participants in a number of important ways, which are discussed in greater detail below.

The Commission notes that, where possible, it has attempted to quantify the costs, benefits, and effects on efficiency, competition, and capital formation expected to result from adopting these rules. In certain cases, however, the Commission is unable to quantify the economic effects. Crucially, many of the relevant economic effects, such as improved risk management and the value of Commission enforcement and oversight, are inherently difficult to quantify. In other cases, we lack the information necessary to provide reasonable estimates. For example, we lack data on prices charged by certain third-party service providers, current trading relationship documentation practices for entities and transactions not already subject to similar rules from other regulators, the fraction of outstanding positions that when

reconciled will result in a dispute and the costs incurred by the participants in resolving the dispute. To the best of our knowledge, no such data is publicly available. Where the Commission is unable to quantify the economic effects, the discussion is qualitative in nature and includes, where possible, descriptions of the direction of these effects.

#### B. Economic Baseline

To assess the economic impact of the risk mitigation rules described in this release, the Commission is using as a baseline the security-based swap market as it exists at the time of this release, including applicable rules that have already been adopted, and excluding rules that have been proposed but not yet finalized. The analysis includes the statutory and regulatory provisions that currently govern the security-based swap market pursuant to the Dodd-Frank Act, as well as rules adopted in, among others, the Business Conduct Standards Adopting Release,<sup>250</sup> the Trade Acknowledgment and Verification Adopting Release,<sup>251</sup> the Capital, Margin, and Segregation Adopting Release,<sup>252</sup> and the Recordkeeping and Reporting Adopting Release.<sup>253</sup> Moreover, because participants in the security-based swap market may also operate in other markets, particularly the swaps market, we have considered both the direct and indirect impact of rules that have been adopted by other regulators (e.g., the CFTC as well as foreign regulatory bodies) in formulating the baseline.

Furthermore, the overall Title VII regulatory framework will have consequences for the ways in which security-based swaps are transacted which, in turn, will affect the activities addressed by these rules. For example, the rules being adopted generally do not apply to security-based swaps cleared through a registered clearing agency. Therefore, the scope of future mandatory clearing requirements may affect the overall level of security-based swap activity subject to the final rules being adopted, as well as the overall costs borne by SBS Entities.

#### 1. Security-Based Swap Market Activity and Participants

##### a. Available Data From the Security-Based Swap Market

The Commission’s understanding of the market is informed, in part, by

available data on security-based swap transactions, though the Commission acknowledges that limitations in the data limit the extent to which it is possible to quantitatively characterize the market. Since this data does not cover the entire market, the Commission has analyzed market activity using a sample of transactions that includes only certain segments of the market. The Commission believes, however, that the data underlying this analysis provides reasonably comprehensive information regarding single-name credit default swap (“CDS”) transactions and the composition of the participants in the single-name CDS market.

Specifically, the analysis of the state of the current security-based swap market is based on data obtained from the DTCC Derivatives Repository Limited Trade Information Warehouse (“DTCC-TIW”), especially data regarding the activity of market participants in the single-name CDS market during the period from 2006 to 2017.<sup>254</sup> Although the definition of “security-based swap” is not limited to single-name CDS,<sup>255</sup> single-name CDS contracts make up a majority of security-based swaps, and we believe that the single-name CDS data is sufficiently representative of the market to inform our analysis of the current security-based swap market. According to data published by the Bank for International Settlements (“BIS”), the global notional amount outstanding in single-name CDS was approximately \$4.6 trillion,<sup>256</sup> in multi-name index CDS was approximately \$4.4 trillion, and in multi-name, non-index CDS was approximately \$343 billion.<sup>257</sup> The total

<sup>254</sup> In prior releases, the Commission has examined data for other time periods. For example, in the Business Conduct Standards Adopting Release, the Commission presented an analysis of TIW data for November 2006 through December 2014. While the exact numbers of various groups of transacting agents and account holders in that analysis differ from the figures reported in this section (for a longer time period), we do not observe significant structural differences in market participation. Compare 81 FR at 30102 (Tables 1 and 2) with Tables 1 and 2 below.

<sup>255</sup> While other repositories may collect data on transactions in total return swaps on equity and debt, we do not currently have access to such data for these products (or other products that are security-based swaps). Additionally, the Commission explains below that data related to single-name CDS provides reasonably comprehensive information for the purpose of this analysis.

<sup>256</sup> The global notional amount outstanding represents the total face amount used to calculate payments under outstanding contracts. The gross market value is the cost of replacing all open contracts at current market prices.

<sup>257</sup> See BIS, Semi-annual OTC derivatives statistics at December 2017, Table 10.1, available at: [https://www.bis.org/statistics/d10\\_1.pdf](https://www.bis.org/statistics/d10_1.pdf) (last accessed September 24, 2019).

<sup>248</sup> See The President’s Working Group on Financial Markets, Policy Statements on Financial Market Developments, (Mar. 2008) (“PWG Report”), available at: [https://www.treasury.gov/resource-center/fin-mkts/Documents/pwgpolicystatemktturmoil\\_03122008.pdf](https://www.treasury.gov/resource-center/fin-mkts/Documents/pwgpolicystatemktturmoil_03122008.pdf).

<sup>249</sup> The rules also (1) address the potential availability of substituted compliance in connection with those portfolio reconciliation, portfolio compression, and trading relationship documentation requirements and (2) require SBS Entities to make and keep records demonstrating compliance with the new risk mitigation requirements (which are reflected as amendments to the Commission’s recently adopted security-based swap recordkeeping rules).

<sup>250</sup> See *supra* note 172.

<sup>251</sup> See *supra* note 5.

<sup>252</sup> See *supra* note 89. See also *supra* note 161 and associated text.

<sup>253</sup> See *supra* note 162 and Section II.D.

gross market value outstanding in single-name CDS was approximately \$130 billion, and in multi-name CDS instruments was approximately \$174 billion.<sup>258</sup> The global notional amount outstanding in equity forwards and swaps as of December 2017 was \$3.21 trillion, with total gross market value of \$197 billion.<sup>259</sup>

The Commission further notes that the data available from TIW does not encompass those CDS transactions that both: (i) Do not involve U.S. counterparties;<sup>260</sup> and (ii) are based on non-U.S. reference entities. Notwithstanding this limitation, the TIW single-name CDS data should provide sufficient information to permit the Commission to identify the types of market participants active in the

<sup>258</sup> See *id.*

<sup>259</sup> These totals include swaps and security-based swaps, as well as products that are excluded from the definition of “swap,” such as certain equity forwards. See OTC, Equity-Linked Derivatives Statistics, Table D8, available at: <https://www.bis.org/statistics/d8.pdf> (last accessed September 24, 2019). For the purposes of this analysis, the Commission assumes that multi-name index CDS are not narrow-based index CDS and therefore, do not fall within the security-based swap definition. See 15 U.S.C. 78c(a)(68)(A). See also Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 FR 48208. The Commission also assumes that all instruments reported as equity forwards and swaps are security-based swaps, potentially resulting in underestimation of the proportion of the security-based swap market represented by single-name CDS. Therefore, when measured on the basis of gross notional outstanding single-name CDS contracts appear to constitute roughly 59% of the security-based swap market. Although the BIS data reflects the global OTC derivatives market, and not just the U.S. market, the Commission has no reason to believe that these ratios differ significantly in the U.S. market.

<sup>260</sup> Following publication of the Warehouse Trust Guidance on CDS data access, TIW surveyed market participants, asking for the physical address associated with each of their accounts (*i.e.*, where the account is organized as a legal entity). This physical address is designated the registered office location by TIW. When an account reports a registered office location, we have assumed that the registered office location reflects the place of domicile for the fund or account. When an account does not report a registered office location, we have assumed that the settlement country reported by the investment adviser or parent entity to the fund or account is the place of domicile. Thus, for purposes of this analysis, the Commission has classified accounts as “U.S. counterparties” when they have reported a registered office location in the United States. The Commission notes, however, that this classification is not necessarily identical in all cases to the definition of U.S. person under Rule 3a71–3(a)(4).

security-based swap market and the general pattern of dealing within that market.<sup>261</sup>

#### b. Affected SBS Entities

Final SBS Entity registration rules have been adopted, but compliance is not yet required. Therefore, we do not have data on the actual number of SBS Entities that will register with the Commission, or the number of persons associated with registered SBS Entities. The Commission has elsewhere estimated that up to 50 entities may register with the Commission as security-based swap dealers, and up to five additional entities may register as major security-based swap participants.<sup>262</sup> These estimates remain unchanged.

Firms that act as dealers play a central role in the security-based swap market. Based on an analysis of 2017 single-name CDS data in TIW, accounts of those firms that are likely to exceed the security-based swap dealer *de minimis* thresholds, and thereby trigger the requirement to register as SBS dealers intermediated transactions with a gross notional amount of approximately \$2.9 trillion. Approximately 55% of that figure is intermediated by the top five dealer accounts.<sup>263</sup>

Dealers transact with hundreds or thousands of counterparties. Approximately 21% of accounts of firms expected to register as SBS dealers and observable in TIW have entered into security-based swaps with over 1,000 unique counterparty accounts as of year-end 2017.<sup>264</sup> Another 25% of these

<sup>261</sup> The challenges the Commission faces in estimating measures of current market activity stem, in part, from the absence of comprehensive reporting requirements for security-based swap market participants. The Commission has adopted rules regarding trade reporting, data elements, and public reporting for security-based swaps that are designed to, when fully implemented, provide the Commission with additional measures of market activity that will allow us to better understand and monitor activity in the security-based swap market. See Regulation SBSR Adopting Release, 81 FR at 53545.

<sup>262</sup> See, *e.g.*, Registration Adopting Release, 80 FR at 49000.

<sup>263</sup> The Commission staff analysis of DTCC Derivatives Repository Limited Trade Information Warehouse transaction records indicates that approximately 99% of single-name CDS price-forming transactions in 2017 involved an ISDA-recognized dealer.

<sup>264</sup> Many dealer entities and financial groups transact through numerous accounts. Given that

accounts transacted with 500 to 1,000 unique counterparty accounts; 29% transacted with 100 to 500 unique accounts; and 25% of these accounts intermediated security-based swaps with fewer than 100 unique counterparties in 2017. The median dealer account transacted with 495 unique accounts (with an average of approximately 570 unique accounts). Non-dealer counterparties transacted almost exclusively with these dealers. The median non-dealer counterparty transacted with two dealer accounts (with an average of approximately three dealer accounts) in 2017.

#### c. Other Market Participants

In addition to dealers, thousands of other participants appear as counterparties to security-based swap contracts in our sample, and include, but are not limited to, investment companies, pension funds, private funds, sovereign entities, and industrial companies. We observe that most non-dealer users of security-based swaps do not engage directly in the trading of swaps, but trade through banks, investment advisers, or other types of firms acting as dealers or agents. Based on an analysis of the counterparties to trades reported to the TIW, there are 2,110 entities engaged directly in trading between November 2006 and December 2017.<sup>265</sup>

individual accounts may transact with hundreds of counterparties, the Commission may infer that entities and financial groups may transact with at least as many counterparties as the largest of their accounts.

<sup>265</sup> These 2,110 entities, which are presented in more detail in Table 1, *infra*, include all DTCC-defined “firms” shown in TIW as transaction counterparties that report at least one transaction to TIW as of December 2017. The staff in the Division of Economic and Risk Analysis classified these firms, which are shown as transaction counterparties, by machine matching names to known third-party databases and by manual classification. See, *e.g.*, Security-Based Swap Transactions Connected With a Non-U.S. Person’s Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office or in a U.S. Branch or Office of an Agent; Security-Based Swap Dealer De Minimis Exception, Exchange Act Release No. 77104 (Feb. 10, 2016) 81 FR 8598, 8602 n.43 (Feb. 19, 2016). Manual classification was based in part on searches of the EDGAR and Bloomberg databases, the SEC’s Investment Adviser Public Disclosure database, and a firm’s public website or the public website of the account represented by a firm. The staff also referred to ISDA protocol adherence letters available on the ISDA website.

As shown in Table 1 below, close to three-quarters of these entities (DTCC-defined “firms” shown in TIW, which we refer to here as “transacting agents”) were identified as investment advisers, of which approximately 40% (about 30% of all transacting agents) were

registered as investment advisers under the Advisers Act.<sup>266</sup> Although investment advisers are the vast majority of transacting agents, the transactions they executed account for only 12.8% of all single-name CDS trading activity reported to the TIW,

measured by the number of transaction-sides (each transaction has two transaction sides, *i.e.*, two transaction counterparties). The vast majority of transactions (83.3%) measured by the number of transaction-sides were executed by ISDA-recognized dealers.

TABLE 1—THE NUMBER OF TRANSACTING AGENTS BY COUNTERPARTY TYPE AND THE FRACTION OF TOTAL TRADING ACTIVITY, FROM NOVEMBER 2006 THROUGH DECEMBER 2017, REPRESENTED BY EACH COUNTERPARTY TYPE

Transacting agents	Number	Percent	Transaction share (%)
Investment Advisers .....	1,635	77.5	12.8
—SEC registered .....	658	31.2	8.6
Banks .....	262	12.4	3.4
Pension Funds .....	29	1.4	0.1
Insurance Companies .....	42	2.0	0.2
ISDA-Recognized Dealers <sup>267</sup> .....	17	0.8	83.3
Other .....	125	5.9	0.2
Total .....	2,110	100.0	100

Principal holders of CDS risk exposure are represented by “accounts” in the TIW.<sup>268</sup> The staff’s analysis of these accounts in TIW shows that the 2,110 transacting agents classified in Table 1 represent 13,137 principal risk holders. Table 2, below, classifies these principal risk holders by their

counterparty type and whether they are represented by a registered or unregistered investment adviser.<sup>269</sup> For instance, banks in Table 1 allocated transactions across 349 accounts, of which 20 were represented by investment advisers. In the remaining instances, banks traded for their own

accounts. Meanwhile, ISDA-recognized dealers in Table 1 allocated transactions across 91 accounts. Private funds are the largest type of account holders that we were able to classify, and although not verified through a recognized database, most of the funds we were not able to classify appear to be private funds.<sup>270</sup>

TABLE 2—THE NUMBER AND PERCENTAGE OF ACCOUNT HOLDERS—BY TYPE—WHO PARTICIPATE IN THE SECURITY-BASED SWAP MARKET THROUGH A REGISTERED INVESTMENT ADVISER, AN UNREGISTERED INVESTMENT ADVISER, OR DIRECTLY AS A TRANSACTING AGENT, FROM NOVEMBER 2006 THROUGH DECEMBER 2017

Account holders by type	Number	Represented by a registered investment adviser		Represented by an unregistered investment adviser		Participant is transacting agent <sup>271</sup>	
		Number	Percent	Number	Percent	Number	Percent
Private Funds .....	3,857	1,973	51%	1,859	48%	25	1%
DFA Special Entities .....	1,319	1,262	96%	37	3%	20	2%
Registered Investment Companies .....	1,159	1,082	93%	73	6%	4	0%
Banks (non-ISDA-recognized dealers) ....	349	20	6%	8	2%	321	92%
Insurance Companies .....	301	196	65%	34	11%	71	24%
ISDA-Recognized Dealers .....	91	0	0%	0	0%	91	100%
Foreign Sovereigns .....	83	63	76%	3	4%	17	20%
Non-Financial Corporations .....	75	52	69%	4	5%	19	25%
Finance Companies .....	20	11	55%	0	0%	9	45%
Other/Unclassified .....	5,883	3,745	64%	1,887	32%	251	4%
All .....	13,137	8,404	64%	3,905	30%	828	6%

<sup>266</sup> See 15 U.S.C. 80b1–80b21. Transacting agents participate directly in the security-based swap market, without relying on an intermediary, on behalf of principals. For example, a university endowment may hold a position in a security-based swap that is established by an investment adviser that transacts on the endowment’s behalf. In this case, the university endowment is a principal that uses the investment adviser as its transacting agent.

<sup>267</sup> For the purpose of this analysis, the ISDA-recognized dealers are those identified by ISDA as belonging to the G14 or G16 dealer group during the period: JP Morgan Chase NA (and Bear Stearns), Morgan Stanley, Bank of America NA (and Merrill Lynch), Goldman Sachs, Deutsche Bank AG, Barclays Capital, Citigroup, UBS, Credit Suisse AG,

RBS Group, BNP Paribas, HSBC Bank, Lehman Brothers, Société Générale, Credit Agricole, Wells Fargo and Nomura. See, e.g., <https://www.isda.org/a/5eiDE/isda-operations-survey-2010.pdf>.

<sup>268</sup> “Accounts” as defined in the TIW context are not equivalent to “accounts” in the definition of “U.S. person” provided by Rule 3a71–3(a)(4)(i)(C) under the Exchange Act. They also do not necessarily represent separate legal persons. One entity or legal person may have multiple accounts. For example, a bank may have one DTCC account for its U.S. headquarters and one DTCC account for one of its foreign branches.

<sup>269</sup> Unregistered investment advisers include all investment advisers not registered under the Investment Advisers Act and may include

investment advisers registered with a state or a foreign authority as well as investment advisers that are exempt reporting advisers under Section 203(l) or 203(m) of the Investment Advisers Act.

<sup>270</sup> For the purposes of this discussion, “private fund” encompasses various unregistered pooled investment vehicles, including hedge funds, private equity funds, and venture capital funds. There remain over 5,800 DTCC accounts unclassified by type. Although unclassified, each account was manually reviewed to verify that it was not likely to be a special entity within the meaning of the Dodd-Frank Act and instead was likely to be an entity such as a corporation, an insurance company, or a bank.

#### d. Outstanding Positions

Our analysis here focuses on outstanding positions in single-name CDS. As we have previously noted, although the definition of a security-based swap is not limited to single-name CDS, we believe that the single-name CDS data is sufficiently representative of the market and therefore can directly inform the analysis of the state of the current security-based swap market.<sup>272</sup> In 2017, there were 1,534,753 single-name CDS transactions reported to DTCC–TIW, of which 1,036,155 were transactions with a clearing agency as a counterparty.<sup>273</sup>

<sup>271</sup> This column reflects the number of participants who are also trading for their own accounts.

<sup>272</sup> While other repositories may collect data on transactions in total return swaps on equity and debt, we do not currently have access to such data for these products (or other products that are security-based swaps). In the Cross-Border Proposing Release, we explained that we believed that data related to single-name CDS was reasonable for purposes of this analysis; such transactions appear to constitute roughly 82% of the security-based swap market as measured on a notional basis. See Cross-Border Proposing Release, 78 FR at 31120, n. 1301. None of the commenters to that release disputed these assumptions, and we therefore continue to believe that, although the BIS data reflect the global OTC derivatives market, and not just the U.S. market, these ratios are an adequate representation of the U.S. market.

Also consistent with our approach in that release, with the exception of the analysis regarding the degree of overlap between participation in the single-name CDS market and the index CDS market (cross-market activity), our analysis below does not include data regarding index CDS (including CDS based on narrow-based security indices) as we do not currently have sufficient information to identify the relative volumes of index CDS that are either swaps or security-based swaps.

<sup>273</sup> For the purposes of this analysis, we estimate there were approximately 1.53 million single-name CDS transactions in 2017, of which approximately 1.04 million were transactions with a clearing agency as a counterparty. In addition to CDS, security-based swap products include equity swaps, such as total return swaps on single names and swaps based on narrow-based security indices. The Commission currently lacks comprehensive data on equity swaps, including data on transaction volumes and notional amounts. While there were more than 1.53 million security-based swap transactions in 2017, we do not currently have sufficient information to precisely identify the number of transactions beyond those that were single-name CDS. However, while recognizing that average notional transaction amounts for equity and multi-name CDS may differ from average notional transaction amounts for CDS, our estimate (using data from 2015) that single-name CDS constitute roughly 82% of the security-based swap market implies that there were approximately 337,000 security-based swap transactions in 2017 in addition to the approximately 1.53 million single-name CDS transactions we identify in the DTCC–TIW data, or 1.87 million total security-based swap transactions. Note that our estimate that single-name CDS constitutes roughly 82% of the security-based swap market is based on notional transaction amounts rather than transaction counts; in using this figure to estimate the total number of security-based swap transactions, we have assumed that the average notional amount is the same across single-name CDS, multi-name CDS, and equity swaps.

