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# The SEC Adopts Security-Based Swap Rules Governing Risk Mitigation Techniques for Uncleared Security-Based Swaps

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On December 18, 2019, the Securities and Exchange Commission (the SEC or Commission) adopted new rules pursuant to Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) requiring the application of risk mitigation techniques to portfolios of uncleared security-based swaps.<sup>1</sup> Specifically, the Commission has adopted Rules 15Fi-3, 15Fi-4 and 15Fi-5, which establish requirements for registered security-based swap dealers and major security-based swap participants (each registered security-based swap dealer and each major security-based swap participant is referred to as an “SBS Entity” and collectively are referred to as “SBS Entities”) to: (1) periodically reconcile outstanding security-based swaps with counterparties; (2) engage in certain forms of portfolio compression exercises, as appropriate; and (3) execute written trading relationship documentation with each of their counterparties prior to, or contemporaneously with, executing a security-based swap transaction.<sup>2</sup> Each of these rules is discussed in more detail below.

The effective date for these rules will be April 6, 2020. The compliance date for these rules will be the same as the compliance date for the registration of SBS Entities or October 6, 2021.

## *I. Rule 15Fi-3: Portfolio Reconciliation*

### **A. Scope of the Portfolio Reconciliation Requirements**

As part of adopting Rule 15Fi-3, the Commission amended existing Rule 15Fi-1 by adding four new terms defining “portfolio reconciliation.” These definitions were added to establish the scope of the portfolio reconciliation requirements in Rule 15Fi-3. As noted in the release, these four definitions are substantively identical to the Commodity Futures Trading Commission’s (CFTC) corresponding definitions applicable to 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”).

### **B. Rule 15Fi-3(a): Portfolio Reconciliation with Other SBS Entities**

The portfolio reconciliation requirements defined 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 and the size of the securities-based swap portfolio between them. In addition, Rule 15Fi-3(a)(1) also will require SBS Entities to agree in writing with each of the counterparties on the terms of the portfolio reconciliation, including agreement on the selection of any third-party service provider used to perform the reconciliation, if applicable.

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

Rule 15Fi-3(a)(4) will require each SBS Entity to resolve immediately any discrepancy in a material term, whether identified directly as part of the portfolio reconciliation process or otherwise. Additionally, Rule 15Fi-3(a)(5) will require each SBS Entity to have policies and procedures reasonably designed to resolve a valuation discrepancy no later than five business days from the date it was discovered.

#### **D. Rule 15Fi-3(b): Portfolio Reconciliation with Other Counterparties**

Rule 15Fi-3(b) provides the reconciliation requirements for security-based swap portfolios between an SBS Entity and a counterparty that is not an SBS Entity. However, unlike Rule 15Fi-3(a), which expressly requires portfolio reconciliation with respect to transactions where both counterparties are SBS Entities, Rule 15Fi-3(b) will require each SBS Entity 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. Rule 15Fi-3(b)(1) also will require that the applicable policies and procedures be reasonably designed to ensure that each SBS Entity agree in writing with each of its non-SBS Entity counterparties on the terms of the portfolio reconciliation, including the agreement on the selection of a third-party service provider that will perform the reconciliation.

#### **E. Reporting of Valuation Disputes**

Rule 15Fi-3(c) will require prompt notification to the Commission by each SBS Entity of any security-based swap valuation dispute that exceeds \$20 million (or its equivalent in any other currency) at either the transaction or portfolio level if the dispute has not been resolved.<sup>3</sup> SBS Entities also must provide notice 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 million (or its equivalent in any other currency) at either the transaction or portfolio level.<sup>4</sup>

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

Rule 15Fi-3(d) will provide 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.”

