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SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34-84861; File No. S7-28-18]

RIN 3235-AL83

Risk Mitigation Techniques for Uncleared Security-Based Swaps

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission ("SEC" or "Commission") is proposing rules that would require the application of specific risk mitigation techniques to portfolios of security-based swaps not submitted for clearing. In particular, the proposal would 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 proposing an interpretation to address the application of the portfolio reconciliation, portfolio compression, and trading relationship documentation requirements to cross-border security-based swap activities and is proposing to amend Rule 3a71-6 to address the potential availability of substituted compliance in connection with those requirements. Moreover, the proposed rules

would make corresponding changes to the recordkeeping, reporting, and notification requirements applicable to SBS Entities. Finally, the Commission is requesting comment on how certain aspects of the proposed rules address how a security-based swap data repository ("SDR") could potentially satisfy its obligation to verify the terms of each security-based swap with both counterparties to the transaction.

DATES: Comments should be received on or before [insert date 60 days after publication in Federal Register].

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-28-18 on the subject line; or

Paper Comments:

- Send paper comments to Brent J. Fields, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-28-18. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/proposed.shtml). Comments are also available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549 on official business days between the hours of 10:00 a.m. and 3:00 p.m. Persons submitting comments are cautioned that we do not redact or edit personal

identifying information from comment submissions. You should submit only information that you wish to make available publicly.

Studies, memoranda, or other substantive items may be added by the Commission or staff to the comment file during this rulemaking. A notification of the inclusion in the comment file of any such materials will be made available on the SEC's website. To ensure direct electronic receipt of such notifications, sign up through the "Stay Connected" option at www.sec.gov to receive notifications by e-mail.

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 proposing for public comment the following new rules:

Commission Reference		**CFR Citation (17 CFR)**
Securities Exchange Act of 1934 ("Exchange Act")[1]	Rule 15Fi-3	§ 240.15Fi-3
	Rule 15Fi-4	§ 240.15Fi-4
	Rule 15Fi-5	§ 240.15Fi-5

[1] 15 U.S.C. 78a et seq.

The Commission also is proposing for comment 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[2]	§ 240.17a-3
	Rule 17a-4	§ 240.17a-4
	Rule 18a-5 (proposed)	§ 240.18a-5 (proposed)
	Rule 18a-6 (proposed)	§ 240.18a-6 (proposed)

Finally, the Commission is requesting comment under:

Commission Reference		CFR or USC Citation
Exchange Act	Section 13(n)(5)(B)	15 U.S.C. § 78m(n)(5)
	Rule 13n-4(b)(3)	17 CFR § 240.13n-4(b)(3)

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[2] In April 2014, the Commission proposed new Rules 18a-5 and 18a-6, and amendments to existing Rules 17a-3 and 17a-4. See Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers; Capital Rule for Certain Security-Based Swap Dealers, Exchange Act Release No. 71958 (Apr. 17, 2014), 79 FR 25194 (May 2, 2014) ("SBS Books and Records Proposing Release"). Although those proposed rules and rule amendments have not yet been adopted by the Commission, all of the relevant proposals included in this release are based on the proposed regulatory text contained in the SBS Books and Records Proposing Release.

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I. Proposed Rules and Rule Amendments

A. 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"),[3] 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.[4] Section 15F(i)(2) of the Exchange Act provides that the Commission shall adopt rules governing documentation standards for SBS Entities.[5]

The Commission previously adopted rules requiring SBS Entities to provide trade acknowledgments and to verify those trade acknowledgments with their counterparties to security-based swap transactions,[6] but has not proposed rules concerning portfolio reconciliation, portfolio compression, or trading relationship documentation. By contrast, the Commodity Futures Trading Commission ("CFTC") has implemented rules setting forth standards for the timely and accurate confirmation of swaps, 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

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3 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.

4 15 U.S.C. 78o-10(i)(1).

5 15 U.S.C. 78o-10(i)(2).

6 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").

participant hereafter referred to as a "Swap Entity" and together referred to as "Swap Entities") and their counterparties.[7]

Accordingly, the Commission is today proposing 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. In developing this proposal, we have consulted and coordinated with the CFTC, the prudential regulators,[8] and

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[7] 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"). The European Commission ("EC") has implemented similar measures. See Commission Delegated Regulation (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. Regulatory authorities in other jurisdictions (e.g., the Hong Kong Monetary Authority and the Monetary Authority of Singapore) 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-Category9/csa_20160707_95-401_collateral-requirements-cleared-derivatives.pdf.