Currently, security-based swap transactions are generally negotiated and executed bilaterally, typically with a dealer as one of the counterparties. Indeed, based on our analysis of DTCC–TIW data for 2017, more than 99% of single-name CDS transactions have an ISDA-recognized dealer as a counterparty, and 31% of transactions are between two ISDA-recognized dealers.<sup>274</sup>

As of December 30, 2017 there were 360,473 outstanding positions (with a gross notional value of \$4.196 trillion) in single-name corporate CDS of which 252,108 positions (\$2.095 trillion) did not include a CCP as one of the counterparties. Of the 252,108 positions, 158,674 positions (\$1.383 trillion) were between two market participants the Commission expects will register as SBS Entities, based on an analysis of DTCC–TIW data.<sup>275</sup> In addition, 90,559 positions (\$0.684 trillion) were between an expected SBS Entity and a market participant not expected to register as an SBS Entity and 2,875 (\$0.028 trillion) were between two participants not expected to register as SBS Entities.

If transactions are examined instead, there were 383,212 price-forming transactions in calendar-year 2017 (with an aggregate gross trade size of \$5.304 trillion) in single-name corporate CDS of which 175,600 transactions (\$4.321 trillion) did not include a CCP as one of the counterparties. Of those 175,600 transactions, 75,119 transactions (\$1.695 trillion) were between two expected SBS Entities, 99,370 transactions (\$2.245 trillion) were between an expected SBS Entity and a participant not expected to register, and 1,171 transactions (\$0.382 trillion) were between two participants not expected to register as SBS Entities.

Further analysis of the data reveals that of the 24 expected SBS Entities with outstanding positions as of December 30, 2017, 10 are not U.S. persons and may be subject to similar requirements as those being adopted

<sup>274</sup> For the purpose of this analysis, the reference to “ISDA-recognized dealers” means those dealers identified by ISDA as belonging to the G14 or G16 dealer group during the period. This group includes: JP Morgan Chase NA (and Bear Stearns), Morgan Stanley, Bank of America NA (and Merrill Lynch), Goldman Sachs, Deutsche Bank AG, Barclays Capital, Citigroup, UBS, Credit Suisse AG, RBS Group, BNP Paribas, HSBC Bank, Lehman Brothers, Société Générale, Credit Agricole, Wells Fargo and Nomura. See, e.g., <https://www.isda.org/a/5eiDE/isda-operations-survey-2010.pdf>. See also Aldasoro, Inaki, and Torsten Ehlers, 2018, The Credit Default Swap Market: What a Difference a Decade Makes, BIS Quarterly Review June 2018, Graph 2, available at: [https://www.bis.org/publ/qtrpdf/r\\_qt1806b.pdf](https://www.bis.org/publ/qtrpdf/r_qt1806b.pdf).

<sup>275</sup> See *supra* Section VI.C for current estimates of the number of SBS Entities.

here by foreign regulators. We note that the data available to us from DTCC–TIW does not encompass those CDS positions that both: (i) Do not involve U.S. counterparties;<sup>276</sup> and (ii) are based on non-U.S. reference entities. Notwithstanding this limitation, we believe that the DTCC–TIW data provides sufficient information to identify the types of market participants active in the security-based swap market and the general pattern of transactions within that market.<sup>277</sup> We find that of the outstanding positions on December 30, 2017, 317,854 positions (\$1.661 trillion) include at least one expected SBS Entity, 3,037 (\$0.018 trillion) are between non-U.S. domiciled expected SBS Entities and 60,948 (\$0.489 trillion) are between a non-U.S., domiciled expected SBS Entity and a participant not expected to register as an SBS Entity.

#### 2. Current Portfolio Reconciliation Practices

While the Commission does not have data on current portfolio reconciliation practices of security-based swap market participants,<sup>278</sup> certain market participants we expect will register as SBS Entities are already subject to similar requirements from other regulators. In particular, those entities that are registered with the CFTC as

<sup>276</sup> We note that DTCC–TIW’s determinations as to the domicile of a counterparty or reference entity may not reflect our definition of “U.S. person” in all cases. Our definition of “U.S. person” follows the definition used in the Commission’s June 2014 release where it, among other things, adopted rules and guidance regarding the application of the certain Title VII definitions in the cross-border context. See Cross-Border Adopting Release, 79 FR at 47303.

<sup>277</sup> The challenges we face in estimating measures of current market activity stems, in part, from the absence of comprehensive reporting requirements for security-based swap market participants. The Commission has adopted rules regarding trade reporting, data elements, and public reporting for security-based swaps that are designed to, when fully implemented, provide us with appropriate measures of market activity. See Regulation SBSR Adopting Release, 80 FR at 14699–700.

<sup>278</sup> Although the Commission does not have information on the number of valuation discrepancies between counterparties in SBS markets, a June 2017 survey on dealer financing noted that two-fifths of survey respondents reported that the volume of valuation disputes increased somewhat over the September 2016 to June 2017 period. Small net fractions of dealers responded that the volume, duration, and persistence of mark and collateral disputes had increased in OTC derivatives, especially in foreign exchange and interest rate contracts. Three-fifths of dealers responded that, on average, it takes more than two days but less than a week to resolve a mark and collateral dispute on VM. One-third indicated two days or fewer. See Yesol Huh, Division of Research and Statistics, Federal Reserve Board, The June 2017 Senior Credit Officer Opinion Survey on Dealer Financing Terms, available at: [https://www.federalreserve.gov/data/scoos/files/scoos\\_201706.pdf](https://www.federalreserve.gov/data/scoos/files/scoos_201706.pdf).

Swap Entities are also subject to CFTC rules on portfolio reconciliation. These rules require Swap Entities to reconcile their swap portfolios with one another and to provide counterparties who are not registered as Swap Entities with regular opportunities for portfolio reconciliation.<sup>279</sup> The Commission has reviewed these rules and believes that, other than as expressly noted above in Section II.A, they are substantively identical to these final rules.<sup>280</sup>

Further, SBS Entities that are domiciled outside of the U.S. may be subject to similar requirements of regulators from their home jurisdiction. For example, entities subject to Chapter VII, Article 13 of EU Regulation No 149/2013 already must comply with portfolio reconciliation requirements similar to those in the adopted rules. The EU regulations require all counterparties to agree on arrangements under which portfolios shall be reconciled before entering into an OTC derivative contract. Furthermore, the frequency of portfolio reconciliation under those regulations depends on both whether either counterparty is a “financial counterparty” or a “non-financial counterparty” (each as defined in European regulations), and the number of outstanding contracts between the two counterparties.

In addition to regulations that may apply to certain SBS Entities that are either dually registered with the CFTC as Swap Entities or subject to similar portfolio reconciliation rules in other jurisdictions, portfolio reconciliation forms a part of current market practices. In particular, ISDA publishes a set of “best practices” for its members for the OTC derivatives collateral process that addresses, among other things, portfolio reconciliation of non-cleared OTC derivatives.<sup>281</sup> These “best practices” include written agreement between counterparties as to the terms of the reconciliation and reconciliation tolerances, and also while acknowledging both the CFTC and EU rules pertaining to portfolio reconciliation, provide best practices that augment existing rules.<sup>282</sup>

### 3. Current Portfolio Compression Practices

While the Commission does not have data on current portfolio compression practices of security-based swap market participants, certain SBS Entities are already subject to similar compression requirements in other contexts similar to the situation involving portfolio reconciliation. Specifically, SBS Entities that are also registered with the CFTC as Swap Entities are subject to CFTC rules on portfolio compression. As discussed above, the Commission has reviewed those rules and believes that they are, other than as expressly noted above in Section II.B, substantively identical to these final rules.

Further, SBS Entities that are domiciled outside of the U.S. may be subject to similar requirements from regulators in their home jurisdiction. For example, entities subject to Chapter VII, Article 14 of EU Regulation No 149/2013 already must comply with portfolio compression requirements. Under these requirements any entity that has 500 or more non-cleared OTC derivative contracts with any one counterparty must have procedures in place to regularly (at least twice a year) analyze the possibility of conducting a portfolio compression exercise in order to reduce their counterparty credit risk and engage in such a portfolio compression exercise. The EU regulations differ from the rules being adopted in a few important ways, including their application to all OTC derivative positions, not just security-based swaps, as well as the minimum frequency of compression exercises. Moreover, both financial and non-financial counterparties are required under the EU regulations to ensure that they are able to provide “a reasonable and valid explanation to the relevant competent authority for concluding that a portfolio compression exercise is not appropriate.”

In addition to regulations that may apply to certain SBS Entities that are either dually registered with the CFTC as Swap Entities or subject to similar portfolio compression rules in other jurisdictions, portfolio compression forms a part of current market practices. The ISDA Collateral Best Practices also includes a best practice that addresses portfolio compression, explaining that trades that are subject to industry-wide trade-reducing events should be

reconciliation rules and notes that while broadly similar do include some differences. ISDA states that the “best practices” are intended to augment those rules by addressing points of practical significance that are not directly regulated. See ISDA Collateral Best Practices, pages 19–20.

removed from the portfolio on the day the trade-reducing event occurs and that this should be in agreement with governing documentation for the applicable risk reducing process.<sup>283</sup>

Although we lack data on current portfolio compression practices of individual SBS market participants, the importance of portfolio compression is illustrated by the scope of its use among security-based swap market participants.<sup>284</sup> In March 2010, DTCC explicitly attributed the reduction in the gross notional value of the credit derivatives in its warehouse to industry supported portfolio compression.<sup>285</sup> Using data from TriOptima, the BIS reports CDS portfolio compression rates as high as 25% of notional outstanding in the first half of 2008.<sup>286</sup> Compression volumes fell steadily over the following years due, in part, to falling transaction volumes and the rise of central clearing.<sup>287</sup> TriOptima, as well as other firms, continue to offer compression services, and the Commission believes that the fact that market participants continue to find it worthwhile to pay for such services lends support to the argument that market participants view portfolio compression as a valuable tool.

The chart below illustrates the opportunities for portfolio compression between 2010 and 2017 for single-name security-based swaps.<sup>288</sup> As the gap between gross and net notional values widens, the opportunities for portfolio compression increase. Over our reference period, however, the difference between gross and net notional values has declined. For

<sup>283</sup> See ISDA Collateral Best Practices, *supra* note 281, Best Practice 8.4.

<sup>284</sup> The data available to the Commission with respect to portfolio compression does not allow for enumeration of the actual participants which participate in such practices; however, inferences regarding the scope can be drawn from the magnitude of the reduction in the gross notional value of the credit derivatives.

<sup>285</sup> See DTCC Press Release, *DTCC Trade Information Warehouse Completes Record Year Processing OTC Credit Derivatives*, (Mar. 11, 2010). Notably, beginning in August 2008, ISDA encouraged compression exercises for CDS by selecting the service provider and defining the terms of service.

<sup>286</sup> See Aldasoro, Inaki, and Torsten Ehlers, 2018, *The Credit Default Swap Market: What a Difference a Decade Makes*, BIS Quarterly Review June 2018, Graph 1 panel 2 and accompanying text, available at: [https://www.bis.org/publ/qtrpdf/r\\_qt1806b.pdf](https://www.bis.org/publ/qtrpdf/r_qt1806b.pdf). In March of 2010, the staff of the FRBNY estimated that since 2008 nearly \$50 trillion gross notional of CDS positions has been eliminated through portfolio compression. See FRBNY OTC Derivatives Report, *supra* note 18.

<sup>287</sup> *Id.*

<sup>288</sup> The chart below includes only gross and net notional of single-name security-based swaps. The inclusion of index security-based swaps could expand potential compression opportunities available to SBS Entities.

<sup>279</sup> See 17 CFR 23.502 (Portfolio reconciliation).

<sup>280</sup> See, e.g., *supra* Section II.A for a discussion of similarities and differences in approach to the definition of material terms that must be reconciled.

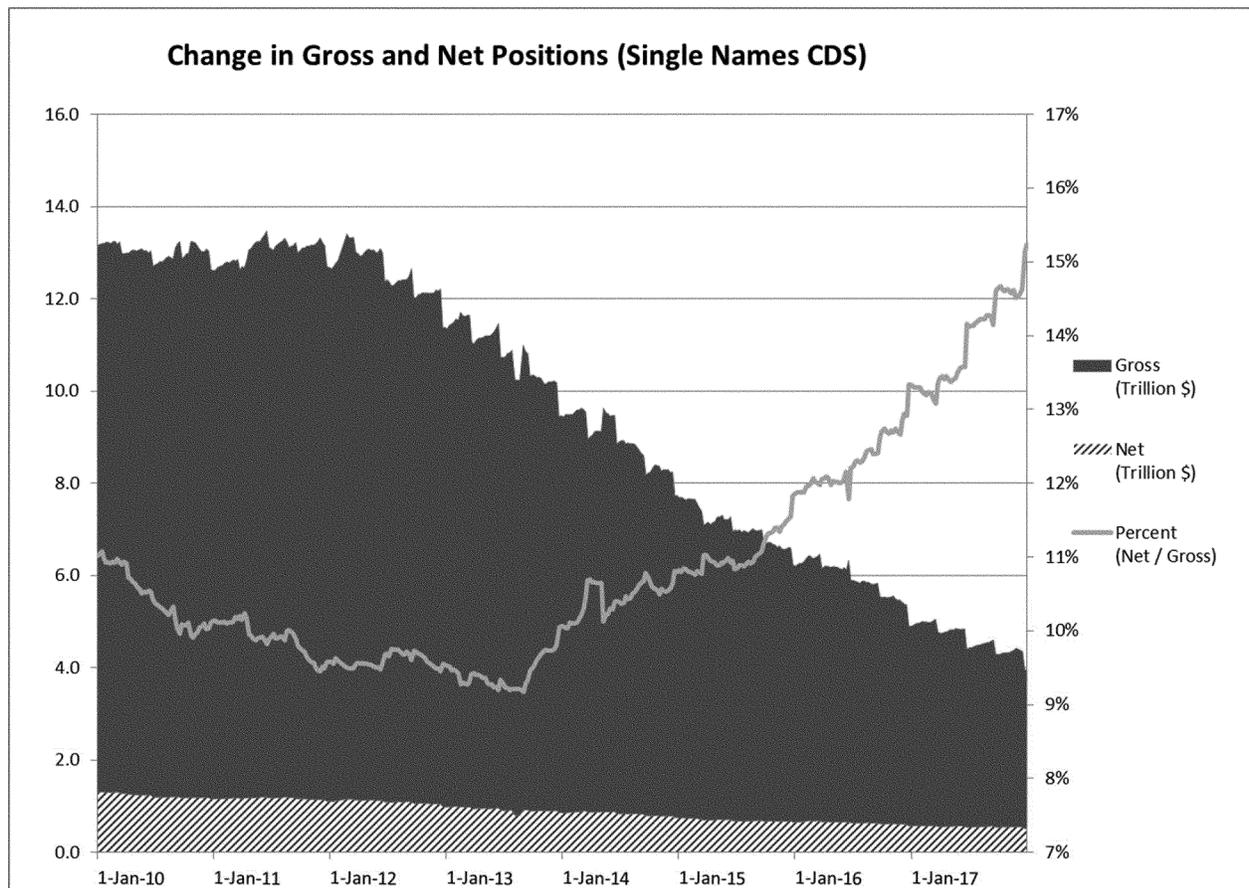
<sup>281</sup> See ISDA, 2013 Interim Updated Best Practices for the OTC Derivatives Collateral Process, Best Practices 10.1–10.6 (Oct. 23, 2013), available at: <https://www2.isda.org/attachment/NjA3NQ==/2013%20ISDA%20Best%20Practices%20for%20the%20OTC%20Derivatives%20Collateral%20Process%20-%20FINAL.pdf> (“ISDA Collateral Best Practices”).

<sup>282</sup> The ISDA Collateral Best Practices include citations to both the CFTC and EU portfolio

instance, in 2010, the percentage, which captures the ratio of net to gross notional value, was 11.0%, but this number has been gradually increasing

through December 30, 2018 when it was 15.2%. Smaller ratios indicate greater opportunities for portfolio compression; however, as shown in the chart below,

based on changes in gross and net notional value over time, unexploited opportunities for compression are diminishing.<sup>289</sup>



It is possible that market participants may already be taking advantage of portfolio compression opportunities. However, the Commission does not infer that the entirety of the reduction in the gap between gross and net notional values is due to portfolio compression exercises. Other plausible explanations for the reduction in the gross notional value of security-based swaps include both fewer and/or smaller new transactions, expiration of existing positions without rollover into new positions, and loss or consolidation of market participants throughout time. Due to limitations of the data available to the Commission, it is infeasible to distinguish the overall effect of portfolio compression exercises on the reduction in the gross notional value of the security-based swap market from the alternative explanations presented above.

#### 4. Current Trading Relationship Documentation Practices

Memorializing the specific terms of the security-based swap trading relationship and security-based swap transactions between counterparties is prudent business practice and, in fact, many market participants already use standardized documentation. Examination of the use of ISDA Master Agreements (the measure of trading relationship documentation available to the Commission in the data provided by DTCC-TIW) shows that the percentage of transactions with these agreements declines from 78.2% in 2008 to 34.1% in 2017, with the peak occurring in 2010 (96.1%). However, as trading relationship documentation may be different when the counterparty is a CCP, an analysis of documentation on aggregate security-based swap transactions (both cleared and

uncleared) may be misleading. With the introduction of ICE Clear Credit in 2009, the percentage of cleared transactions has increased over time, thus a seemingly more relevant measure to look at is the frequency of use of ISDA Master Agreements for uncleared transactions. Approximately 99% of all uncleared transactions are reported (by DTCC-TIW) as using trading relationship documentation (in the form of ISDA Master Agreements) in 2017 compared to 78.2% in 2008. Accordingly, the Commission generally believes that many, if not most, market participants currently execute and maintain trading relationship documentation of the type required by the adopted rules in the ordinary course of their businesses, including documentation that contains several of the terms that will be required by the adopted rules.

<sup>289</sup> The result is likely driven by banks and securities firms. See Aldasoro, Inaki, and Torsten Ehlers, 2018, *supra* note 286, Graph 5.

Finally, and similar to the discussion regarding the reconciliation and compression, SBS Entities that are also registered with the CFTC as Swap Entities are subject to CFTC rules requiring the use of trading relationship documentation. As discussed above, the Commission has reviewed those rules and believes that they are, other than as expressly noted above in Section II.C, substantively identical to these final rules.

### *C. Economic Costs and Benefits, Including Impact on Efficiency, Competition, and Capital Formation*

In this section we first discuss the expected effects of the rules being adopted on efficiency, competition, and capital formation, focusing particularly on the risk mitigation benefits that stem from the use of portfolio reconciliation, expanding opportunities for portfolio compression, and improvements in documentation. We then turn our discussion to additional costs and benefits, including compliance costs and alternatives considered of these rules.

#### 1. Effects on Efficiency, Competition, and Capital Formation

Risk mitigation rules have the potential to affect efficiency, competition, and capital formation in the security-based swap market, primarily through a reduction in operational, market, and credit risks that accompany outstanding security-based swap positions. In addition, the substituted compliance framework may provide additional effects that are distinct from the broader market impacts that are described below. As with the benefits and costs, we believe that several of the effects described below only occur to the extent that current market practices do not already conform to the rules being adopted.