## *II. Rule 15Fi-4: Portfolio Compression*

#### **A. Scope of Rule 15Fi-4: Portfolio Compression Exercises**

The Commission has adopted Rules 15Fi-4(a)(2) and 15Fi-4(a)(3), which require SBS Entities to establish, maintain and follow written policies and procedures for periodically engaging in bilateral portfolio compression exercises and multilateral portfolio compression exercises with any counterparties that are SBS Entities.<sup>5</sup> In the event that an SBS Entity transacts with a counterparty that is not an SBS Entity, the policies and procedures must provide that portfolio compression exercises occur when appropriate and only to the extent requested by any such counterparty. Rule 15Fi-4 is similar to rules adopted by the CFTC. Note, however, that the SEC identified three main differences between Rule 15Fi-4 and CFTC rules. First, CFTC Rule 23.503(a)(3)(i) contains a requirement 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. The SEC noted there is no comparable requirement in Rule 15Fi-4(a)(3). Next, CFTC Rule 23.503(a)(3)(ii) contains a requirement 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. CFTC Rule 23.503(a)(3) does not contain a requirement addressing bilateral portfolio compression exercises, which is addressed in Rule 15Fi-4(a). Finally, 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 qualifier that the compression or offset covered by the applicable policies and procedures would only need to occur “when appropriate.” Rule 15Fi-4(b) does contain such qualifier.

#### **B. Scope of Rule 15Fi-4: Bilateral Offset**

The Commission also has adopted Rule 15Fi-4(a)(1), which will require 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.

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

The Commission has adopted an exception to the portfolio compression requirements. Similar to the exception to the portfolio reconciliation requirements, Rule 15Fi-4(c) grants 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.”

### *III. Rule 15Fi-5: Trading Relationship Documentation*

#### **A. Scope of Rule 15Fi-5**

The Commission has adopted Rule 15Fi-5, which provides the requirements for SBS Entities related to the use of written trading relationship documentation in connection with their security-based swap transactions, including requirements to adopt policies and procedures. Rule 15Fi-5 further provides that the policies and procedures be approved in writing by a senior officer of the SBS Entity, and that a record of the approval be retained.

Rule 15Fi-5(b)(1) will require that security-based swap trading relationship documentation to be in writing. The trading relationship documentation must include all terms governing the trading relationship between the SBS Entity and its counterparty, including 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. All trade acknowledgments and verifications of security-based swap transactions required under Rule 15Fi-2 will be deemed to be security-based swap trading relationship documentation.<sup>6</sup> Rule 15Fi-5(b)(3) will require the policies and procedures to provide that the security-based swap trading relationship documentation include credit support arrangements.

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

Rule 15Fi-5(b)(4) will require the policies and procedures to provide that the relevant swap trading relationship documentation between certain types of counterparties include written documentation in which the parties agree on the process 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), and the risk management requirements under Section 15F(j) of the Exchange Act (and applicable regulations). Such valuations need to be based on recently executed transactions, valuations provided by independent third parties or other objective criteria to the extent practicable.

#### **C. Rules 15Fi-5(b)(5) and (6): Other Disclosure Requirements**

Rule 15Fi-5 will require 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. 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 the Federal Deposit Insurance Corporation receivership for banks or orderly liquidation for certain financial companies that meet the requirements set forth in Title II of the Dodd-Frank Act.

Additionally, 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.

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

Pursuant to Rule 15Fi-5(c), each SBS Entity must have an independent auditor to conduct periodic audits to sufficiently identify any material weakness in its documentation policies and procedures. Additionally, the SBS Entity must maintain a record of the results of each audit for a period of three years after the conclusion of the audit.<sup>7</sup> The independent auditor generally would not be an internal auditor, but the SEC left open the possibility that the internal auditor may be independent if the

function is structured properly.

## **E. Exceptions to the Trading Relationship Documentation Requirements**

There are three different exceptions contained in Rule 15Fi-5(a)(1) to the 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. 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. Third, 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, subject to certain conditions.