[8] For purposes of this statement, the term "prudential regulator" is defined in Section 1a(39) of the 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

foreign regulatory authorities in accordance with the consultation mandate of the Dodd-Frank Act.[9] 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.[10] Through these multilateral and bilateral discussions and the Commission staff's participation in various international task forces and working groups, we have gathered 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.

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the entity is directly supervised by that regulator. Separately, we are proposing a definition of "prudential regulator," to be used for purposes of the proposed portfolio reconciliation and trading relationship documentation requirements. See infra note 48. That proposed definition also references Section 3(a)(74) of the Exchange Act and includes the same list of agencies as noted above.

9 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."

10 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 and the Committee on Payments and Market Infrastructures.

Finally, the Commission recognizes 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. In order to minimize compliance burdens on such potential dual registrants in connection with the rules we are proposing today, we have attempted to harmonize this proposal with the existing CFTC rules wherever possible. There are, however, a limited number of provisions where we preliminarily believe it is appropriate to diverge from a particular aspect of the CFTC rules. Each of those differences is described below, along with the preliminary reasons for the different approaches. To the extent that no such substantive difference is described, it is because we have preliminarily determined that none exists. However, below we welcome and solicit comment on any potential substantive differences between the proposed rules and the corresponding CFTC rules, as well as on the decision to harmonize with the CFTC, both as an overall approach and with respect to any specific provisions of the proposed rules.

B. Rule 15Fi-3 (Portfolio Reconciliation)

1. Overview of Portfolio Reconciliation

In the Trade Acknowledgement and Verification Adopting Release, the Commission noted the importance of confirming trades in a timely manner, explaining that the process of confirming the terms of a transaction is essential for SBS Entities "to effectively measure and manage market and credit risk."[11] The Commission further explained that "a backlog of

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[11] Trade Acknowledgement and Verification Adopting release, 81 FR at 39833.

unconfirmed trades could hinder the settlement process, particularly if errors go undetected or a counterparty disputes the terms of a transaction."[12] Such disruptions in the settlement process 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.[13]

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 security-based swap transaction is accurately confirmed by both parties during the trade acknowledgement and verification process, reconciliation helps to identify any discrepancies in terms that do not remain constant throughout the life of a trade. Furthermore, if a discrepancy is not identified during the trade acknowledgement and verification process, it could be identified during a subsequent reconciliation exercise.

The Commission preliminarily believes that 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 properly confirmed during the trade acknowledgment and verification process, such as due to some form of systems or human error, that discrepancy could lead to complications at various points throughout the life of the

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12 Id.

13 Id.

transaction, which could become particularly problematic if it remains undetected until such time as the parties are required to perform on their obligations.[14] Thus, portfolio reconciliation could help to mitigate the possibility of a discrepancy unexpectedly affecting performance under the security-based swap transaction by increasing the likelihood that the parties are and remain in agreement with respect to all material terms.

This practice is particularly 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).

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

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[14] 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 system accurately reflect the economic details of trades that have not yet been matched."). Although this particular 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. This is particularly true for terms that do not remain constant during the life of a trade.

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.[15] 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."[16]

In light of this information, the Commission preliminarily believes that the use of portfolio reconciliation to help maintain an agreed-upon valuation of a security-based swap throughout the lifecycle of a transaction should be a hallmark of prudent risk mitigation practices within the operations of an SBS Entity. Accordingly, the Commission is proposing new Rule 15Fi-3 under the Exchange Act,[17] which generally would require those entities, in connection with security-based swaps not submitted for clearing, 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

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15 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.").

16 Id. at 82.

17 Unless otherwise noted, all references to rules (both proposed and existing) without an accompanying statutory reference are to rules adopted (or proposed to be adopted) under the Exchange Act.

counterparties who are not SBS Entities. In both cases, the frequency of the portfolio reconciliation would be based on the number of outstanding transactions with the applicable counterparty.

2. Scope of the Portfolio Reconciliation Requirements

For purposes of proposed Rule 15Fi-3,[18] the Commission is proposing to amend existing Rule 15Fi-1 to add a definition of "portfolio reconciliation."[19] As proposed, this term would be defined to mean any process by which the counterparties to one or more uncleared security-based swaps:

(i) Exchange the material terms of all security-based swaps in the security-based swap portfolio between the counterparties;

(ii) 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

(iii) Resolve any discrepancy in valuations or material terms.

For purposes of this proposed definition, the Commission also is proposing to amend Rule 15Fi-1 to add the terms "security-based swap portfolio," which would be defined to mean all security-based swaps currently in effect between a particular SBS Entity and a particular

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18 The corresponding CFTC rule is 17 CFR 23.502. The structure of the CFTC rule, including the subsections, mirrors the structure of proposed Rule 15Fi-3.