##### a. Broad Market Effects

In the adopting release for final rules requiring SBS Entities to provide trade acknowledgments and to verify those trade acknowledgments with their counterparties to security-based swap transactions, the Commission explained the importance of confirming trades in a timely manner, noting that confirmation of the terms of a transaction is essential for SBS Entities “to effectively measure and manage market and credit risk.”<sup>290</sup> In this regard, portfolio reconciliation addresses many of these same issues, but unlike the confirmation process,

which occurs at the outset of a transaction, reconciliation operates throughout the life of the transaction.<sup>291</sup>

Failure to periodically conduct portfolio reconciliation may cause errors and disputes over the terms of a transaction that may exist to go undetected, leading to errors in measurement and management of market and credit risks associated with particular transactions. More generally, timely portfolio reconciliation will provide counterparties with accurate information that will enable them to evaluate their own risk exposure in a timely manner. Efficient and cost-effective risk management may conserve resources and free up capital that can be deployed in other asset classes, promoting risk-sharing and efficient capital allocation. In addition, cost-effective risk management may reduce the overall costs of financial intermediation, allowing market participants to increase lending and other capital formation activities.

Similarly, periodic portfolio reconciliation and improved standards for transaction documentation may contribute to broader market stability, particularly during periods of distress. Disagreement as to one or more material terms of a transaction or inadequate documentation could hinder timely and efficient settlement of security-based swap transactions, particularly in the case of a credit event on a reference entity on which many different counterparties have, in the aggregate, a large notional outstanding exposure. During periods of financial distress, uncertainty about terms, value, and documentation of outstanding transactions could contribute to liquidity and cash shortfalls that threaten the stability of the financial system. Thus, to the extent that the final rules being adopted reduce uncertainty about outstanding transactions, we expect reduced risk of uncertainty about the credit risk of potential counterparties, particularly during a financial crisis.

Finally, to the extent that portfolio reconciliation requirements differ from current market practices, these rules have the potential to affect competition across multiple dimensions. If the costs of portfolio reconciliation, portfolio compression, and complying with transaction documentation rules for security-based swap transactions are largely fixed (*i.e.*, the costs come from establishing infrastructure and systems necessary to perform portfolio reconciliation and portfolio compression and comply with

documentation requirements) rather than varying with the number of transactions or positions outstanding, smaller dealers intermediating a smaller number of trades may have a larger burden placed on them; larger dealers, on the other hand, may be able to spread the costs over a greater number of trades or positions, with a lower average cost per trade or position of complying with these rules. Similarly, the costs of establishing an infrastructure to comply with these requirements may create a barrier to entry for market participants wishing to establish a SBS dealer business.<sup>292</sup>

##### b. Substituted Compliance

As discussed above, if the Commission has made a positive substituted compliance determination with respect to a particular foreign regulatory regime, SBS Entities operating in that jurisdiction may be able to satisfy their Title VII risk mitigation requirements by complying with similar requirements of the foreign financial regulatory system. Substituted compliance would be available only for SBS Entities who are not U.S. persons.

The Commission is amending its rules to make substituted compliance potentially available to the portfolio reconciliation, portfolio compression, and trading relationship documentation requirements in order to minimize the likelihood that SBS dealers are subjected to potentially duplicative or conflicting regulation. The Commission believes that duplicative regulations that achieve comparable regulatory outcomes increase the compliance burdens on market participants without corresponding increases in benefits. By decreasing the compliance burden for foreign SBS dealers active in the U.S. market, the availability of substituted compliance could encourage foreign firms' participation in the U.S. market, increasing the ability of U.S. firms to access global liquidity, and reducing the likelihood that liquidity would fragment along jurisdictional lines. Such participation and access to liquidity might result in increased competition between both U.S. and foreign

<sup>292</sup> The Commission does not expect that this effect will extend to major SBS participants, which are by definition the largest non-dealer participants in the security-based swap market. As described in the economic baseline, out of more than 4,000 security-based swap market participants, we expect at most five to register as major SBS participants. These entities maintain substantial positions in security-based swaps, as defined in the Intermediary Definitions Adopting Release, and the Commission expects these entities have sufficient resources and infrastructure to comply with portfolio reconciliation and documentation requirements.

<sup>290</sup> See Trade Acknowledgment and Verification Adopting Release, 81 FR at 39833.

<sup>291</sup> See *supra* Section II.A.

intermediaries without compromising the regulatory benefits intended by the applicable risk mitigation rules.

## 2. Portfolio Reconciliation

Disputes related to confirming the terms of a swap, as well as swap valuation disputes, have long been recognized as a significant problem in the OTC derivatives market. The Commission believes that the ability to determine definitively the value of a security-based swap at any given time is an important component of many of the OTC derivatives market reforms contained in the Dodd-Frank Act and is a component of sound risk management practices.<sup>293</sup> Security-based swap valuation is also crucial for determining capital and margin requirements applicable to SBS Entities and therefore plays a primary role in risk mitigation for uncleared security-based swaps. Portfolio reconciliation is considered an effective means of identifying and resolving these disputes at a time and in a manner that will be least disruptive to the counterparties and the broader financial system.

Parties may dispute valuations of thinly traded security-based swaps where there is not agreement on valuation methodologies or the source for formula inputs. Many of these security-based swaps are thinly traded either because of their limited liquidity or because they are simply too customized to have comparable counterparts in the market. As many of these security-based swaps are valued by dealers internally by “marking-to-model,” their counterparties may dispute the inputs and methodologies used in the model. As uncleared security-based swaps are bilateral, privately negotiated contracts, on-going security-based swap valuation for purposes of initial and variation margin calculation and security-based swap terminations or novations, also has been largely a process of on-going negotiation between the parties. The effects of an inability to agree on the value of a security-based swap became especially acute during the financial crisis that immediately preceded passage of the Dodd-Frank Act when there was widespread failure of the market inputs needed to value many security-based swaps.<sup>294</sup>

<sup>293</sup> See ISDA Collateral Best Practices, *supra* note 281, Section 10.

<sup>294</sup> The lack of liquidity in markets for mortgage-backed securities led to wide disparities in the valuation of CDS referencing mortgage-backed securities (especially collateralized debt obligations). Such wide disparities led to large collateral calls from dealers on AIG, hastening its downfall. See CBS News, “Calling AIG? Internal

## a. Requirements

The Commission is adopting rules that generally will require each SBS Entity (1) to engage in portfolio reconciliation with counterparties who are also SBS Entities at periodic intervals, the length of which is based on the number of outstanding transactions with the counterparty and (2) to establish, maintain, and follow written policies and procedures reasonably designed to ensure that it engages in portfolio reconciliation with counterparties who are not SBS Entities, also at periodic intervals, the length of which is based on the number of outstanding transactions with the counterparty.<sup>295</sup>

The Commission is adopting rules that vary the portfolio reconciliation requirement based on the particular type of counterparty with which the SBS Entity transacts. For transactions between two SBS Entities, the rules require the two sides to engage in portfolio reconciliation at frequencies that are based on the size of the security-based swap portfolio between the two parties.<sup>296</sup> In addition to the requirements regarding the frequency of the reconciliation, Rule 15Fi-3(a)(1) requires SBS Entities to agree in writing with each of their SBS Entity counterparties on the terms of the portfolio reconciliation including, if applicable, agreement on the selection of any third party service provider who may be performing the reconciliation.

To the extent that the two SBS Entities identify a discrepancy, the rule requires the parties to take certain steps. First, Rule 15Fi-3(a)(4) requires the two sides to resolve immediately any discrepancy in a material term, whether identified directly as part of the portfolio reconciliation or otherwise. Second, Rule 15Fi-3(a)(5) requires each SBS Entity to establish, maintain, and follow written policies and procedures reasonably designed to resolve any discrepancy in a valuation identified as

Docs Reveal Company Silent About Dozens of Collateral Calls,” June 23, 2009, available at: [http://www.cbsnews.com/stories/2009/06/23/cbsnews\\_investigates/main5106672.shtml](http://www.cbsnews.com/stories/2009/06/23/cbsnews_investigates/main5106672.shtml). See also Financial Crisis Inquiry Commission, The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, Chapter 8, available at: <https://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf>.

<sup>295</sup> Pursuant to Rule 15Fi-3(d), the new requirements regarding portfolio reconciliation would not apply to a clearing transaction (*i.e.*, a security-based swap that is, directly or indirectly, submitted to and cleared by a clearing agency registered pursuant to Section 17A of the Act (15 U.S.C. 78q-1) or by a clearing agency that the Commission has exempted from registration by rule or order). See *supra* Section II.A.6.

<sup>296</sup> See Rule 15Fi-3(a).

part of a portfolio reconciliation or otherwise as soon as possible, but in any event within five business days after the date on which the discrepancy is first identified. As a condition to this requirement, however, Rule 15Fi-3(a)(5) requires each SBS Entity to establish, maintain, and follow written policies and procedures reasonably designed to identify how the SBS Entity will comply with any variation margin requirements under Section 15F(e) of the Exchange Act<sup>297</sup> and any related regulations pending resolution of the valuation discrepancy. Finally, Rule 15Fi-3(a)(5) clarifies that for purposes of the requirement to resolve valuation discrepancies within five business days of being identified, a difference between the lower valuation and the higher valuation of less than 10% of the higher valuation need not be deemed a discrepancy.<sup>298</sup>

Separately, with respect to transactions between an SBS Entity and a counterparty that is not an SBS Entity, Rule 15Fi-3(b) requires each SBS Entity to establish, maintain, and follow written policies and procedures reasonably designed to ensure that it engages in portfolio reconciliation as set forth in the rule.<sup>299</sup> This policies and procedures requirement is in contrast to Rule 15Fi-3(a), which expressly requires portfolio reconciliation with respect to transactions where both counterparties are SBS Entities.

Rule 15Fi-3(b) contains a number of requirements regarding the contents of the policies and procedures required therein, as they relate to reconciliation with non-SBS Entities, which are largely consistent with the requirements imposed directly on the parties under Rule 15Fi-3(a). Specifically, Rule 15Fi-3(b)(3) provides that such policies and procedures must require that the portfolio reconciliation be performed no less frequently than: (1) Once each calendar quarter for each security-based swap portfolio that includes more than 100 security-based swaps at any time during the calendar quarter and (2) once annually for each security-based swap portfolio that includes no more than 100 security-based swaps at any time during the calendar year.

In addition, Rule 15Fi-3(b)(4) requires each SBS Entity to establish, maintain, and follow written procedures reasonably designed to resolve within five business days any discrepancies in the valuation or a material term of each

<sup>297</sup> 15 U.S.C. 78o-10(e).

<sup>298</sup> This 10% threshold would apply on a transaction-by-transaction basis, and not on a portfolio level.

<sup>299</sup> See Rule 15Fi-3(b).

security-based swap identified as part of a portfolio reconciliation or otherwise with a counterparty that is not an SBS Entity.<sup>300</sup>

Finally, Rule 15Fi-3(c) requires each SBS Entity to promptly notify the Commission of any security-based swap valuation dispute in excess of \$20,000,000 (or its equivalent in any other currency) if not resolved within:

- Three business days, if the dispute is with a counterparty that is an SBS Entity, or
- five business days, if the dispute is with a counterparty that is not an SBS Entity.

Such notification is required to be in a form and manner acceptable to the Commission, and is also required to be sent to any applicable prudential regulator (*i.e.*, for any SBS Entity that is also a bank, to its bank regulator). SBS Entities are also required to notify the Commission, in a form and manner acceptable to the Commission, and any applicable prudential regulator, if the amount of any security-based swap valuation dispute that was the subject of a previous notice increases or decreases by more than \$20,000,000 (or its equivalent in any other currency), at either the transaction or portfolio level.<sup>301</sup>

For the security-based swap market to operate efficiently and to reduce credit and operational risk between counterparties, the Commission believes that, although the frequency of portfolio reconciliation depends on the number of positions with a counterparty, reconciliation should occur by position because terms may vary across positions with the same counterparty. By identifying and managing mismatches in key economic terms and valuation for individual transactions across an entire portfolio, these rules are intended to require a process in which risk between counterparties can be identified and reduced.

#### b. Benefits

Reconciliation is beneficial not only to the parties involved but also to the

<sup>300</sup> Similar to the requirement in paragraph (a) of the rule for portfolio reconciliation with counterparties that are either SBS dealers or major SBS participants, Rule 15Fi-3(b)(4) provides that a difference between the lower valuation and the higher valuation of less than 10% of the higher valuation need not be deemed a discrepancy for purposes of that paragraph. See *supra* note 63 and accompanying text (discussing the 10% threshold in the context of Rule 15Fi-3(a)(5)).

<sup>301</sup> See *supra* Section II.A.5. Each amended notice is required to be provided to the Commission and any applicable prudential regulator no later than the last business day of the calendar month in which the applicable security-based swap valuation dispute increases or decreases by the applicable dispute amount.

market as a whole. By identifying and managing disputed key economic terms or valuation for each transaction across a portfolio, an entity's counterparty credit risk and operational risk can be diminished. By requiring a systematic reconciliation process, as well as policies and procedures related to portfolio reconciliation between counterparties, SBS Entities will be able to better identify and correct problems in a timely manner in their post-execution processes (including confirmation) in order to reduce the number of disputes and improve the integrity and efficiency of their internal processes. Accordingly, expanding the universe of participants subject to the reconciliation requirements can help to reduce the risk bilateral markets may pose to the broader financial system.

As discussed above, because shortcomings in credit risk management and documentation may only become evident during a crisis, some benefits of portfolio reconciliation will accrue to the financial system as a whole while the ongoing direct costs are borne by the individual market participant. Therefore, in the absence of these rules, the level and frequency of portfolio reconciliation chosen by individual market participants may be less than what would be desired by all market participants in order to properly manage risks to the financial system.

In addition, the Commission believes that the tiering of obligations, whereby the frequency of the portfolio reconciliation is based on the number of outstanding transactions with the applicable counterparty, represents a reasonable attempt to calibrate the costs to the benefits expected from reconciling a person's security-based swap portfolio at regular intervals. In this respect, those benefits are expected to rise for larger—and often more complex—portfolios that may represent a greater potential for loss than a smaller, less complex portfolio.

The Commission believes that, given the expected benefits of making the frequency of portfolio reconciliation a function of the size of a portfolio with a particular counterparty, setting the frequency of reconciliation identical to that adopted by the CFTC will provide additional benefit for SBS Entities that are also registered with the CFTC as Swap Entities. In particular, harmonizing the frequency of reconciliation for swaps and SBS should reduce implementation cost and reduce operational complexity.

Similarly, the Commission notes that the EC has adopted portfolio reconciliation requirements for the EU that are similar to those being adopted

by the Commission in this release. The Commission believes that aligning its portfolio reconciliation requirements with those in other major security-based swap markets will benefit SBS Entities by avoiding the imposition of disparate compliance and operational policies and procedures.

Moreover, Rule 15Fi-3(a)(2) provides that portfolio reconciliation may be performed either on a bilateral basis by the counterparties or by a third party selected by the counterparties in accordance with paragraph (a)(1) of the rule. Under this approach, the process for selecting a third-party service provider—or the actual identity of the service provider—should be included in the written agreement between the two sides setting forth the terms of the portfolio reconciliation process.

In the absence of periodic portfolio reconciliation, if the counterparties to a security-based swap transaction are not in agreement with respect to each of the terms of the transaction that may affect each party's rights and obligations, any such difference could lead to complications at various points throughout the trade.<sup>302</sup> These discrepancies could be exacerbated if they remain undetected until such times as the parties become obligated to perform on their requirements under the contract. Such discrepancies could be particularly problematic if they are discovered during a period of financial stress for the market participant.<sup>303</sup> Thus, portfolio reconciliation may help to mitigate the possibility of a discrepancy unexpectedly affecting performance by ensuring that the parties are and remain in agreement with respect to all of the material terms of the security-based swap transaction.

Regular reconciliation of all portfolios is a process to reduce counterparty credit exposure and operational risk and help prevent disputes from arising. The rule should promote market integrity and reduce risk by establishing procedures that will promote legal certainty concerning security-based swap transactions, assist with the early resolution of valuation disputes, reduce operational risk, and increase operational efficiency.

The rules being adopted may have differential benefits for smaller market participants. Smaller market participants may not have the bargaining power necessary to compel larger counterparties to coordinate on portfolio reconciliation. Since SBS Entities, absent a mandate, are likely to focus risk management resources on

<sup>302</sup> See *supra* note 11.

<sup>303</sup> See *supra* note 246.

larger counterparties, the ability of smaller counterparties to require the necessary cooperation from their counterparties who are SBS Entities will be improved. Reduced uncertainty concerning material terms and valuation methodologies could reduce the risks to these smaller participants for using SBS for hedging market risk to which they may be exposed.

Portfolio reconciliation is particularly relevant with respect to terms related to the valuation of the instrument.

Unresolved discrepancies regarding the value of a security-based swap can lead to, among other things, active disputes between counterparties with respect to the amount of margin that must be posted or collected, as well as errors and other complications that may result in significant uncollateralized exposure in the uncleared security-based swap markets (or alternately, potentially inefficient overcollateralization). Accordingly, the Commission believes that requiring counterparties to clearly document the applicable processes and requirements for calculating and exchanging margin in connection with a security-based swap transaction is an important step in achieving this broader regulatory objective.

The notification requirement of Rule 15Fi-3(c) will provide the Commission with information about disagreements over position values between counterparties. Valuation is one of the most fundamental elements for determining the economic rights and obligations of each of the counterparties to a security-based swap transaction. For example, market participants manage credit risks to their counterparties by exchanging margin with each other in an amount determined using the value of the underlying security-based swap. If those valuations are not accurate for any reason, such as human or system errors, problems with the valuation methodology, or an issue affecting the timeliness of the calculation, that error could result in one of the counterparties having an uncollateralized credit exposure and a potential for loss in the event of a default. We therefore expect that the notification requirement could assist the Commission in anticipating potential valuation problems that could ultimately lead to market disruption, and in identifying potential issues with respect to an SBS Entity's internal valuation methodology. As noted above, the CFTC has adopted a nearly identical requirement with the same \$20,000,000 threshold, and the Commission believes that divergence from that requirement could lead to additional costs for SBS Entities that are also registered with the

CFTC as Swap Entities.<sup>304</sup> Finally, as discussed above, the Commission believes reconciliation may provide indirect benefits by improving the accuracy of SDR data.<sup>305</sup> As described above in Section II.A, the information that SBS Entities will initially be required to reconcile with their counterparties will include each term that is required to be reported to a registered SDR under Rule 901 under the Exchange Act.<sup>306</sup>

#### c. Costs

The portfolio reconciliation rules in Rule 15Fi-3 are similar to the corresponding CFTC rules for Swap Entities. As a result, the one-time costs to develop, test, and implement new procedures and technology that may be required in order to be compliant with the rules being adopted are mitigated by the fact that many SBS Entities also are likely to be Swap Entities. These dually registered entities are likely to be familiar with these general requirements and have the infrastructure in place to comply with similar rules that apply to their swap business.

SBS Entities that are not also CFTC-regulated Swap Entities and that do not currently use an electronic platform or vendor service to conduct portfolio reconciliation will need to expend significant time and resources to modify the necessary systems to comply with Rule 15Fi-3. Even those SBS Entities that do use electronic platforms or vendors services may find it necessary to make significant adjustments to comply with the rules. The Commission estimates a one-time upfront cost of approximately \$5-10 million for an SBS Entity that is not also a Swap Entity.<sup>307</sup> Although the Commission does not currently have cost data for either reconciliation performed in-house or by third-party service providers, and therefore cannot quantify these costs, the Commission believes that the ongoing portfolio reconciliation cost would likely be a function of portfolio size and the availability of third party service providers.