## **F. Amendments to Recordkeeping Rules**

The Commission also has amended the recordkeeping, reporting and notification requirements applicable to SBS Entities. Specifically, the Commission has amended Rule 17a-3 under the Exchange Act, which applies to SBS Entities that are registered broker-dealers under Section 15(b) of the Exchange Act, and Rule 18a-5, which applies to SBS Entities that are not registered broker-dealers under Section 15(b) of the Exchange Act. These amended rules will 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; a copy of each valuation dispute notification required to be provided to the Commission pursuant to Rule 15Fi-3(c); 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. The Commission has amended Rule 17a-4, which is applicable to broker-dealers registered under Section 15(b), including broker-dealer SBS Entities, and Rule 18a-6, which is applicable to entities that are not so registered. Specifically, Rules 17a-4 and 18a-6 will require SBS Entities to retain certain records required to be made and kept under Rules 17a-3 and 18a-5 for at least three years, the first two years in an easily accessible place.

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

The Commission has adopted a broad interpretation related to cross-border swap activities. Specifically, the Commission will treat the portfolio reconciliation, portfolio compression and trading relationship documentation requirements under Rules 15Fi-3 through 15Fi-5 as entity-level requirements that apply to an SBS Entity's entire security-based swap business without exception. This treatment includes any security-based swap business an SBS conducts with foreign counterparties.

## *V. Availability of Substituted Compliance for Rules 15Fi-3 through 15Fi-*

The Commission has amended Rule 3a71-6 allowing SBS Entities that are not US persons as defined in Rule 3a71-3(a)(4) with the option to seek to avail themselves of substituted compliance to satisfy the portfolio reconciliation, portfolio compression and trading relationship requirements under Title VII of the Dodd-Frank Act. Put differently, foreign SBS Entities can seek 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.

## *VI. Conclusion*

The Commission has made significant changes to the security-based swap industry by adopting Rules 15Fi-3, 15Fi-4 and 15Fi-5 under Title VII of the Dodd-Frank Act. These rules establish requirements for SBS Entities to (1) periodically reconcile outstanding security-based swaps with counterparties; (2) engage in certain forms of portfolio compression exercise, as appropriate; and (3) execute written trading relationship documentation with each of their counterparties prior to, or contemporaneously with, executing a security-based swap transaction. The compliance date for these rules will be October 6, 2021.

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1. *SEC Adopts Actions to Stand Up Security-Based Swap Regulatory Regime*, Press Release, SEC (Dec. 18, 2019).
  2. *See Risk Mitigation Techniques for Uncleared Security-Based Swaps*, SEC, 83 Fed. Reg. 6359 (Feb. 4, 2020) (hereinafter “Risk Mitigation Techniques Adopting Release”).
  3. The CFTC has adopted a nearly identical requirement with the same \$20 million threshold and time frames. Risk Mitigation Techniques Adopting Release at 6367-68; *see also* Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, CFTC, 77 Fed. Reg. 55904, 55914 (Sept. 11, 2012).
  4. The Commission incorporated this provision from the National Futures Association (NFA) Interpretive Notice titled “NFA Interpretive Notice to Compliance Rule 2-49: Swap Valuation Dispute Filing Requirements.” Risk Mitigation Techniques Adopting Release at 6367-68.
  5. A portfolio compression exercise is a process in 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.
  6. Rule 15Fi-2 provides the substantive trade acknowledgment and verification requirements, an exception for clearing transactions, an exception for certain transactions that are executed on a security-based swap execution facility or a national securities exchange or that are accepted for clearing by a clearing agency, and the exemption from Rule 10b-10. *Id.* at 56; *see also* Trade Acknowledgment and Verification of Security-Based Swap Transactions, SEC, 81 Fed. Reg. 39808 (Jun. 17, 2016).

7. The requirement is slightly different than CFTC Rule 23.504(c), which notes an independent “internal or external” auditor. Risk Mitigation Techniques Adopting Release at 6375.

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## *Authors*



**Bruce H. Newman**

**PARTNER**

✉ [bruce.newman@wilmerhale.com](mailto:bruce.newman@wilmerhale.com)

☎ +1 212 230 8835