19 See proposed Rule 15Fi-1(l). The corresponding CFTC definition is in 17 CFR 23.500(i).

counterparty,[20] and "valuation," which would be defined to mean the current market value or net present value of a security-based swap.[21] Both of these definitions help to establish the scope of the portfolio reconciliation requirements in proposed Rule 15Fi-3, with the former defining which security-based swaps are subject to the rule and the latter defining one of the two categories of information that must be exchanged during a reconciliation (the other being "material terms"). Moreover, for consistency with the corresponding CFTC rules applicable to Swap Entities, these definitions are substantively identical to the CFTC's corresponding definitions, which we preliminarily believe are appropriately scoped and clear for purposes of proposed Rule 15Fi-3.

With respect to the phrase "material terms," the proposed definition would follow a similar approach to the one taken by the CFTC in that it would base the definition on the terms required to be reported to an SDR pursuant to Regulation SBSR.[22] Unlike the approach taken by the CFTC, however, which has adopted a single definition of "material terms," the definition in proposed Rule 15Fi-1(i) would be bifurcated depending on whether a security-based swap transaction had already been included in a security-based swap portfolio and reconciled pursuant to proposed Rule 15Fi-3.[23] With respect to any security-based swap that has not yet been

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20 See proposed Rule 15Fi-1(o). The corresponding CFTC definition is in 17 CFR 23.500(k)

21 See proposed Rule 15Fi-1(q). The corresponding CFTC definition is in 17 CFR 23.500(m).

22 17 CFR 242.900 to 242.909.

23 CFTC Rule 23.500(g) defines "material terms" to include the minimum primary economic terms (as defined in Appendix 1 of part 45 of the CFTC's regulations) of a swap, other than the 24 specific data fields identified in that rule. See 17 CFR 23.500(g). Among the excluded fields are: (1) the status of either counterparty as a swap dealer,

reconciled as part of a security-based swap portfolio, "material terms" would be defined to mean each term that is required to be reported to a registered SDR pursuant to Rule 901 under the Exchange Act.[24] With respect to all other security-based swaps within a security-based swap portfolio, the definition of "material terms" would continue 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.[25]

The Commission preliminarily believes that the data set submitted to an SDR under Rule 901 is an appropriate measure for determining which terms should be reconciled pursuant to proposed Rule 15Fi-3. As noted above, the Commission believes 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. To effect that objective, we are proposing that the term "portfolio reconciliation" be defined in part as the exchange of the "material terms" of all security-based swaps in the security-based swap portfolio

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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.

24 See proposed Rule 15Fi-1(i)(1) (referencing 17 CFR 242.901).

25 See proposed Rule 15Fi-1(i)(2).

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."[26] The Commission therefore preliminarily believes 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 preliminarily believes that basing the definition of "material terms" on what is required to be reported to an SDR provides certainty for SBS Entities regarding what information must be reconciled, which should in turn reduce the burdens on those entities without lessening the benefits of the proposed rule (which are described earlier in this section and in the Economic Analysis section below). Furthermore, the proposed approach 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. Moreover, this proposed approach would promote the same policy goals that underpin a particular requirement imposed on SDRs to verify the terms of each security-based swap with both counterparties to the transaction, as discussed in detail in Section I.E below.

The Commission preliminarily believes that the proposed rule is reasonably tailored to avoid unnecessary burdens while still promoting important risk mitigation goals inherent to the portfolio reconciliation process. That said, certain terms of a security-based swap transaction may be material the first time that a transaction is reconciled, but might not be material during a

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[26] 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").

subsequent reconciliation. This could be true, for example, with respect to any term of a transaction that does not affect any ongoing rights or obligations of the parties and that has no effect on the valuation of the security-based swap. Accordingly, the definition of "material terms" in proposed Rule 15Fi-1(i)(2) provides that with respect to any subsequent reconciliations, SBS Entities may exclude any term that is not relevant to the ongoing rights and obligations of the parties and the valuation of the security-based swap, regardless of the fact that the term was required to be reported to an SDR under Regulation SBSR.[27] For example, the Commission preliminarily believes that the 24 terms excluded from the CFTC definition could be excluded from the proposed definition of "material terms" in the context of security-based swaps that have previously been reconciled.[28]

Finally, the Commission recognizes that our proposed definition of "material terms" would differ from the corresponding CFTC definition in that Swap Entities would never need to reconcile the 24 terms excluded from the definition of "material terms" in CFTC Rule 23.500(g).