In contrast, when commenting on the CFTC's then-proposed portfolio reconciliation rule, a third party provider of multilateral compression services stated that a large number of

Swap Entities were already regularly reconciling their portfolios with each other and with other entities and that the increased frequency and inclusion of smaller portfolios as was being proposed by the CFTC should prove no obstacle to such entities.<sup>308</sup> If SBS Entities have similar business practices, then this comment suggests start-up and on-going portfolio reconciliation costs could be small. In addition, and as discussed above, portfolio reconciliation generally forms a part of current market practices and is included in a set of best practices published by ISDA.<sup>309</sup> Taken together, this information suggests that the upfront costs for building new systems to comply with Rule 15Fi-3 are not likely to be as high as indicated above.

The Commission believes that certain costs will arise despite the fact that an SBS Entity also may be registered with the CFTC as a Swap Entity, and therefore subject to similar rules already adopted by the CFTC. Such costs may include (i) increased costs to account for possible differences between the SEC and CFTC related to the terms considered to be material for purposes of the reconciliation requirement; (ii) the additional resources necessary to design, compose, and implement the required policies and procedures; (iii) the additional resources needed to comply with the dispute resolution timeframes; and (iv) the compilation and maintenance of applicable records. These costs, however, are by nature specific to each entity's internal operations; absent specific information from commenters, the Commission cannot provide reasonable estimations regarding the resources needed to comply.

The rule also requires SBS Entities to agree in writing with each of their counterparties on the terms of the portfolio reconciliation including, if applicable, agreement on the selection of any third party service provider who may be performing the reconciliation. Accordingly, each counterparty to a SBS Entity subject to these rules will incur an upfront cost in implementing this requirement, particularly since the Commission will expect that such terms be agreed to in writing prior to, or contemporaneously with, the two parties executing any new security-based swap transaction. These costs would be mitigated if, once the parties

<sup>304</sup> See *supra* Section II.A.

<sup>305</sup> See SDR Adopting Release, 80 FR at 14528-48, for a discussion of the expected economic benefits accurate SBS data held at SDRs.

<sup>306</sup> See Rule 15Fi-1(i)(1) (referencing 17 CFR 242.901).

<sup>307</sup> This estimate is based on an estimate supplied by ISDA to the CFTC in response to their proposed portfolio reconciliation rule. See CFTC Risk Mitigation Adopting Release, 77 FR at 55952-53.

<sup>308</sup> See Letter from Per Sjöberg, Executive Vice President, TriOptima AB to the CFTC, dated Feb. 28, 2011 at 2, available at: <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=30562&SearchText>.

<sup>309</sup> See *supra* notes 281-282 and accompanying text.

have agreed in writing on the terms of the portfolio reconciliation for the first time, the two sides comply with this requirement for subsequent transactions by merely agreeing in writing to abide by the existing agreement regarding the reconciliation process. This practice could help to ensure that portfolio reconciliation begins without delay after execution of the transaction and is designed to minimize the number of disagreements regarding the portfolio reconciliation process itself.

The Commission estimates that of the 55 market participants we expect to register as SBS Entities, approximately 20 will be dually-registered with the CFTC and may already have automated portfolio reconciliation systems in place.<sup>310</sup> Thus, for these entities, the costs associated with modifying these existing systems to account for security-based swap reconciliations is expected to be minimal. For the remaining 35 SBS Entities which are not expected to be dually-registered with the CFTC, the anticipated personnel costs<sup>311</sup> associated with setting up an automated portfolio reconciliation system per SBS Entity is \$63,150, or \$2,210,250 in aggregate.<sup>312</sup> The Commission believes that these costs will be a component of the upfront cost estimate of \$5–10 million discussed above.<sup>313</sup> For each SBS Entity, we anticipate that approximately 190 hours per year will be required for reconciliation or a total of 10,450 hours across the 55 SBS Entities.<sup>314</sup> With respect to

reconciliations with non-SBS counterparties, the Commission estimates that an additional 227.5 hours per SBS Entity, or 12,512.5 hours in aggregate will be needed for automated portfolio reconciliation with these counterparties.<sup>315</sup>

The Commission further estimates that the development and implementation of written policies and procedures as required under Rule 15Fi-3 will impose an initial cost of \$1,302,135.<sup>316</sup> Of the total 55 SBS Entities that would be subject to Rule 15Fi-3, 20 are estimated to be dually-registered with the CFTC, and are anticipated to already have policies and procedures in place with respect to reconciliation. The expected additional time to revise the existing policies and procedures for these SBS Entities is expected to be one hour per SBS Entity, for a cumulative 20 hours, costing \$461.75 per SBS Entity or \$9,235 in aggregate.<sup>317</sup> For the remaining 35 SBS Entities, the Commission estimates that

those counterparty relationships, two are expected to have portfolios in excess of 500 positions, which would need to be reconciled daily (252 trading days per year), four would have between 50 and 500 positions, which would need to be reconciled weekly (52 weeks per year), and the remaining 12 would have less than 50 positions, which would need to be reconciled quarterly (four times per year). The Commission estimates that each portfolio reconciliation would require 30 minutes, 15 minutes per counterparty, through an automated system, thus the total anticipated reconciliation time would be [(2 counterparties × 252 trading days × 0.25 hours) + (4 counterparties × 52 weeks × 0.25 hours) + (12 counterparties × 4 quarters × 0.25 hours)] = 190 hours per SBS Entity, or (190 × 55 SBS Entities) = 10,450 hours in aggregate. See Section VI.D.1.

<sup>315</sup> There are anticipated to be 13,137 total SBS counterparties, of which 55 are registered SBS Entities, leaving 13,082 non-SBS market participants. See *supra* note 220. The Commission estimates that each SBS Entity will transact with approximately 350 of these non-registered participants. Of those 350 counterparties, 35 are expected to have portfolio positions in excess of 100 positions, which would require quarterly reconciliations, while the remaining 315 are expected to have positions of less than 100 security-based swaps, and therefore, would require annual reconciliation. The Commission estimates that each portfolio reconciliation would require 30 minutes through an automated system, thus the total anticipated reconciliation time would be [(35 counterparties × 4 quarters × 0.5 hours) + (315 counterparties × 1 time per year × 0.5 hours)] = 227.5 hours per SBS Entity, or (227.5 × 55 SBS Entities) = 12,512.5 hours in aggregate.

<sup>316</sup> This figure has been updated from that in the proposing release due to the updated estimate of the number of SBS Entities that will be dually registered with the CFTC and updates to hourly rates to account for inflation over the period. See *supra* note 310 and *supra* note 311.

<sup>317</sup> The estimate is based on the following: [(Compliance Attorney (30 minutes) at \$372 per hour) + ((Director of Compliance (15 minutes) at \$496 per hour) + ((Deputy General Counsel (15 minutes) at \$607 per hour)] = \$461.75 per hour per SBS Entity or (\$461.75 per hour × 20 SBS dually-registered Entities) = \$9,235.

it will take approximately 80 hours per entity to establish the written policies and procedures. The costs for these SBS Entities will be \$1,292,900, or \$36,940 per SBS Entity.<sup>318</sup> Once established, the Commission estimates that it will cost SBS Entities approximately \$1,015,850 or \$18,470 per SBS Entity to revise and maintain these policies and procedures.<sup>319</sup> Resolution of valuation discrepancies can be labor intensive. One objective of the rule being adopted is to reduce the incidence of valuation discrepancies through the periodic reconciliations between security-based swap counterparties. It is unlikely, however, that the rule will completely eliminate disputes related to valuation. The Commission lacks data on the fraction of positions that, when reconciled, will result in a dispute as well as the costs likely to be incurred resolving those disputes, and is therefore unable to quantify these costs. However, the Commission recognizes that the costs associated with resolution of these disputes is likely to be higher than costs for reconciliations in which disputes do not arise.

However, the Commission believes that these costs may be mitigated by only requiring counterparties to address differences in valuation greater than 10%. These costs of reconciliation may be further mitigated by agreement between the counterparties to use a third party service provider to assist in resolving valuation discrepancies. Reconciliation of other terms is likely to be less costly as the terms of the agreement are unlikely to change over the life of the contract.

The 10% threshold was designed to both identify large deviations in valuations between SBS Entities, while not requiring those entities to devote significant effort to resolving minor valuation disputes. Further, this threshold is identical to that already adopted by the CFTC.<sup>320</sup> The Commission notes, however, that this 10% threshold is at the transaction level, rather than the entity level. While discrepancies could be random in nature, the risk exists that one

<sup>318</sup> The estimate is based on the following: [(Compliance Attorney (40 hours) at \$372 per hour) + ((Director of Compliance (20 hours) at \$496 per hour) + ((Deputy General Counsel (20 hours) at \$607 per hour)] = \$36,940 per SBS Entity or (\$36,940 × 35 SBS Entities that are not dually-registered) = \$1,292,900 in aggregate.

<sup>319</sup> The estimate is based on the following: [(Compliance Attorney (20 hours) at \$372 per hour) + ((Director of Compliance (10 hours) at \$496 per hour) + ((Deputy General Counsel (10 hours) at \$607 per hour)] = \$18,470 per SBS Entity or (\$18,470 × 55 SBS Entities) = \$1,015,850 in aggregate.

<sup>320</sup> See 17 CFR 23.502 (portfolio reconciliation).

<sup>310</sup> In the Proposing Release, the Commission estimated that of the 55 entities that may register with the Commission as SBS Entities, approximately 35 will be dually-registered with the CFTC as Swap Entities. In a more recent release, however, the Commission updated that estimate, such that we now believe that approximately 20 SBS Entities will also be registered with the CFTC as Swap Entities. See *supra* Section VI.C and references therein. Accordingly, we are using the updated number for calculating the burdens pursuant to Rule 15Fi-3, 15Fi-4, and 15Fi-5.

<sup>311</sup> The hourly rates for internal professionals used throughout Sections VII.C.2.c, VII.C.3.c, and VII.C.4.c of the release are taken from SIFMA's Management & Professional Earnings in the Securities Industry 2013, modified to account for an 1800-hour work-year and inflation, and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead. The hourly rates have been modified from the proposal to account for inflation over the period.

<sup>312</sup> This estimate is based on the following: [(Sr. Programmer (80 hours) × \$337 per hour) + (Sr. Systems Analyst (80 hours) × \$289 per hour) + (Compliance Manager (10 hours) × \$315 per hour) + (Director of Compliance (5 hours) × \$496 per hour) + (Compliance Attorney (20 hours) × \$372 per hour)] = \$63,150 per SBS Entity, or (\$63,150 × 35 SBS Entities) = \$2,210,250 in aggregate.

<sup>313</sup> See *supra* note 307 and associated text.

<sup>314</sup> Each SBS Entity is anticipated to have counterparty relationships with approximately one-third of the other SBS market participants (1/3 × 55 = 18.333), which is rounded to 18 participants. Of

counterparty could have systemic issues in valuation across its entire portfolio, thereby leading to discrepancies in valuation with one or several counterparties and throughout the portfolio. For example, if an entity's valuation model consistently undervalued each of its security-based swap positions by 9%, in aggregate, the overall level of risk could be substantial, even though it would not trigger a discrepancy event as currently defined by the 10% transaction level threshold. Further, since the Commission estimates that approximately 20 of the expected 55 SBS Entities are likely to be dually-registered with the CFTC and active in swap and security-based swap markets, these participants are likely to face higher costs when regulations differ.

The costs of resolving valuation disputes are expected to be mitigated, because the reconciliation requirements are expected to prevent disputes from arising in the first instance through the regular comparison of material terms and valuations. The Commission believes that by requiring SBS Entities to reach agreement with certain counterparties on the methods and inputs for valuation of each security-based swap, as required in connection with the trading relationship documentation requirements in Rule 15Fi-5, the overall framework of these rules should assist SBS Entities in resolving valuation disputes within five business days. In addition, the Commission estimates that SBS Entities will spend an average of 30 hours per year to comply with the notification requirement of Rule 15Fi-3(c) costing \$11,160 per SBS Entity or \$613,800 in aggregate.<sup>321</sup>

Lastly, portfolio reconciliation costs are also mitigated by virtue of the fact that cleared security-based swaps are not within the scope of the requirements of these rules. The Commission believes that CCPs establish settlement prices for each cleared security-based swap every business day for margining purposes and this process is more appropriately addressed by rules governing a clearing agency's risk management practices.<sup>322</sup> Because a large part of the security-based swap portfolios of SBS Entities may consist of cleared security-based swaps to which the reconciliation requirements will not apply, the sizes of the bilateral, uncleared portfolios (to

which the requirement would apply) may be limited.<sup>323</sup>

#### d. Alternatives

The rule being adopted creates a specific definition of "material terms" for purposes of determining what discrepancies must be resolved in connection with the portfolio reconciliation which includes each term required to be reported to an SDR, or the Commission pursuant to Rule 901 under the Exchange Act<sup>324</sup> provided, however, that such definition does not include any term that is not relevant to the ongoing rights and obligations of the parties and the valuation of the security-based swap.

The Commission's definition of "material terms" in the rule proposal was bifurcated, and depended on whether the relevant security-based swap transaction had already been included in a security-based swap portfolio and reconciled pursuant to proposed Rule 15Fi-3.<sup>325</sup> With respect to any security-based swap that has *not* yet been reconciled as part of a security-based swap portfolio, "material terms" would have been defined to mean each term that is required to be reported to a registered SDR pursuant to Rule 901 under the Exchange Act.<sup>326</sup> With respect to all other security-based swaps within a security-based swap portfolio, the definition of "material terms" would have continued 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 security-based swap. As discussed above, both of the comment letters received raised concerns with the proposed definition of "material terms."<sup>327</sup> In particular, commenters expressed the opinion that the proposed bifurcated approach would raise operational and technical issues that would be costly to resolve with no

tangible benefit for an SBS Entity's risk mitigation activity.

As discussed above, after careful review and consideration of these comments, the Commission modified its definition of "material terms" to more closely align with the CFTC's corresponding definition. Commenters indicated that the costs and burdens imposed on SBS Entities of implementing the proposed bifurcated approach were not justified in light of what commenters viewed as an incomplete and partial solution to the SDR verification issue. In light of these comments, the Commission believes it appropriate and less burdensome for SBS Entities to harmonize the definition of "material terms" in Rule 15Fi-1(i) with the corresponding CFTC definition by not adopting the proposed bifurcated approach.<sup>328</sup>

The Commission also considered not providing a specific definition of "material terms" and allowing SBS Entities discretion in determining those terms that are relevant to the ongoing rights or obligations of the parties or affect the valuation of the security-based swap. The Commission concluded that the data required to be submitted to an SDR in connection with regulatory reporting requirements is an appropriate measure for determining which terms should be reconciled pursuant to Rule 15Fi-3. The Commission also believes that tying the definition of "material terms" to reporting requirements to an SDR could reduce the burdens on some SBS Entities by potentially allowing them to leverage the same electronic systems used for SDR reporting for purposes of the portfolio reconciliation requirements.

The portfolio size breakpoints and frequencies are consistent with those adopted by the CFTC for Swap Entities and are therefore likely to be familiar to those entities that are registered as both an SBS Entity and a Swap Entity. These are also the breakpoints adopted by the EC. Further, the Commission believes that alternative breakpoints based on the number of transactions which deviate from those adopted by the CFTC and the EC would likely impose additional costs on SBS Entities without any corresponding increases in material benefits to those participants.

Although the notion of breakpoints based on number of transactions previously has been accepted by the CFTC and other regulatory agencies, the Commission notes that breakpoints based on alternative measures could be considered. In particular, breakpoints for reconciliation could be categorized

<sup>321</sup> The estimate is based on the following: [Compliance Attorney (30 hours) at \$372 per hour] = \$11,160 per entity × 55 SBS entities = \$613,800. This estimate is larger than that provided in the proposal because of the increase in the estimate of the number of hours to file notices and amendments. See *supra* Section VI.D.3.

<sup>322</sup> See *supra* Section II.A.

<sup>323</sup> Currently, there is no regulatory requirement in the United States to clear security-based swaps. As of December 2015, approximately 56% of the total volume of new trade activity in single-name security-based swap products had been cleared through ICE Clear Credit. Further, approximately 79% of index CDS transactions were centrally cleared as of December 2015 (see <https://www.isda.org/a/kVDDE/swapsinfo-q4-2015-review-final.pdf>); therefore, single-name security-based swaps potentially could be cleared at a similar rate.

<sup>324</sup> See *supra* note 30.

<sup>325</sup> See Proposing Release at 4617-4618.

<sup>326</sup> Rule 901 (17 CFR 242.901) is part of Regulation SBSR, which governs the reporting to registered SDRs of security-based swap data and public dissemination by registered SDRs of a subset of that data. See 17 CFR 242.900 to 242.909.

<sup>327</sup> See *supra* Section II.A.1.

<sup>328</sup> See *id.*

by either gross (or net) notional amounts of positions or the current market value of positions, and identified as levels or scaled by some measure such as the aggregate notional value of the market (for gross or net notional values) or the assets of the SBS Entity (if market values are used instead). Although the number of security-based swaps between counterparties is easy to capture, it may actually be misleading with respect to the complexity or magnitude of the risk between counterparties.

For instance, say two counterparties have over 500 transactions between them, but the average value of each transaction is only \$5 million notional value. The total exposure between the two counterparties would only be \$2.5 billion, but this portfolio would need to be reconciled daily due to the number of transactions. If, on the other hand, two counterparties have only 40 transactions, but the average value of each transaction is \$1 billion notional value, the overall exposure would be \$40 billion (16 times greater exposure than the 500 transaction counterparties), but this portfolio would only be reconciled quarterly. Basing breakpoints on some measure other than the number of transactions may enable SBS Entities to better assess the overall level of counterparty credit risk as well as operational risk associated with their security-based swap portfolios. Setting aside these concerns, the Commission believes that breakpoints based on the number of transactions is likely to capture the complexity of SBS Entities' portfolios, and that reconciliations based on this dimension are likely to identify discrepancies in a timely manner. Further, given that the Commission estimates that approximately 20 of the expected 55 SBS Entities are likely to be dually-registered with the CFTC and active in both swap and security-based swap markets, this alternative could potentially impose additional costs due to differences in regulatory requirements.

The Commission has also considered alternatives to the requirement that valuation discrepancies exceeding 10% must be resolved within five business days. The 10% threshold is consistent with the rule adopted by the CFTC for Swap Entities and, as a result, is likely to be familiar to those entities that are registered as both an SBS Entity and a Swap Entity. The Commission believes that the 10% threshold is high enough to prevent market participants from incurring costs to resolve small valuation differences that would have only a small effect on margin or other

risk management practices, yet low enough to prevent difference in valuation from resulting in significant miscalculations in risk management.

As noted above, there are potential economic costs that could accrue to counterparties related to both the 10% threshold and the five business day resolution window. An alternative (albeit supplementary) approach would be an additional requirement of a valuation threshold related to the overall portfolio discrepancies, in aggregate and/or with individual counterparties. For instance, if the aggregate portfolio has valuation discrepancies of 5% or 10%, this could trigger a discrepancy event, even if the individual transaction-level discrepancies fall below the prescribed threshold as documented currently in the rule. Relatedly, while the five business day window is narrow enough to potentially stem valuations from deviating for extended periods of time while still providing a horizon in which parties can work through their valuation disputes, entities can face significant counterparty risk over seemingly short-term horizons. For relatively stable valuation disputes in which the value does not continue to deviate further from the agreed-upon level, then a five business day window is likely to be sufficient; however, a more compressed alternative horizon could be invoked when the discrepancies in value continue to widen between counterparties. The Commission believes that the five business day horizon is sufficient and serves as an upper-bound by which time market participants should have addressed and corrected any material discrepancies that arose during reconciliation. Moreover, this approach is consistent with requirements from other regulators, and given the Commission's estimates on SBS Entities that are likely to be dually-registered with the CFTC, any differences in regulation would likely impose additional costs to those entities.

Finally, Rule 15Fi-3(c) will require each SBS Entity to promptly notify the Commission of any security-based swap valuation dispute in excess of \$20,000,000 (or its equivalent in any other currency) if not resolved within:

- Three business days, if the dispute is with a counterparty that is an SBS Entity, or
- five business days, if the dispute is with a counterparty that is not an SBS Entity.

Such notification will be required to be in a form and manner acceptable to the Commission, and will also be required to be sent to any applicable

prudential regulator (*i.e.*, for any SBS Entity that is also a bank, to its bank regulator). SBS Entities are also required to promptly notify the Commission, in a form and manner acceptable to the Commission, and any applicable prudential regulator, if the amount of any security-based swap valuation dispute that was the subject of a previous notice increases or decreases by more than \$20,000,000 (or its equivalent in any other currency), at either the transaction or portfolio level.<sup>329</sup>

The Commission has considered as an alternative, requiring SBS Entities to make and keep records of valuation discrepancies that exceed \$20,000,000 rather than requiring that they be reported to the Commission. The Commission concluded that the benefit of receiving an early warning of potential problems before they surfaced though an ordinary course of review of books and records justifies any additional cost imposed on SBS entities.

Pursuant to Rule 15Fi-3(d), the new requirements regarding portfolio reconciliation will not apply to a security-based swap that is, directly or indirectly, submitted to and cleared by a clearing agency registered pursuant to Section 17A of the Exchange Act or by a clearing agency that the Commission has exempted from registration by rule or order pursuant to Section 17A.<sup>330</sup> The Commission modified the proposed exception for cleared security-based swaps so that it now applies to the initial bilateral transaction between the original counterparties (in addition to the resulting transactions between those counterparties and the clearing agency once the original transaction has been novated) and to permit the exception to be used when the clearing agency has been exempted from registration pursuant to Section 17A of the Exchange Act.<sup>331</sup> The Commission modified the exception in this manner in response to comments received, as well as to be consistent with the Commission's margin requirements for security-based swap transactions and the approach taken by the CFTC.<sup>332</sup>

<sup>329</sup> See *supra* Section II.A.5. Each amended notice is required to be provided to the Commission and any applicable prudential regulator no later than the last business day of the calendar month in which the applicable security-based swap valuation dispute increases or decreases by the applicable dispute amount.

<sup>330</sup> See *supra* Section II.A.6.

<sup>331</sup> See *id.*

<sup>332</sup> Specifically, CFTC Rule § 23.502(c) provides that "[n]othing in this section shall apply to a swap that is cleared by a derivatives clearing organization." 17 CFR 23.502(d).

which should reduce implementation and compliance costs.

The Commission has considered as an alternative, allowing a SBS Entity to be deemed in compliance with certain rules regarding portfolio reconciliation if the SBS Entity is also registered as a swap dealer or major swap participant with the CFTC and is in compliance with the corresponding CFTC portfolio reconciliation rules. The Commission concluded that differences between its rules and rules adopted by the CFTC may provide certain benefits to SBS Entities and other market participants that would not be available under a rule that was identical to the corresponding CFTC rule. For example, the requirement in the rule that each term required to be reported to a registered SDR under Rule 901 must be reconciled may facilitate the verification of transaction data by SDRs, which could address concerns raised by market participants and data repositories. Such benefits could be unavailable under such an approach given that CFTC portfolio reconciliation rules do not require all of this information to be reconciled.<sup>333</sup>

### 3. Portfolio Compression

Portfolio compression is an important post-trade processing mechanism that can be an effective and efficient tool for the management of risk by security-based swap market participants. Portfolio compression is a mechanism whereby directionally opposite transactions with substantially similar terms among two or more counterparties are terminated and, if any exposure remains, replaced with a smaller number of transactions of decreased notional value in an effort to reduce the risk, cost, and inefficiency of maintaining offsetting transactions on the counterparties' books. Because portfolio compression participants are permitted to establish their own credit, market, and cash payment risk tolerances and to establish their own mark-to-market values for the transactions to be compressed, the process does not alter the risk profiles of the individual participants beyond a level acceptable to the participant. Portfolio compression is commonly acknowledged as a useful risk management tool.<sup>334</sup>

<sup>333</sup> See *supra* Section II.A for a discussion of the proposed reconciliation rules and the verification of transaction data by SDRs. See also *supra* note 57 for a discussion of differences between CFTC and Commission requirements concerning third party reconciliation.

<sup>334</sup> See <http://www2.isda.org/news/isda-publishes-paper-highlighting-achievements-in-portfolio-compression>.

#### a. Requirements

The Commission is adopting rules and providing interpretations that generally will require each SBS Entity to establish, maintain, and follow written policies and procedures for engaging in certain forms of portfolio compression exercises with each of its counterparties. Depending on the number of counterparties, the portfolio compression exercise would be defined as either a "bilateral portfolio compression exercise" or as a "multilateral portfolio compression exercise."

Under Rule 15Fi-4(a), SBS Entities are required to establish, maintain, and follow written policies and procedures for periodically engaging in both bilateral portfolio compression exercises and multilateral portfolio compression exercises, when appropriate, with each counterparty that is also an SBS Entity.<sup>335</sup> For transactions with non-SBS Entities, the policies and procedures required under the rule will require only that portfolio compression exercise would have to occur when appropriate and only if requested by any such counterparty.<sup>336</sup>

#### b. Benefits

As a mechanism for post-trade management of risk in security-based swaps, portfolio compression provides benefits not only to the counterparties in each transaction but also to the markets as a whole. A portfolio compression exercise permits firms to identify instances in which directionally opposite transactions with similar terms can be terminated or replaced, with a smaller number of transactions with decreased notional value, reducing the overall risk, cost, and inefficiencies associated with maintaining offsetting transactions. As such, portfolio compression is recognized as an important risk management tool.<sup>337</sup> By expanding the universe of participants required to maintain portfolio compression policies

<sup>335</sup> See Rules 15Fi-4(a)(2) and (3).

<sup>336</sup> See Rule 15Fi-4(b).

<sup>337</sup> For example, in 2008, the PWG identified frequent portfolio compression of outstanding trades as a key policy objective in the effort to strengthen the OTC derivatives market infrastructure. See PWG Report, *supra* note 248. Similarly, the 2010 staff report issued by the FRBNY outlined policy perspectives on OTC derivatives infrastructure and identified trade compression as an element of strong risk management and recommended that market participants engage in regular, market-wide portfolio compression exercises. See FRBNY OTC Derivatives Report, *supra* note 18. Since the years immediately following the 2008 financial crisis, compression outside of CCPs has been somewhat less common and has declined substantially from its 2008 peak. See *supra* note 286.

and procedures, credit risk in the uncleared security-based swaps market can be reduced and may provide benefits to the entire financial system.

Further, the termination of redundant security-based swap transactions through the portfolio compression process is likely to result in the potential reduction of both counterparty and operational risk at the SBS Entity level. The use of portfolio compression also could reduce the overall level of bilateral risk exposures, while leaving the net positions of market participants unaltered, thereby improving operational efficiency. Improvements in operational efficiency may arise due to fewer overall positions for each entity, a reduction in carried margin and variation margin calculations, and fewer (and potentially less frequent) portfolio reconciliations. This would also reduce the number of bilateral positions that would have to be resolved in the event of insolvency of a market participant. These reductions in risk and improvements in operational efficiency of SBS Entities could benefit the financial system as a whole, thereby potentially increasing the number of market participants as well as improving liquidity.

Although the costs of participating in portfolio reconciliation are fully internalized by each counterparty, the potential benefits, particularly for multilateral compression exercises, increase with the number of counterparties that participate. Under Rule 15Fi-4(a), SBS Entities are required to establish, maintain, and follow written policies and procedures for periodically engaging in both bilateral portfolio compression exercises and multilateral portfolio compression exercises, in each case when appropriate, with counterparties that also are an SBS Entities.<sup>338</sup> To the extent that an SBS Entity transacts with a counterparties that are not SBS Entities, the policies and procedures required under the rule require only that portfolio compression exercises occur when appropriate and only if requested by any such counterparty. In the absence of these rules, some counterparties may not participate in compression activities reducing the potential benefits available to other counterparties and the financial system generally.

As noted in the economic baseline, the emergence of third-party vendors has provided portfolio compression services for security-based swaps. SBS Entities may be able to continue to benefit from the services of these third-

<sup>338</sup> See *supra* Section II.B.

party vendors to provide additional portfolio compression opportunities for these firms.

These rules provide flexibility to security-based swap market participants with respect to portfolio compression. The Commission believes that by not adopting prescriptive requirements, an SBS Entity can allow its counterparties flexibility in the manner in which they reduce the size of their security-based swap portfolios in light of each counterparty's unique risks and operations. Moreover, the rules regarding bilateral offset have been designed to reflect the understanding by the Commission that firms may have legitimate economic and business reasons for maintaining fully offsetting security-based swap transactions. For example, certain portfolio compression exercises could result in adverse credit exposures to certain counterparties. The results of a particular multilateral compression exercise may result in a credit exposure to a particular counterparty that exceeds credit exposure limits for that counterparty.

Thus, the Commission believes that the policies and procedures should be flexible enough to allow an SBS Entity to take the most appropriate course of action with respect to managing its risks, while at the same time, encouraging SBS Entities to consider the risk mitigation possibilities of portfolio compression in a non-arbitrary manner and consistent with the purposes of Section 15F(i) of the Exchange Act. As such, Rules 15Fi-4(a)(1) and (b) require a firm's policies and procedures to address the termination of fully offsetting security-based swaps only "when appropriate."

Finally, the Commission notes that both the CFTC and the EC have adopted portfolio compression requirements that are substantially similar to those being adopted by the Commission in this release.<sup>339</sup> By closely aligning portfolio compression requirements through consultation with the CFTC and European authorities, the Commission believes that SBS Entities will benefit from a largely unitary regulatory regime that does not require separate compliance and operational policies and procedures.

### c. Costs

SBS Entities will necessarily have to design, compose, and implement policies and procedures to regularly evaluate compression opportunities with their counterparties as well as those opportunities offered by third parties. However, the Commission

believes that given the large risk management benefits available from the regular compression of offsetting trades—benefits including reduced risk and enhanced operational efficiency—SBS Entities already undertake regular portfolio compression exercises. For this reason and those discussed below, the Commission believes that the relevant costs will primarily be the creation of policies and procedures.

The greater the level of standardization in security-based swaps, the less costly it becomes to identify compression opportunities. In April 2009, ISDA announced the implementation of the 2009 ISDA Credit Derivatives Determinations Committees and Auction Settlement CDS Protocol, known colloquially in the industry as the "Big Bang Protocol," which introduced a number of documentation changes to help standardize single-name CDS contracts.<sup>340</sup> Among these changes were the introduction of standard coupon rates and standard effective dates. Following the standardization of single-name CDS, compression in this market segment increased.<sup>341</sup> As that standardization continues, we expect that the cost of identifying appropriate compression opportunities should continue to fall. Using single-name corporate CDS data from DTCC-TIW discussed above, we find the percentage of new trades in North American Single-Name Corporate that have standardized coupons has risen from 95.2% in 2012 to 99.8% in 2017. The reduction in the number of roll-dates from four to two in order to both improve liquidity as well as to align with updates to CDS indices<sup>342</sup> also may result in increased standardization and therefore may reduce the costs of identifying compression opportunities.

The Commission estimates that the development and implementation of

<sup>340</sup> See Press Release, ISDA Announces Successful Implementation of 'Big Bang' CDS Protocol; Determinations Committees and Auction Settlement Changes Take Effect (Apr. 8, 2009), available at: <https://www.isda.org/a/XS6EE/ISDA-Announces-Successful-Implementation-of-E2%80%98Big-Bang%E2%80%99-CDS-Protocol-Determinations-Committees-and-Auction-Settlement-Changes-Take-Effect.docx>.

<sup>341</sup> See Nicholas Vause, Counterparty risk and contract volumes in the credit default swap market, BIS Quarterly Review (Dec. 2010), available at: [http://www.bis.org/publ/qtrpdf/r\\_qt1012g.pdf](http://www.bis.org/publ/qtrpdf/r_qt1012g.pdf). ("TriOptima became the first company to offer CDS portfolio compression when it extended its TriReduce service from interest rate swaps to the CDS market in 2005. In the CDS market, TriReduce has compressed mainly portfolios of CDS indices and index tranches, but single names have accounted for an increasing share of its compression volumes since standardisation in 2009.")

<sup>342</sup> See <http://www2.isda.org/asset-classes/credit-derivatives/single-name-cds-roll/>.

written policies and procedures as required by Rule 15Fi-4 will impose an initial cost of \$1,302,135 in aggregate.<sup>343</sup> Of the 55 market participants the Commission expects will register as SBS Entities and be subject to Rule 15Fi-4, the Commission estimates that approximately 20 of these market participants are registered with the CFTC, and are anticipated to already have policies and procedures in place with respect to portfolio compression. The expected additional time to revise the existing policies and procedures for these SBS Entities is expected to be one hour per SBS Entity, for a cumulative 20 hours, costing \$461.75 per SBS Entity or \$9,235 in aggregate.<sup>344</sup> For the remaining 35 SBS Entities, the Commission estimates that it will take approximately 80 hours per entity to establish the written policies and procedures. The costs for these SBS Entities will be \$1,292,900, or \$36,940 per SBS Entity.<sup>345</sup> Once established, the Commission estimates that it will cost SBS Entities approximately \$1,015,850 or \$18,470 per SBS Entity to revise and maintain these policies and procedures.<sup>346</sup>

The Commission further estimates that an SBS Entity will devote approximately 124.16 hours per year for portfolio offsets and compression exercises (6,828.8 aggregate hours), a substantial portion of which will be automated, and some of which may be handled by third-party vendors.<sup>347</sup>

<sup>343</sup> This figure has been updated from that in the Proposing Release due to the updated estimate of the number of SBS Entities that will be dually registered with the CFTC and updates to hourly rates to account for inflation over the period. See *supra* note 310 and *supra* note 311.

<sup>344</sup> The estimate is based on the following: (((Compliance Attorney (30 minutes) at \$372 per hour) + ((Director of Compliance (15 minutes) at \$496 per hour) + ((Deputy General Counsel (15 minutes) at \$607 per hour)) = \$461.75 per hour per SBS Entity or (\$461.75 per hour × 20 SBS dually-registered Entities) = \$9,235.

<sup>345</sup> The estimate is based on the following: (((Compliance Attorney (40 hours) at \$372 per hour) + ((Director of Compliance (20 hours) at \$496 per hour) + ((Deputy General Counsel (20 hours) at \$607 per hour)) = \$36,940 per SBS Entity or (\$36,940 × 20 SBS Entities that are not dually-registered) = \$1,292,900.

<sup>346</sup> The estimate is based on the following: (((Compliance Attorney (20 hours) at \$372 per hour) + ((Director of Compliance (10 hours) at \$496 per hour) + ((Deputy General Counsel (10 hours) at \$607 per hour)) = \$18,470 per SBS Entity or (\$18,470 × 55 SBS Entities) = \$1,015,850 in aggregate.

<sup>347</sup> The Commission estimates that each SBS Entity will transact with approximately 368 counterparties (18 SBS Entities and 350 non-SBS market participants). It is estimated that approximately one offset per year will take place between counterparties and it is expected to take five minutes to complete, for a total number of hours of (2.5/60 × 18 + 5/60 × 350) or 29.91 hours

<sup>339</sup> See *supra* note 6 and accompanying text.

Similar to our discussion for portfolio reconciliation (Section VII.C.2.c), the Commission expects that the costs of implementing portfolio compression exercises through an automated process will be minimal for those SBS Entities that are dually-registered with the CFTC, as many of those systems will already be in place. With respect to the remaining 35 SBS Entities that are not dually-registered, the Commission anticipates that any cost associated with implementing the portfolio reconciliation system may also account for the portfolio compression exercises that may periodically take place; therefore, the overall costs of portfolio compression systems should be minimal.

In terms of quantification of the costs of compression, the Commission also notes that there are a number of third-party vendors that provide compression services, and some of these providers may charge fees based on results achieved (such as number of swaps or security-based swaps compressed). Assuming that third-party vendors charge a fee directly related to the outcome of the compression exercise (as opposed to a fixed fee in whole or some portion thereof for portfolio compression activities), the direct costs of portfolio compression by third-party vendors would therefore likely be directly related to the economic benefits of reduced counterparty and operational risk realized through the compression exercises. The Commission does not currently have pricing data for third-party service providers that offer portfolio compression services and so is unable to quantify the costs to market participants who make use of these services.

Many non-SBS Entities typically trade only in small volumes and on one side of a particular security-based swap, to create a synthetic position in the underlying asset or to hedge another position, for example. Such one-sided market positions reduce the opportunities to engage in periodic compression cycles. For SBS Entities that do not currently participate in compression cycles, there could be costs to modify the participant's risk systems and connectivity enhancements that

per year per SBS Entity. Further, each SBS Entity is expected to conduct six bilateral compressions with SBS Entities and 350 bilateral compressions with non-SBS counterparties, each taking 15 minutes for total hours of  $[(7.5/60 \times 6) + (15/60 \times 350)] = 88.25$  hours. Lastly, each SBS Entity is anticipated to complete 12 multilateral compressions each year, each taking 30 minutes for a total of 6 hours. Total time for each SBS Entity for portfolio compression exercises is estimated to be  $(29.91 + 88.25 + 6) = 124.16$  hours, or 6828.8 hours (124.16 hours  $\times$  55 SBS Entities).

would allow for sharing the necessary information required to identify compression opportunities and for the booking and processing of a large volume of security-based swaps in a short time period. Multilateral compression cycles are typically managed with automated tools to support tear-up and new trade creation that end-users usually do not possess, and the costs of obtaining such tools cannot be justified by the benefits. The rule does not require market participants to engage in mandatory compression cycles, but only to establish, maintain, and follow written policies and procedures for engaging in certain forms of portfolio compression exercises.

#### d. Alternatives

The adopted rule requires that SBS Entities establish, maintain, and follow written policies and procedures as they relate to certain forms of portfolio compression exercises with each of its counterparties. As such, the Commission did not mandate the specific contents of the policies and procedures created to comply with these rules.<sup>348</sup> However, a number of more specific requirements for portfolio compression could be included. For example, the current rule as adopted only requires policies and procedures that address compression to the extent requested by the counterparty rather than a more prescriptive requirement.<sup>349</sup>

Pursuant to Rule 15Fi-4, SBS Entities are required "periodically" to examine the possibility for whether portfolio compression exercises can take place. While this provides flexibility to the counterparties in terms of the frequency with which rebalancing would have to be explored, it leaves open the possibility that market participants will suboptimally select the frequency with which portfolio compression exercises can occur, which could impose externalities on SBS counterparties as well as the financial system as a whole. As an alternative, the Commission considered requiring a minimum frequency of analysis of portfolio compression exercises. For instance, at least twice a year, SBS Entities could conduct an analysis of the possibility of a portfolio compression exercise in order to reduce their counterparty credit risk and engage in such a portfolio compression exercise, similar to those adopted by the EC.<sup>350</sup> Given that

<sup>348</sup> There is one exception to this statement. See *supra* note 97.

<sup>349</sup> See *supra* Section II.B.

<sup>350</sup> See EU Regulation 149/2013, art. 14, 2013 O.J. 11, 22.

portfolio compression has been identified to be a valuable and important tool for risk management, it is likely that many SBS Entities already have in place policies and procedures for periodic evaluation of compression possibilities, thus imposing a minimum standard could be burdensome and costly for firms to implement with little if any corresponding benefit.

Relatedly, the frequency with which SBS Entities evaluate their prospects for portfolio compression opportunities could be related to the number of transactions between counterparties (as is required for portfolio reconciliation by Rule 15Fi-3). For instance, if counterparties have portfolios in excess of 500 transactions, an analysis of portfolio compression could be conducted quarterly, while for SBS Entities with portfolios between 50 and 500 transactions, portfolio compression exercises could be explored twice a year. For counterparties with fewer than 50 transactions between them (or for portfolios with non-SBS Entities), portfolio compression exercises could be simply "periodically." This would allow counterparties to assess the counterparty credit risk at frequencies aligned with the complexities of their portfolios without incurring substantive additional costs of this increase in periodic evaluation of portfolio compression opportunities. The Commission considered the costs and benefits to market participants of imposing policies and procedures related to portfolio compression based on the number of transactions between counterparties. However, it is likely that market participants expected to register as SBS Entities already have policies and procedures in place to evaluate portfolio compression opportunities with counterparties, and requiring alterations to these policies could be costly for these entities without corresponding benefits.

Pursuant to Rule 15Fi-4(c), the new requirements regarding portfolio compression will not apply to a security-based swap that is, directly or indirectly, submitted to and cleared by a clearing agency registered pursuant to Section 17A of the Exchange Act or by a clearing agency that the Commission has exempted from registration by rule or order pursuant to Section 17A.<sup>351</sup> The Commission modified the proposed exception for cleared security-based swaps so that it now applies to the initial bilateral transaction between the original counterparties (in addition to the resulting transactions between those counterparties and the clearing agency

<sup>351</sup> See *supra* Section II.B.3.

once the original transaction has been novated) and to permit the exception to be used when the clearing agency has been exempted from registration pursuant to Section 17A of the Exchange Act.<sup>352</sup> The Commission modified the exception in this manner in response to comments received, as well as to be consistent with the Commission's margin requirements for security-based swap transactions and the approach taken by the CFTC,<sup>353</sup> which should reduce implementation and compliance costs.

The Commission has considered as an alternative, allowing an SBS Entity to be deemed in compliance with certain rules regarding portfolio compression if the SBS Entity is also registered as a swap dealer or major swap participant with the CFTC and is in compliance with the corresponding CFTC portfolio compression rules. The Commission concluded that, as a practical matter, the rules are nearly equivalent, suggesting that any additional compliance cost arising from differences in these rules for an entity that is registered with both the CFTC and the Commission should be small. The Commission believes that the differences that do exist (such as the adopted rule providing that requested compression by an entity that is not a security-based swap dealer or major security-based swap participant need only be conducted if appropriate)<sup>354</sup> may provide marginal benefits to SBS market participants (such as by preventing portfolio compression that is not appropriate given the particular circumstances of the trade and the counterparties to that trade).<sup>355</sup>

#### 4. Trading Relationship Documentation

OTC derivatives market participants typically have relied on the use of industry standard legal documentation, including master netting agreements, definitions, schedules, and confirmations, to document their security-based swap trading relationships. This industry standard documentation offers a framework for documenting the transactions between counterparties for OTC derivatives

products.<sup>356</sup> The standard documentation is designed to set forth the legal, trading, and credit relationship between the parties and to facilitate netting of transactions in the event that parties have to close-out their position with one another or determine credit exposure for margin and collateral management. Notwithstanding the standardization of such documentation, some or all of the terms of the master agreement and other documents are subject to negotiation and modification.

##### a. Requirements

The Commission is adopting rules and interpretations that generally will require each SBS Entity to establish, maintain, and follow written policies and procedures reasonably designed to ensure that it executes written trading relationship documentation with its counterparties prior to, or contemporaneously with, executing a security-based swap. The security-based swap trading relationship documentation is required to be in writing and to include all material terms governing the trading relationship between counterparties.

Further, the rules being adopted will also require that the security-based swap trading relationship documentation include credit support arrangements.<sup>357</sup> One of the key elements of Title VII reforms was to ensure that uncleared OTC derivatives were appropriately collateralized, thus the documentation of processes for calculating and exchanging margin in connection with security-based swaps helps to achieve the broader regulatory objective.<sup>358</sup>

The rules also will establish minimum standards with respect to identifying the matters that must be addressed in the security-based swap trading documentation, and outline certain requirements related to the resolution of discrepancies, particularly those involving differences in the valuation of security-based swaps. In the event that discrepancies in valuation arise, the rule requires that counterparties must provide documentation for either an alternative method for determining value of the security-based swap or documentation

on the resolution process for such disputes.

The rule also requires that counterparties to the security-based swap provide information on their legal status, particularly in the event of liquidation, as well as to provide certain information of a security-based swap accepted for clearing by a clearing agency, in order to reduce any potential confusion regarding the status of the trade following its acceptance and novation at the clearing agency. Lastly, Rule 15Fi-5 requires a periodic independent audit to identify any material deficiencies in the trading relationship documentation policies and procedures.

##### b. Benefits

Inadequate or incomplete documentation of open security-based swap transactions could, in some cases, result in collateral and legal disputes between the two counterparties, thereby exposing both sides to significant counterparty credit risk. By way of contrast, adequate documentation between counterparties offers a framework for establishing the trading relationship between the parties from the outset of the transaction, which should minimize both the number and magnitude of potential disputes.

Further, having policies and procedures regarding trading relationship documentation in place is important for all aspects of the transaction, the valuation of the transaction and how it affects margin requirements on an on-going basis is critical for managing both counterparty credit as well as operational risk. Pursuant to Rule 15Fi-5, counterparties are required to provide information on the valuation methods, procedures, rules, and inputs (within limits so as to not reveal private information regarding proprietary valuation models), while further stipulating that either alternative valuation methods or valuation discrepancy resolutions are detailed in the trading relationship documentation. These benefits are both complemented by, and accrue to, the portfolio reconciliation process contemplated by Rule 15Fi-3. That is, comprehensive and accurate documentation of a transaction may contribute to a smoother reconciliation process by reducing the possibility of discrepancies; and any discrepancies that may still arise could subsequently be identified and resolved through reconciliation.

As discussed above, because shortcomings in credit risk management and documentation may only become evident during a crisis, some benefits of

<sup>352</sup> See *id.*

<sup>353</sup> Specifically, CFTC Rule § 23.503(c) provides that "[n]othing in this section shall apply to a swap that is cleared by a derivatives clearing organization." 17 CFR 23.503(c).

<sup>354</sup> See *supra* Section II.B.1.

<sup>355</sup> The corresponding CFTC compression rule applicable to transactions with counterparties that are not Swap Entities does not contain the caveat that any form of compression or offset covered by the applicable policies and procedures would only need to occur "when appropriate." See *supra* Section II.B.1.

<sup>356</sup> One commonly used form of the industry standard documentation is the ISDA Master Agreement and related definitions, schedules, and confirmations specific to particular asset classes. As noted in Section VI.B.4, over 99% of uncleared security-based swap transactions use an ISDA Master Agreement as reported in DTCC-TIW.

<sup>357</sup> See *supra* Section II.C.

<sup>358</sup> 15 U.S.C. 78c-5(f).

complying with these rules will accrue to the financial system as a whole while the ongoing direct costs are borne by the individual market participant. Therefore, in the absence of these rules, trading relationship documentation practices employed by individual market participants may be less thorough than would be desired by all market participants in order to properly manage risks to the financial system. However, the widespread use of standard documentation mitigates both the potential benefit and costs of the rules being adopted.

### c. Costs

Market participants will likely incur ongoing costs associated with the rules concerning trading relationship documentation. Market participants will have to (1) negotiate and document all terms of each trading relationship; (2) design, compose, and implement policies and procedures reasonably designed to ensure the execution of security-based swap trading relationship documentation, including valuation documentation; (3) obtain documentation from counterparties who are claiming the end user exception to clearing; and (4) periodically audit documentation and keep records and/or make reports as required under these rules.

The Commission estimates that the initial burden to negotiate and draft trading relationship documentation will be \$4,666,103 per SBS Entity, or \$256,635,638 in aggregate across the 55 SBS Entities.<sup>359</sup> The Commission further estimates that the development and implementation of written policies and procedures as required under Rule 15Fi-5 will impose an initial cost of \$1,302,135 in aggregate.<sup>360</sup> Of the total 55 SBS Entities as expected by the Commission that would be subject to

<sup>359</sup> Each SBS Entity is anticipated to be counterparty to 18 other SBS Entities and 350 non-SBS market participants, for a total of 368 counterparties. The initial negotiation and draft in expected to take 15 hours per counterparty that is a SBS entity and 30 hours per counterparty for all other counterparties. See Section VI.D.5. The estimation is as follows: [((Compliance Manager (15 hours) × \$315) + (Director of Compliance (7.5 hours) × \$496) + (Deputy General Counsel (7.5 hours) × \$607)) × 350 counterparties] + [((Compliance Manager (7.5 hours) × \$315) + (Director of Compliance (3.75 hours) × \$496) + (Deputy General Counsel (3.75 hours) × \$607)) × 18 SBS entity counterparties] = \$4,666,102.50 per SBS Entity, or (\$4,666,102.50 × 55 SBS Entities) = \$256,635,637.50 in aggregate.

This figure has been updated from that in the Proposing Release due to the updated estimate of the number of SBS Entities that will be dually registered with the CFTC and updates to hourly rates to account for inflation over the period. See *supra* note 310 and *supra* note 311.

<sup>360</sup> *Id.*

Rule 15Fi-5, 20 are anticipated to be registered concurrently with the CFTC, and are anticipated to already have policies and procedures in place with respect to relationship documentation. The expected additional time to revise the existing policies and procedures for these Entities is expected to be one hour per Entity, for a cumulative 20 hours, costing \$461.75 per Entity or \$9,235 in aggregate.<sup>361</sup> For the remaining 35 SBS Entities, the Commission estimates that it will take approximately 80 hours per entity to establish the written policies and procedures. The costs for these SBS Entities will be \$1,292,900, or \$36,940 per SBS Entity.<sup>362</sup> Once established, the Commission estimates that it will cost SBS Entities approximately \$1,015,850 or \$18,470 per SBS Entity to revise and maintain these policies and procedures.<sup>363</sup> Lastly, Rule 15Fi-5 requires periodic independent audits of the trading relationship documentation. The Commission estimates that the costs associated with these audits will be \$853,760 per SBS Entity, or \$46,956,800 in aggregate.<sup>364</sup>

Memorializing the specific terms of the security-based swap trading relationship and security-based swap transactions between counterparties is prudent business practice and, in fact, many market participants already use standardized documentation.<sup>365</sup> Accordingly, the Commission believes that many, if not most, market participants that are expected to register as SBS Entities currently execute and maintain trading relationship documentation of the type required by these rules in the ordinary course of their businesses, including documentation that contains several of the terms that will be required by these

<sup>361</sup> The estimate is based on the following: [((Compliance Attorney (30 minutes) at \$372 per hour) + ((Director of Compliance (15 minutes) at \$496 per hour) + ((Deputy General Counsel (15 minutes) at \$607 per hour))] = \$461.75 per hour per SBS Entity or (\$461.75 per hour × 20 SBS dually-registered Entities) = \$9,235.

<sup>362</sup> The estimate is based on the following: [((Compliance Attorney (40 hours) at \$372 per hour) + ((Director of Compliance (20 hours) at \$496 per hour) + ((Deputy General Counsel (20 hours) at \$607 per hour))] = \$36,940 per SBS Entity or (\$36,940 × 35 SBS Entities that are not dually-registered) = \$1,292,900 in aggregate.

<sup>363</sup> The estimate is based on the following: [((Compliance Attorney (20 hours) at \$372 per hour) + ((Director of Compliance (10 hours) at \$496 per hour) + ((Deputy General Counsel (10 hours) at \$607 per hour))] = \$18,470 per SBS Entity or (\$18,470 × 55 SBS Entities) = \$1,015,850 in aggregate.

<sup>364</sup> The estimate is based on the following: [368 counterparties × 10 hours per Audit × Auditor (\$232 per hour)] = \$853,760 per SBS Entity, or (\$853,760 × 55 SBS Entities) = \$46,956,800 in aggregate.

<sup>365</sup> As noted in Section VII.B.4, as of 2017, the DTCC-TIW data shows that over 99% of SBS Entities use the ISDA Master Agreement.

rules. Thus, the hour and dollar burdens associated with the security-based swap trading relationship documentation requirements may be limited to amending existing documentation to expressly include any additional terms required by the rules. In addition the Commission anticipates that standardized security-based swap trading relationship documentation will eventually incorporate changes that may be necessary to comply with many of the requirements of this rule reducing the cost to individual security-based swap market participants.<sup>366</sup>

Rule 15Fi-5 also includes certain exceptions that are intended to mitigate costs incurred by market participants while preserving the risk mitigating benefits of thorough trading relationship documents. First, the rule will provide an exception for security-based swaps executed prior to the date on which the SBS Entity is required to be in compliance with the trading relationship documentation rule, as it may be costly and impractical to require SBS Entities to bring existing transactions into compliance with these rules. The Commission notes that this exception may increase the likelihood of disputes in valuation with respect to such transactions, which will be subject to the portfolio reconciliation requirement of Rule 15Fi-3 even though they are not subject to the documentation requirements of Rule 15Fi-5. Such disputes could be costly to resolve and may lead to greater uncertainty with respect to counterparty credit risk.

The rule further provides exceptions for any security-based swap that is, directly or indirectly, submitted to and cleared by a clearing agency registered pursuant to Section 17A of the Exchange Act or by a clearing agency that the Commission has exempted from registration by rule or order pursuant to Section 17A. Once a security is cleared, the transaction is primarily governed by the terms of the agreement between clearing member and the clearing agency. Lastly, the rule will provide an exception for security-based swaps executed anonymously on a national securities exchange or an SB SEF, provided that these security-based swaps are intended to be cleared and are actually submitted for clearing to a clearing agency that provides CCP services. This exception is intended to

<sup>366</sup> In response to prior Dodd Frank Act related regulatory requirements, ISDA in partnership with third party providers, has created technology-based solutions enabling counterparties to modify OTC derivatives related documentation quickly and efficiently. See <http://www2.isda.org/dodd-frank-documentation-initiative/>.

recognize that documentation requirements may be nearly impossible to fulfill within the context of cleared anonymous transactions.<sup>367</sup>

#### d. Alternatives

As proposed, Rule 15Fi-5(b)(1) would have required that the trading relationship documentation also include terms governing “applicable regulatory reporting obligations (including pursuant to Regulation SBSR).” ISDA and SIFMA noted that the particular documentation requirement would have essentially mirrored the reporting requirements in Regulation SBSR, including the reporting hierarchy established by that rule, which would be duplicative, burdensome and impose additional costs on SBS Entities, and that also may not address the underlying SDR verification issue.<sup>368</sup> Accordingly, the Commission has carefully considered these comments and has modified Rule 15Fi-5(b)(1), such that it no longer requires that the trading relationship documentation include terms governing applicable regulatory reporting obligations.

The Commission has evaluated reasonable alternatives to the rules on trading relationship documentation. One alternative would be that all SBS Entities are required to adhere to an industry-accepted standard form of trading documentation, instead of establishing policies and procedures related to documentation. It is unlikely that this alternative would materially alter the primary benefits of the rule, namely that of reducing disputes over documentation that could lead to increased counterparty risk, but could increase overall compliance costs without analogous increases in benefits, due to reduced operational flexibility.

Further, the rule requires that SBS Entities undertake a periodic, independent audit to identify material weaknesses in its documentation policies and procedures. As adopted, there is flexibility on behalf of the SBS Entity as to how and when those audits occur. Alternatively, the Commission has considered limiting to only external auditors and requiring a once per year audit of trading relationship documentation. Although this alternative would not materially amend the primary benefits related to the audit of SBS Entities’ policies and procedures related to trading relationship documentation, the Commission

anticipates that this alternative could increase compliance costs by reducing operational flexibility.

Rule 15Fi-5(a)(1)(ii) provides an exception to the trading relationship documentation requirements for any security-based swap that is, directly or indirectly, submitted to and cleared by a clearing agency registered pursuant to Section 17A of the Exchange Act or by a clearing agency that the Commission has exempted from registration by rule or order pursuant to Section 17A.<sup>369</sup> The Commission modified the proposed exception for cleared security-based swaps so that it now applies the initial bilateral transaction between the original counterparties (in addition to the resulting transactions between those counterparties and the clearing agency once the original transaction has been novated) and to permit the exception to be used when the clearing agency has been exempted from registration pursuant to Section 17A of the Exchange Act.<sup>370</sup> The Commission modified the exception in this manner in response to comments received, as well as to be consistent with the Commission’s margin requirements for security-based swap transactions and the approach taken by the CFTC,<sup>371</sup> which should reduce implementation and compliance costs.

The Commission has considered as an alternative, allowing an SBS Entity to be deemed in compliance with certain rules regarding trading relationship documentation if the SBS Entity is also registered as a swap dealer or major swap participant with the CFTC and is in compliance with the corresponding CFTC trading relationship documentation rules. The Commission concluded that, as a practical matter, the rules are nearly equivalent, suggesting that any additional compliance cost arising from differences in these rules for an entity that is registered with both the CFTC and the Commission should be small. The Commission believes that differences that do exist are necessary and appropriate. For example, to the extent that a transaction entered into on an anonymous basis on a national securities exchange or SB SEF that is then rejected for clearing but continues to exist, the Commission believes that the counterparties to the ongoing security-based swap should have in

place a written agreement on the terms of that transaction.<sup>372</sup>

#### 5. Recordkeeping Requirements

The Commission is also adopting rules that will modify existing Rules 17a-3 and 17a-4, as well as recently adopted Rules 18a-5 and 18a-6 for the recordkeeping and reporting requirements applicable to SBS Entities. The amendments will involve requiring each SBS Entity to make and keep current information relevant to portfolio reconciliation and portfolio compression exercises and to retain all security-based swap trading relationship documentation required to be created under Rule 15Fi-5, as well as each policy and procedure created pursuant to Rules 15Fi-3, 15Fi-4, and 15Fi-5.

##### a. Requirements

The Commission is amending Rule 17a-3 (which applies to SBS Entities that are also registered with the Commission as broker-dealers) and recently adopted Rule 18a-5 (which applies to SBS Entities that are not registered with the Commission as broker-dealers). Under these amendments, each SBS Entity will be required to make and keep records of each security-based swap portfolio reconciliation and portfolio compression exercise, which is believed to promote compliance with Rules 15Fi-3 and 15Fi-4 as well as support SBS Entities in the event that disputes arise in relation to previous reconciliations or compressions. The amendments will also require that SBS Entities make and keep records of valuation disputes in excess of \$20 million if not resolved within three (for SBS Entities) or five (for non-SBS counterparties) days.

The Commission also is amending Rule 17a-4 (which applies to SBS Entities that are also registered with the Commission as broker-dealers) and recently adopted Rule 18a-6 (which applies to SBS Entities that are not registered with the Commission as broker-dealers), which address record retention. All records made and kept under the amendments to Rule 17a-3 and recently adopted Rule 18a-5 will need to be retained for at least three years. Further, all policies and procedures related to Rules 15Fi-3 through 15Fi-5, all written agreements between counterparties on terms of portfolio reconciliation, and all security-based swap trading relationship documentation with counterparties will need to be retained until at least three years following the termination of said

<sup>367</sup> The exception with respect to security-based swap transactions on national exchanges or SB SEF is limited. See Section I.I.C for a complete discussion of those limitations.

<sup>368</sup> See *supra* Section I.I.C.1. See also ISDA/SIFMA Letter.

<sup>369</sup> See *supra* Section I.I.C.5.

<sup>370</sup> See *id.*

<sup>371</sup> Specifically, CFTC Rule § 23.504(a)(1)(iii) excludes from the written trading relationship documentation requirements “swaps cleared by a derivatives clearing organization.” 17 CFR 23.504(a)(1)(iii).

<sup>372</sup> See *supra* Section I.I.C.

policies and procedures and/or documentation.

#### b. Benefits

In proposing these requirements, the Commission considered the potential benefits of improving the oversight, transparency, and documentation of security-based swap activities. The amendments to Rules 17a-3 and 17a-4, and recently adopted Rules 18a-5 and 18a-6 are intended to facilitate oversight of SBS Entities, thus the benefits associated with the amendments related to recordkeeping are beneficial not only to the SBS Entities, but also are expected to facilitate regulatory oversight.

Requiring retention of records related to portfolio reconciliation, portfolio compression, and trading relationship documentation for a minimum of three years provides SBS Entities with a well-established track record should disputes about terms of the security-based swap arise. The benefits of these amendments, to the extent that they enhance existing practice, could reduce both counterparty credit risk as well as operational risk for the SBS Entities. Further, the amendments are expected to facilitate examinations by the Commission of SBS Entities.

#### c. Costs

The Commission also recognizes that there will be costs associated with the new rules and rule amendments. These include the costs of creating procedures to ensure that records are kept as required and the costs associated with ongoing record maintenance. As the recordkeeping requirements are being adopted as amendments to Rules 17a-3 and 17a-4 and recently adopted Rules 18a-5 and 18a-6, the incremental costs of compliance from these amendments is likely to be minimal.

Rules 15Fi-3, 15Fi-4, and 15Fi-5 require that SBS Entities establish and maintain written policies and procedures related to portfolio reconciliation, portfolio compression exercises, and trading relationship documentation. Further, SBS Entities are already required to comply with the retention of written policies and procedures with respect to Rule 15Fi-2 related to trade acknowledgement and verification, and should have recordkeeping systems previously instituted. Therefore, only minor modifications will need to be made in order to make the systems compliant with the amendments regarding recordkeeping requirements for portfolio reconciliation, portfolio compression exercises, and trading relationship documentation.

Generally, the Commission does not expect the amendments to Rules 17a-3 and 17a-4, and recently adopted Rules 18a-5 and 18a-6 to create material burdens for registrants, although as noted above the Commission does expect that there will be incremental costs related to complying with the rule amendments.<sup>373</sup>

#### d. Alternatives

The Commission has considered reasonable alternatives to the adopted amendments. In particular, the costs and benefits associated with the required recordkeeping horizon have been evaluated. Shorter horizons (of less than three years) would lessen the overall recordkeeping burden by reducing the retention requirements and corresponding storage of records. However, as it may take time for disputes, particularly in the event of liquidations to be fully settled, shorter horizons may lead to the elimination of relevant records prior to resolution. On the other hand, longer horizons for maintaining records could be costly with respect to storage and system requirements. However, longer record preservation would reduce the likelihood that historical records are unavailable if needed at some point in the future.

Rule 15Fi-5(c) requires 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 the rule. The Commission considered using the same requirement as that required by the CFTC that the audit be conducted by an independent internal or external auditor. The Commission chose not to follow this approach because in its experience overseeing accounting and auditing standards in the context of certain disclosure requirements under the federal securities laws, an internal auditor typically reports to the management of the applicable entity, which by definition would not satisfy the test for auditor independence under any existing statutory or regulatory provision that the Commission administers.<sup>374</sup> However, because the rule would still encompass any auditor, whether external or internal, that is in fact independent, the Commission believes that the practical differences between the Commission's rule and the corresponding CFTC rule are negligible.

<sup>373</sup> See *supra* Section II.D.

<sup>374</sup> See *supra* Section II.C.

#### 6. Cross-Border Application of Rules 15Fi-3 Through 15Fi-5.

In early 2016, the Commission adopted Rule 3a71-6 under the Exchange Act, which determined that non-U.S. SBS Entities could satisfy certain requirements of Section 15F by complying with comparable regulatory requirements of a foreign financial regulatory system.<sup>375</sup> At the time the substituted compliance rule was initially adopted, it applied solely to business conduct standards; however, Rule 3a71-6 was amended in the Trade Acknowledgement and Verification Adopting Release to provide foreign SBS Entities with the potential to rely on substituted compliance to satisfy Title VII trade confirmation requirements.<sup>376</sup>

##### a. Requirements

The Commission is further amending Rule 3a71-6 to allow non-U.S. SBS Entities to potentially be able to satisfy through substituted compliance the Title VII portfolio reconciliation, portfolio compression, and trading relationship documentation requirements in Rules 15Fi-3 through 15Fi-5. The Commission has determined that the principles previously set forth in the Business Conduct Standards Adopting Release and the Trade Acknowledgement and Verification Adopting Release with respect to substituted compliance should in large part similarly pertain to the reconciliation, compression, and documentation requirements in these rules.

##### b. Benefits

The Commission is adopting amendments to Rule 3a71-6 to permit consideration of substituted compliance in order to reduce the probability that SBS Entities are subject to potentially duplicative or conflicting regulation. Market participants that face duplicative regulatory regimes are likely to attain comparable regulatory outcomes, but at a cost of increased compliance burdens without an analogous increase in benefits. The availability of substituted compliance could decrease the compliance burden for non-U.S. SBS Entities, particularly as it pertains to portfolio reconciliation, portfolio compression, and trading relationship documentation. Allowing for the possibility of substituted compliance may help achieve the risk mitigation requirements set forth in Rules 15Fi-3

<sup>375</sup> See Business Conduct Standards Adopting Release, 81 FR at 30074.

<sup>376</sup> See Trade Acknowledgement and Verification Adopting Release, 81 FR at 39827-28.

through 15Fi-5, in particular as it reduces legal uncertainty, counterparty credit risk exposure, and operational risk for market participants.

Further, the Commission anticipates broader market implications of substituted compliance, namely an increase in foreign SBS dealers' activity in the U.S. market, the expansion of access by both U.S. and foreign SBS Entities to global liquidity, and a reduction in the possibility of liquidity fragmentation along jurisdictional lines. The availability of substituted compliance for non-U.S. SBS Entities also could promote market efficiency, while enhancing competition in U.S. markets. Increased participation and access to liquidity is likely to improve efficiencies related to hedging and risk sharing, while simultaneously increasing competition between domestic and foreign SBS Entities.

### c. Costs

The Commission believes that the availability of substituted compliance for portfolio reconciliation, portfolio compression, and trading relationship documentation will not substantially alter the benefits intended by Rules 15Fi-3 through 15Fi-5. In particular, it is expected that the availability of substituted compliance will not detract from the risk mitigation benefits that stem from periodic portfolio reconciliation, as well as policies and procedures regarding portfolio compression exercises and trading relationship documentation.

To the extent that substituted compliance reduces duplicative compliance costs, non-U.S. SBS Entities entering into transactions in which substituted compliance is available may incur lower overall costs associated with portfolio reconciliation, portfolio compression, and documentation exercises with their counterparties than they would otherwise incur without the option of substituted compliance availability, either because a non-U.S. SBS Entity may have already implemented foreign regulatory requirements which have been deemed comparable by the Commission, or because security-based swap counterparties eligible for substituted compliance do not need to duplicate compliance with two sets of comparable requirements.

A substituted compliance request can be made either by a foreign regulatory jurisdiction on behalf of its market participants, or by the registered market participant itself.<sup>377</sup> The decision to

request substituted compliance is voluntary, and therefore, to the extent that requests are made by individual market participants, such participants would request substituted compliance only if compliance with foreign regulatory requirements was less costly, in their own assessment, than compliance with both the foreign regulatory regime and the relevant Title VII requirements, including portfolio reconciliation, portfolio compression, and trading relationship documentation requirements. Even after a substituted compliance determination is made, market participants would only choose substituted compliance for portfolio reconciliation, compression, and documentation requirements if the benefits that they expect to receive from transacting in the U.S. markets exceed the costs that they expect to bear for doing so.

### VIII. Regulatory Flexibility Act Certification

The Regulatory Flexibility Act of 1980 ("RFA")<sup>378</sup> requires the Commission, in promulgating rules, to consider the impact of those rules on small entities. Section 603(a)<sup>379</sup> of the Administrative Procedure Act,<sup>380</sup> as amended by the RFA, the Commission certified in the Proposing Release that new Rules 15Fi-3 through 15Fi, and the proposed amendments to Rules 3a71-6, 15Fi-1, 17a-3, 17a-4, 18a-5 and 18a-6 would not have a significant economic impact on any "small entity"<sup>381</sup> for purposes of the RFA.<sup>382</sup> The Commission received no comments on its certification.

For purposes of Commission rulemaking in connection with the RFA,<sup>383</sup> a small entity includes: (1) When used with reference to an "issuer" or a "person," other than an

<sup>378</sup> 5 U.S.C. 601 *et seq.*

<sup>379</sup> 5 U.S.C. 603(a).

<sup>380</sup> 5 U.S.C. 551 *et seq.*

<sup>381</sup> Although Section 601(b) of the RFA defines the term "small entity," the statute permits agencies to formulate their own definitions. The Commission has adopted definitions for the term "small entity" for the purposes of Commission rulemaking in accordance with the RFA. Those definitions, as relevant to this rulemaking, are set forth in 17 CFR 240.0-10 ("Rule 0-10"). See Statement of Management on Internal Accounting Control, Exchange Act Release No. 18451 (Jan. 28, 1982), 47 FR 5215 (Feb. 4, 1982).

<sup>382</sup> See Proposing Release, 84 FR at 4670-71.

<sup>383</sup> Although Section 601(b) of the RFA defines the term "small entity," the statute permits agencies to formulate their own definitions. The Commission has adopted definitions for the term "small entity" for the purposes of Commission rulemaking in accordance with the RFA. Those definitions, as relevant to this rulemaking, are set forth in Rule 0-10 under the Exchange Act, 17 CFR 240.0-10. See Exchange Act Release No. 18451 (Jan., 28, 1982), 47 FR 5215 (Feb., 4, 1982) (File No. AS-305)

investment company, an "issuer" or "person" that, on the last day of its most recent fiscal year, had total assets of \$5 million or less;<sup>384</sup> (2) a broker-dealer with total capital (net worth plus subordinated liabilities) of less than \$500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a-5(d) under the Exchange Act,<sup>385</sup> or, if not required to file such statements, a broker-dealer with total capital (net worth plus subordinated liabilities) of less than \$500,000 on the last day of the preceding fiscal year (or in the time that it has been in business, if shorter); and is not affiliated with any person (other than a natural person) that is not a small business or small organization.<sup>386</sup> Under the standards adopted by the Small Business Administration, small entities in the finance and insurance industry include the following: (i) For entities engaged in credit intermediation and related activities, entities with \$175 million or less in assets;<sup>387</sup> (ii) for entities engaged in non-depository credit intermediation and certain other activities, entities with \$7 million or less in annual receipts;<sup>388</sup> (iii) for entities engaged in financial investments and related activities, entities with \$7 million or less in annual receipts;<sup>389</sup> (iv) for insurance carriers and entities engaged in related activities, entities with \$7 million or less in annual receipts;<sup>390</sup> and (v) for funds, trusts, and other financial vehicles, entities with \$7 million or less in annual receipts.<sup>391</sup>

With respect to SBS Entities, based on feedback from market participants and our information about the security-based swap markets, and consistent with our position in prior Dodd-Frank Act rulemakings, the Commission continues to believe that (1) the types of entities that will engage in more than a *de minimis* amount of dealing activity involving security-based swaps—which generally would be large financial institutions—would not be "small entities" for purposes of the RFA and (2) the types of entities that may have security-based swap positions above the level required to be "major security-based swap participants" would not be

<sup>384</sup> See 17 CFR 240.0-10(a).

<sup>385</sup> 17 CFR 240.17a-5(d).

<sup>386</sup> See 17 CFR 240.0-10(c).

<sup>387</sup> See 13 CFR 121.201 (Subsector 522).

<sup>388</sup> See *id.* at Subsector 522.

<sup>389</sup> See *id.* at Subsector 523.

<sup>390</sup> See *id.* at Subsector 524.

<sup>391</sup> See *id.* at Subsector 525.

<sup>377</sup> See Cross-Border Adopting Release, 79 FR at 47277.

“small entities” for purposes of the RFA.<sup>392</sup>

For the foregoing reasons, the Commission certifies that Rules 15Fi-3 through 15Fi, and the amendments to Rules 3a71-6, 15Fi-1, 17a-3, 17a-4, 18a-5 and 18a-6 will not have a significant economic impact on a substantial number of small entities for the purposes of the RFA.

## IX. Other Matters

Pursuant to the Congressional Review Act,<sup>393</sup> the Office of Information and Regulatory Affairs has designated these rules as a “major rule,” as defined by 5 U.S.C. 804(2).

If any of the provisions of these final rules, or the application thereof to any person or circumstance, is held to be invalid, such invalidity shall not affect other provisions or application of such provisions to other persons or circumstances that can be given effect without the invalid provision or application.

### Statutory Basis

Pursuant to the Exchange Act, 15 U.S.C. 78a *et seq.*, as amended, and particularly sections 3(b), 15F, 17, and 23(a) (15 U.S.C. 78c(b), 78o-10, 78q, 78w(a), and 78mm), the Commission is amending §§ 240.3a71-6, 240.15Fi-1, 240.17a-3, 240.17a-4, 240.18a-5, and 240.18a-6 and adopting §§ 240.15Fi-3, 240.15Fi-4, and 240.15Fi-5 under the Exchange Act.

### List of Subjects in 17 CFR Part 240

Reporting and recordkeeping requirements, Securities, Security-based swaps, Security-based swap dealers, Major security-based swap participants.

### Text of the Amendments

In accordance with the foregoing, the Securities and Exchange Commission is amending title 17, chapter II of the Code of Federal Regulations as follows:

## PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

■ 1. The general authority citation for part 240 continues to read as follows:

**Authority:** 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn,

<sup>392</sup> See Proposing Release, 84 FR at 4670; SBS Entity Registration Adopting Release, 80 FR at 49013; SBS Books and Records Proposing Release, 79 FR at 25296-97 and n.1441; Intermediary Definitions Adopting Release, 77 FR at 30743. See also Sections V (Paperwork Reduction Act) and VI (Economic Analysis) (discussing, among other things, the economic impact, including the estimated compliance costs and burdens, of the amendments).

<sup>393</sup> 5 U.S.C. 801 *et seq.*

77sss, 77ttt, 78c, 78c-3, 78c-5, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78n-1, 78o, 78o-4, 78o-10, 78p, 78q, 78q-1, 78s, 78u-5, 78w, 78x, 78dd, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 *et seq.*, and 8302; 7 U.S.C. 2(c)(2)(E); 12 U.S.C. 5221(e)(3); 18 U.S.C. 1350; Pub. L. 111-203, 939A, 124 Stat. 1376 (2010); and Pub. L. 112-106, sec. 503 and 602, 126 Stat. 326 (2012), unless otherwise noted.

\* \* \* \* \*

■ 2. Section 240.3a71-6 is amended by adding paragraph (d)(7) to read as follows:

### § 240.3a71-6 Substituted compliance for security-based swap dealers and major security-based swap participants.

\* \* \* \* \*

(d) \* \* \*  
(7) *Portfolio reconciliation, portfolio compression, and trading relationship documentation requirements.* The portfolio reconciliation, portfolio compression, and trading relationship documentation requirements of section 15F(i) of the Act (15 U.S.C. 78o-10(i)) and §§ 240.15Fi-3 through 240.15Fi-5; provided, however, that prior to making such a substituted compliance determination the Commission intends to consider whether the requirements of the foreign financial regulatory system for engaging in portfolio reconciliation and portfolio compression and for executing trading relationship documentation with counterparties, the duties imposed by the foreign financial regulatory system, and the information that is required to be provided to counterparties pursuant to the requirements of the foreign financial regulatory system, are comparable to those required pursuant to the applicable provisions arising under the Act and its rules and regulations.

■ 3. Revise § 240.15Fi-1 to read as follows:

### § 240.15Fi-1 Definitions.

For the purposes of §§ 240.15Fi-1 through 240.15Fi-5:

(a) The term *bilateral portfolio compression exercise* means an exercise by which two security-based swap counterparties wholly terminate or change the notional value of some or all of the security-based swaps submitted by the counterparties for inclusion in the portfolio compression exercise and, depending on the methodology employed, replace the terminated security-based swaps with other security-based swaps whose combined notional value (or some other measure of risk) is less than the combined notional value (or some other measure of risk) of the terminated security-based swaps in the exercise.

(b) The term *business day* means any day other than a Saturday, Sunday, or legal holiday.

(c) Solely for purposes of § 240.15Fi-2, the term *clearing agency* means a clearing agency as defined in section 3(a)(23) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(23)) that is registered pursuant to section 17A of the Securities Exchange Act of 1934 (15 U.S.C. 78q-1) and provides central counterparty services for security-based swap transactions.

(d) The term *clearing transaction* means a security-based swap that has a clearing agency as a direct counterparty.

(e) The term *day of execution* means the calendar day of the counterparty to the security-based swap transaction that ends the latest, provided that if a security-based swap transaction is:

(1) Entered into after 4:00 p.m. in the place of a counterparty; or

(2) Entered into on a day that is not a business day in the place of a counterparty, then such security-based swap transaction shall be deemed to have been entered into by that counterparty on the immediately succeeding business day of that counterparty, and the day of execution shall be determined with reference to such business day.

(f) The term *execution* means the point at which the counterparties become irrevocably bound to a transaction under applicable law.

(g) The term *financial counterparty* means a counterparty that is not a security-based swap dealer or a major security-based swap participant and that is one of the following:

- (1) A swap dealer;
- (2) A major swap participant;
- (3) A commodity pool as defined in section 1a(10) of the Commodity Exchange Act (7 U.S.C. 1a(10));
- (4) A private fund as defined in section 202(a)(29) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a));
- (5) An employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002); and
- (6) A person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843k).

(h) The term *fully offsetting security-based swaps* means security-based swaps of equivalent terms where no net cash flow would be owed to either counterparty after the offset of payment obligations thereunder.

(i) The term *material terms* means each term that is required to be reported to a registered security-based swap data repository or the Commission pursuant to § 242.901 of this chapter; provided, however, that such definition does not include any term that is not relevant to the ongoing rights and obligations of the parties and the valuation of the security-based swap.

(j) The term *multilateral portfolio compression exercise* means an exercise by which multiple security-based swap counterparties wholly terminate or change the notional value of some or all of the security-based swaps submitted by the counterparties for inclusion in the portfolio compression exercise and, depending on the methodology employed, replace the terminated security-based swaps with other security-based swaps whose combined notional value (or some other measure of risk) is less than the combined notional value (or some other measure of risk) of the terminated security-based swaps in the exercise.

(k) The term *national securities exchange* means an exchange as defined in section 3(a)(1) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(1)) that is registered pursuant to section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f).

(l) The term *portfolio reconciliation* means any process by which the counterparties to one or more security-based swaps:

(1) Exchange the material terms of all security-based swaps in the security-based swap portfolio between the counterparties;

(2) Exchange each counterparty's valuation of each security-based swap in the security-based swap portfolio between the counterparties as of the close of business on the immediately preceding business day; and

(3) Resolve any discrepancy in valuations or material terms.

(m) The term *prudential regulator* has the meaning given to the term in section 3(a)(74) of the Act (15 U.S.C. 78c(a)(74)) and includes 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 Association, and the Federal Housing Finance Agency, as applicable to the security-based swap dealer or major security-based swap participant.

(n) The term *security-based swap execution facility* means a security-based swap execution facility as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)) that is registered pursuant to

section 3D of the Securities Exchange Act of 1934 (15 U.S.C. 78c-4).

(o) The term *security-based swap portfolio* means all security-based swaps currently in effect between a particular security-based swap dealer or major security-based swap participant and a particular counterparty.

(p) The term *trade acknowledgment* means a written or electronic record of a security-based swap transaction sent by one counterparty of the security-based swap transaction to the other.

(q) The term *valuation* means the current market value or net present value of a security-based swap.

(r) The term *verification* means the process by which a trade acknowledgment has been manually, electronically, or by some other legally equivalent means, signed by the receiving counterparty.

■ 4. Section 240.15Fi-3 is added to read as follows:

**§ 240.15Fi-3 Security-based swap portfolio reconciliation.**

(a) *Security-based swaps with security-based swap dealers or major security-based swap participants.* Each security-based swap dealer and major security-based swap participant shall engage in portfolio reconciliation as follows for all security-based swaps in which its counterparty is also a security-based swap dealer or major security-based swap participant.

(1) Each security-based swap dealer or major security-based swap participant shall agree in writing with each of its counterparties on the terms of the portfolio reconciliation including, if applicable, agreement on the selection of any third party service provider who may be performing the portfolio reconciliation.

(2) The portfolio reconciliation may be performed on a bilateral basis by the counterparties or by a third party selected by the counterparties in accordance with paragraph (a)(1) of this section.

(3) The portfolio reconciliation shall be performed no less frequently than:

(i) Once each business day for each security-based swap portfolio that includes 500 or more security-based swaps;

(ii) Once each week for each security-based swap portfolio that includes more than 50 but fewer than 500 security-based swaps on any business day during the week; and

(iii) Once each calendar quarter for each security-based swap portfolio that includes no more than 50 security-based swaps at any time during the calendar quarter.

(4) Each security-based swap dealer and major security-based swap participant shall resolve immediately any discrepancy in a material term of a security-based swap identified as part of a portfolio reconciliation or otherwise.

(5) Each security-based swap dealer and major security-based swap participant shall establish, maintain, and follow written policies and procedures reasonably designed to resolve any discrepancy in a valuation identified as part of a portfolio reconciliation or otherwise as soon as possible, but in any event within five business days after the date on which the discrepancy is first identified, provided that the security-based swap dealer and major security-based swap participant establishes, maintains, and follows written policies and procedures reasonably designed to identify how the security-based swap dealer or major security-based swap participant will comply with any variation margin requirements under section 15F(e) of the Act (15 U.S.C. 78o-10(e)) and § 240.18a-3 (and any subsequent regulations promulgated pursuant to section 15F(e) of the Act (15 U.S.C. 78o-10(e))) pending resolution of the discrepancy in valuation. For purposes of this paragraph (a)(5), a difference between the lower valuation and the higher valuation of less than 10 percent of the higher valuation need not be deemed a discrepancy.

(b) *Security-based swaps with entities other than security-based swap dealers or major security-based swap participants.* Each security-based swap dealer and major security-based swap participant shall establish, maintain, and follow written policies and procedures reasonably designed to ensure that it engages in portfolio reconciliation for all security-based swaps in which its counterparty is neither a security-based swap dealer nor a major security-based swap participant as follows.

(1) Each security-based swap dealer or major security-based swap participant shall agree in writing with each of its counterparties on the terms of the portfolio reconciliation including, if applicable, agreement on the selection of any third party service provider who may be performing the reconciliation.

(2) The portfolio reconciliation may be performed on a bilateral basis by the counterparties or by one or more third parties selected by the counterparties in accordance with paragraph (b)(1) of this section.

(3) The portfolio reconciliation will be required to be performed no less frequently than:

(i) Once each calendar quarter for each security-based swap portfolio that includes more than 100 security-based swaps at any time during the calendar quarter; and

(ii) Once annually for each security-based swap portfolio that includes no more than 100 security-based swaps at any time during the calendar year.

(4) Each security-based swap dealer or major security-based swap participant shall establish, maintain, and follow written procedures reasonably designed to resolve any discrepancies in the valuation or material terms of each security-based swap identified as part of a portfolio reconciliation or otherwise with a counterparty that is neither a security-based swap dealer nor major security-based swap participant in a timely fashion. For purposes of this paragraph (b)(4), a difference between the lower valuation and the higher valuation of less than 10 percent of the higher valuation need not be deemed a discrepancy.

(c) *Reporting of security-based swap valuation disputes*—(1) *Notice requirement.* Each security-based swap dealer and major security-based swap participant shall promptly notify the Commission, in a form and manner acceptable to the Commission, and any applicable prudential regulator of any security-based swap valuation dispute in excess of \$20,000,000 (or its equivalent in any other currency), at either the transaction or portfolio level, if not resolved within:

(i) Three business days, if the dispute is with a counterparty that is a security-based swap dealer or major security-based swap participant; or

(ii) Five business days, if the dispute is with a counterparty that is not a security-based swap dealer or major security-based swap participant.

(2) *Amendments.* Each security-based swap dealer and major security-based swap participant shall notify the Commission, in a form and manner acceptable to the Commission, and any applicable prudential regulator, if the amount of any security-based swap valuation dispute that was the subject of a previous notice made pursuant to paragraph (c)(1) of this section increases or decreases by more than \$20,000,000 (or its equivalent in any other currency), at either the transaction or portfolio level. Such amended notice shall be provided to the Commission and any applicable prudential regulator no later than the last business day of the calendar month in which the applicable security-based swap valuation dispute increases or decreases by the applicable dispute amount.

(d) *Reconciliation of cleared security-based swaps.* Nothing in this section shall apply to any security-based swap that is, directly or indirectly, submitted to and cleared by a clearing agency registered pursuant to section 17A of the Act (15 U.S.C. 78q-1) or by a clearing agency that the Commission has exempted from registration by rule or order pursuant to section 17A of the Act (15 U.S.C. 78q-1).

■ 5. Section 240.15Fi-4 is added to read as follows:

**§ 240.15Fi-4 Security-based swap portfolio compression.**

(a) *Portfolio compression with security-based swap dealers and major security-based swap participants*—(1) *Bilateral offset.* Each security-based swap dealer and major security-based swap participant shall establish, maintain, and follow written policies and procedures for terminating each fully offsetting security-based swap between a security-based swap dealer or major security-based swap participant and another security-based swap dealer or major security-based swap participant in a timely fashion, when appropriate.

(2) *Bilateral compression.* Each security-based swap dealer and major security-based swap participant shall establish, maintain, and follow written policies and procedures for periodically engaging in bilateral portfolio compression exercises, when appropriate, with each counterparty that is also a security-based swap dealer or major security-based swap participant. Such policies and procedures shall address, among other things, the evaluation of bilateral portfolio compression exercises that are initiated, offered, or sponsored by any third party.

(3) *Multilateral compression.* Each security-based swap dealer and major security-based swap participant shall establish, maintain, and follow written policies and procedures for periodically engaging in multilateral portfolio compression exercises, when appropriate, with each counterparty that is also a security-based swap dealer or major security-based swap participant. Such policies and procedures shall address, among other things, the evaluation of multilateral portfolio compression exercises that are initiated, offered, or sponsored by any third party.

(b) *Portfolio compression with counterparties other than security-based swap dealers and major security-based swap participants.* Each security-based swap dealer and major security-based swap participant shall establish, maintain, and follow written policies and procedures for periodically

terminating fully offsetting security-based swaps and for engaging in bilateral or multilateral portfolio compression exercises with respect to security-based swaps in which its counterparty is an entity other than a security-based swap dealer or major security-based swap participant, when appropriate and to the extent requested by any such counterparty.

(c) *Portfolio compression of cleared security-based swaps.* Nothing in this section shall apply to any security-based swap that is, directly or indirectly, submitted to and cleared by a clearing agency registered pursuant to section 17A of the Act (15 U.S.C. 78q-1) or by a clearing agency that the Commission has exempted from registration by rule or order pursuant to section 17A of the Act (15 U.S.C. 78q-1).

■ 6. Section 240.15Fi-5 is added to read as follows:

**§ 240.15Fi-5 Security-based swap trading relationship documentation.**

(a) *Scope*—(1) *Applicability.* The requirements of this section shall not apply to:

(i) Security-based swaps executed prior to the date on which a security-based swap dealer or major security-based swap participant is required to be in compliance with this section;

(ii) Any security-based swap that is, directly or indirectly, submitted to and cleared by a clearing agency registered pursuant to section 17A of the Act (15 U.S.C. 78q-1) or by a clearing agency that the Commission has exempted from registration by rule or order pursuant to section 17A of the Act (15 U.S.C. 78q-1); and

(iii) Security-based swaps executed anonymously on a national securities exchange or a security-based swap execution facility, *Provided that:*

(A) Such security-based swaps are intended to be cleared and are actually submitted for clearing to a clearing agency;

(B) All terms of such security-based swaps conform to the rules of the clearing agency; and

(C) Upon acceptance of such security-based swap by the clearing agency:

(1) The original security-based swap is extinguished;

(2) The original security-based swap is replaced by equal and opposite security-based swaps with the clearing agency; and

(3) All terms of the security-based swap shall conform to the product specifications of the cleared security-based swap established under the clearing agency's rules; and *Provided further,* That if a security-based swap dealer or major security-based swap

participant receives notice that a security-based swap transaction has not been accepted for clearing by a clearing agency, the security-based swap dealer or major security-based swap participant shall be required to comply with the requirements of this section in all respects promptly after receipt of such notice.

(2) *Policies and procedures.* Each security-based swap dealer and major security-based swap participant shall establish, maintain, and follow written policies and procedures reasonably designed to ensure that the security-based swap dealer or major security-based swap participant executes written security-based swap trading relationship documentation with its counterparty that complies with the requirements of this section. The policies and procedures shall be approved in writing by a senior officer of the security-based swap dealer or major security-based swap participant, and a record of the approval shall be retained. Other than trade acknowledgements and verifications of security-based swap transactions under § 240.15Fi-2, the security-based swap trading relationship documentation shall be executed prior to, or contemporaneously with, executing a security-based swap with any counterparty.

(b) *Security-based swap trading relationship documentation.* (1) The security-based swap trading relationship documentation shall be in writing and shall include all terms governing the trading relationship between the security-based swap dealer or major security-based swap participant and its counterparty, 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, governing law, valuation, and dispute resolution.

(2) The security-based swap trading relationship documentation shall include all trade acknowledgements and verifications of security-based swap transactions under § 240.15Fi-2.

(3) The security-based swap trading relationship documentation shall include credit support arrangements, which shall contain, in accordance with applicable requirements under Commission regulations or regulations adopted by prudential regulators and without limitation, the following:

(i) Initial and variation margin requirements, if any;

(ii) Types of assets that may be used as margin and asset valuation haircuts, if any;

(iii) Investment and re-hypothecation terms for assets used as margin for uncleared security-based swaps, if any; and

(iv) Custodial arrangements for margin assets, including whether margin assets are to be segregated with an independent third party, in accordance with the notice requirement in section 3E(f)(1)(A) of the Act (15 U.S.C. 78c-5(f)(1)(A)) (and either § 240.15c3-3(p)(4)(i) or § 240.18a-4(d)(1) thereunder, as applicable), if any.

(4)(i) The security-based swap trading relationship documentation between security-based swap dealers, between major security-based swap participants, between a security-based swap dealer and major security-based swap participant, between a security-based swap dealer or major security-based swap participant and a financial counterparty, and, if requested by any other counterparty, between a security-based swap dealer or major security-based swap participant and such counterparty, shall 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 security-based swap at any time from execution to the termination, maturity, or expiration of such security-based swap for the purposes of complying with the margin requirements under section 15F(e) of the Act (15 U.S.C. 78o-10(e)) and § 240.18a-3 (and any subsequent regulations promulgated pursuant to section 15F(e) of the Act (15 U.S.C. 78o-10(e))), and the risk management requirements under section 15F(j) of the Act (15 U.S.C. 78o-10(j)) of the Act and § 240.15Fh-3(h)(2)(iii)(I) (and any subsequent regulations promulgated pursuant to section 15F(j) of the Act (15 U.S.C. 78o-10(j))). To the maximum extent practicable, the valuation of each security-based swap shall be based on recently executed transactions, valuations provided by independent third parties, or other objective criteria.

(ii) Such documentation shall include either:

(A) Alternative methods for determining the value of the security-based swap for the purposes of complying with this paragraph (b)(4) in the event of the unavailability or other failure of any input required to value the security-based swap for such purposes; or

(B) A valuation dispute resolution process by which the value of the security-based swap shall be determined for the purposes of complying with this paragraph (b)(4).

(iii) A security-based swap dealer or major security-based swap participant is not required to disclose to the counterparty confidential, proprietary information about any model it may use to value a security-based swap.

(iv) The parties may agree on changes or procedures for modifying or amending the documentation at any time.

(5) The security-based swap trading relationship documentation of a security-based swap dealer or major security-based swap participant shall include the following:

(i) A statement of whether the security-based swap dealer or major security-based swap participant is an insured depository institution (as defined in 12 U.S.C. 1813) or a financial company (as defined in section 201(a)(11) of the Dodd-Frank Act, 12 U.S.C. 5381(a)(11));

(ii) A statement of whether the counterparty is an insured depository institution or financial company;

(iii) A statement that in the event either the security-based swap dealer or major security-based swap participant or its counterparty becomes a covered financial company (as defined in section 201(a)(8) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. 5381(a)(8)) or is an insured depository institution for which the Federal Deposit Insurance Corporation (FDIC) has been appointed as a receiver (the "covered party"), certain limitations under Title II of the Dodd-Frank Act or the Federal Deposit Insurance Act may apply to the right of the non-covered party to terminate, liquidate, or net any security-based swap by reason of the appointment of the FDIC as receiver, notwithstanding the agreement of the parties in the security-based swap trading relationship documentation, and that the FDIC may have certain rights to transfer security-based swaps of the covered party under section 210(c)(9)(A) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. 5390(c)(9)(A), or 12 U.S.C. 1821(e)(9)(A); and

(iv) An agreement between the security-based swap dealer or major security-based swap participant and its counterparty to provide notice if either it or its counterparty becomes or ceases to be an insured depository institution or a financial company.

(6) The security-based swap trading relationship documentation of each security-based swap dealer and major security-based swap participant shall contain a notice that, upon acceptance of a security-based swap by a clearing agency:

(i) The original security-based swap is extinguished;

(ii) The original security-based swap is replaced by equal and opposite security-based swaps with the clearing agency; and

(iii) All terms of the security-based swap shall conform to the product specifications of the cleared security-based swap established under the clearing agency's rules.

(c) *Audit of security-based swap trading relationship documentation.* Each security-based swap dealer and major security-based swap participant shall have an independent auditor conduct periodic audits sufficient to identify any material weakness in its documentation policies and procedures required by this section. A record of the results of each audit shall be retained.

■ 7. Section 240.17a-3 is amended by adding paragraph (a)(31) to read as follows:

**§ 240.17a-3 Records to be made by certain exchange members, brokers and dealers.**

\* \* \* \* \*

(a) \* \* \*

(31)(i) A record of each security-based swap portfolio reconciliation, whether conducted pursuant to § 240.15Fi-3 or otherwise, including the dates of the security-based swap portfolio reconciliation, the number of portfolio reconciliation discrepancies, the number of security-based swap valuation disputes (including the time-to-resolution of each valuation dispute and the age of outstanding valuation disputes, categorized by transaction and counterparty), and the name of the third-party entity performing the security-based swap portfolio reconciliation, if any.

(ii) A copy of each notification required to be provided to the Commission pursuant to § 240.15Fi-3(c).

(iii) A record of each bilateral offset and each bilateral portfolio compression exercise or multilateral portfolio compression exercise in which it participates, whether conducted pursuant to § 240.15Fi-4 or otherwise, including the dates of the offset or compression, the security-based swaps included in the offset or compression, the identity of the counterparties participating in the offset or compression, the results of the compression, and the name of the third-party entity performing the offset or compression, if any.

\* \* \* \* \*

■ 8. Section 240.17a-4 is amended by revising paragraph (b)(1) and adding paragraphs (e)(11) and (12) to read as follows:

**§ 240.17a-4 Records to be preserved by certain exchange members, brokers and dealers.**

\* \* \* \* \*

(b) \* \* \*

(1) All records required to be made pursuant to § 240.17a-3(a)(4), (6) through (11), (16), (18) through (20), and (25) through (31), and analogous records created pursuant to § 240.17a-3(e).

\* \* \* \* \*

(e) \* \* \*

(11) The written policies and procedures required pursuant to §§ 240.15Fi-3, 240.15Fi-4, and 240.15Fi-5 until three years after termination of the use of the policies and procedures.

(12)(i) Each written agreement with counterparties on the terms of portfolio reconciliation with those counterparties as required to be created under § 240.15Fi-3(a)(1) and (b)(1) until three years after the termination of the agreement and all transactions governed thereby.

(ii) Security-based swap trading relationship documentation with counterparties required to be created under § 240.15Fi-5 until three years after the termination of such documentation and all transactions governed thereby.

(iii) A record of the results of each audit required to be performed pursuant to § 240.15Fi-5(c) until three years after the conclusion of the audit.

\* \* \* \* \*

■ 9. Section 240.18a-5 is amended by adding paragraphs (a)(18) and (b)(14) to read as follows:

**§ 240.18a-5 Records to be made by certain security-based swap dealers and major security-based swap participants.**

\* \* \* \* \*

(a) \* \* \*

(18)(i) A record of each security-based swap portfolio reconciliation, whether conducted pursuant to § 240.15Fi-3 or otherwise, including the dates of the security-based swap portfolio reconciliation, the number of portfolio reconciliation discrepancies, the number of security-based swap valuation disputes (including the time-to-resolution of each valuation dispute and the age of outstanding valuation disputes, categorized by transaction and counterparty), and the name of the third-party entity performing the security-based swap portfolio reconciliation, if any.

(ii) A copy of each notification required to be provided to the Commission pursuant to § 240.15Fi-3(c).

(iii) A record of each bilateral offset and each bilateral portfolio compression

exercise or multilateral portfolio compression exercise in which it participates, whether conducted pursuant to § 240.15Fi-4 or otherwise, including the dates of the offset or compression, the security-based swaps included in the offset or compression, the identity of the counterparties participating in the offset or compression, the results of the compression, and the name of the third-party entity performing the offset or compression, if any.

(b) \* \* \*

(14)(i) A record of each security-based swap portfolio reconciliation, whether conducted pursuant to § 240.15Fi-3 or otherwise, including the dates of the security-based swap portfolio reconciliation, the number of portfolio reconciliation discrepancies, the number of security-based swap valuation disputes (including the time-to-resolution of each valuation dispute and the age of outstanding valuation disputes, categorized by transaction and counterparty), and the name of the third-party entity performing the security-based swap portfolio reconciliation, if any.

(ii) A copy of each notification required to be provided to the Commission pursuant to § 240.15Fi-3(c).

(iii) A record of each bilateral offset and each bilateral portfolio compression exercise or multilateral portfolio compression exercise in which it participates, whether conducted pursuant to § 240.15Fi-4 or otherwise, including the dates of the offset or compression, the security-based swaps included in the offset or compression, the identity of the counterparties participating in the offset or compression, the results of the compression, and the name of the third-party entity performing the offset or compression, if any.

\* \* \* \* \*

■ 10. Section 240.18a-6 is amended by revising paragraphs (b)(1)(i) and (b)(2)(i) and adding paragraphs (d)(4) and (5) to read as follows:

**§ 240.18a-6 Records to be preserved by certain security-based swap dealers and major security-based swap participants.**

\* \* \* \* \*

(b) \* \* \*

(1) \* \* \*

(i) All records required to be made pursuant to § 240.18a-5(a)(5) through (9) and (12) through (18).

\* \* \* \* \*

(2) \* \* \*

(i) All records required to be made pursuant to § 240.18a-5(b)(4) through (7) and (9) through (14).

\* \* \* \* \*

(d) \* \* \*

(4) The written policies and procedures required pursuant to §§ 240.15Fi-3, 240.15Fi-4, and 240.15Fi-5 until three years after termination of the use of the policies and procedures.

(5)(i) Each written agreement with counterparties on the terms of portfolio

reconciliation with those counterparties as required to be created under § 240.15Fi-3(a)(1) and (b)(1) until three years after the termination of the agreement and all transactions governed thereby.

(ii) Security-based swap trading relationship documentation with counterparties required to be created under § 240.15Fi-5 until three years after the termination of such documentation and all transactions governed thereby.

(iii) A record of the results of each audit required to be performed pursuant to § 240.15Fi-5(c) until three years after the conclusion of the audit.

\* \* \* \* \*

Dated: December 18, 2019.

By the Commission.

**Vanessa A. Countryman,**

*Secretary.*

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