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27 The Commission does not, however, believe that a term would be appropriately excluded from the definition of "material terms" if it was resubmitted to an SDR because of an error in how it was initially reported or due to a lifecycle event. In those circumstances, the Commission preliminarily believes that such term would continue to be material for the same reasons that every term subject to a reporting requirement under Rule 901 would be material the first time that a transaction is reconciled. Once the updated term is reconciled, however, an SBS Entity would be able to exclude that term from subsequent reconciliations to the extent that it determines that it is not relevant to the ongoing rights and obligations of the parties and the valuation of the security-based swap.

28 See supra note 23 (discussing CFTC Rule 23.500(g)). We further recognize that when the CFTC adopted amendments to Rule 23.500(g) to exclude these terms, it noted that "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." See Definitions of "Portfolio Reconciliation" and "Material Terms" for Purposes of Swap Portfolio Reconciliation, 81 FR 27309, 27311 (May 6, 2016).

Nevertheless, we are proposing to require all reported terms to be reconciled at least initially because, among other things, such requirement could potentially help to address an issue related to how registered SDRs can verify the information that they receive, as discussed in detail in Section I.E below. However, below we solicit comment on our approach, and particularly welcome comments on any trade-offs that may exist as between our efforts to address the SDR-related issue and any additional burdens resulting from a definition of "material terms" that departs from the corresponding CFTC rule, particularly in the context of CFTC-regulated Swap Entities that also may register with the Commission as SBS Entities.

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

The Commission is proposing to bifurcate proposed Rule 15Fi-3 based on the particular type of counterparty with which the SBS Entity transacts. For transactions between two SBS Entities, proposed Rule 15Fi-3(a) would 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, expressed in ranges (or tiers).[29]

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 would 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 would be required to occur on a weekly basis. For a security-based swap portfolio between two SBS

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[29] See proposed Rule 15Fi-3(a).

Entities that includes no more than 50 security-based swaps at any time during the calendar quarter, portfolio reconciliation would be required on a quarterly basis.[30]

The Commission preliminarily believes that the proposed tiering of obligations, whereby the frequency of the portfolio reconciliation would be 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. All other things being equal, a larger and more complex portfolio represents a greater potential for loss than a smaller, less complex portfolio. Therefore, the proposed rule would require more frequent reconciliation of the larger, more complex portfolio. We also note that the CFTC has adopted rules that utilize identical levels as our proposal, and that 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.[31]

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30 See proposed Rule 15Fi-3(a)(3). 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 proposed rule as of the date that the requirement applies. 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 fall below that threshold, they could begin reconciling on a weekly basis as of the first business day after the date on which they were able to verify that their security-based swap portfolio has fallen below 500 transactions.

31 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

In addition to the requirements regarding the frequency of the reconciliation, proposed Rule 15Fi-3(a)(1) would require 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.[32] In practice, the Commission notes that an SBS Entity could satisfy such requirement by including the terms governing the portfolio reconciliation process in the written security-based swap

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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).

32 Proposed 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 proposed rule. The Commission notes that CFTC Rule 23.502(a)(2), which is comparable to proposed Rule 15Fi-3(a)(2), uses the term "qualified third party." When it adopted the above 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 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 proposed Rule 15Fi-3(a)(2). We preliminarily believe that it is sufficient for our purposes to refer solely to the fact that a third party has been selected.

trading relationship documentation that the SBS Entity executes with its counterparty which, pursuant to proposed Rule 15Fi-5 would be required to be executed prior to, or contemporaneously with, the two parties executing any new security-based swap transaction.[33] 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 Commission has preliminarily determined not to propose the CFTC's definition of "business day" and to rely on the definition in existing Rule 15Fi-1, which was adopted in 2016 in connection with the trade acknowledgement and verification requirements in Rule 15Fi-2. That definition includes "any day other than a Saturday, Sunday, or legal holiday."[34] Specifically, we believe that the existing definition of "business day" is broadly consistent with other uses of the term within the Commission's rules.[35] We also do not believe it necessary to have two different definitions of the same term promulgated under the same legal authority (i.e., Section 15F(i) of the Exchange Act), one for purposes of the portfolio reconciliation rules and the other for purposes of the trade acknowledgement and verification

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33 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.

34 Under this proposal, the definition of "business day" currently in Rule 15Fi-1(a) would be renumbered as proposed Rule 15Fi-1(b).

35 See, e.g., 17 CFR 270.2a-7(a)(4) ("Business day means any day other than Saturday, Sunday, or any customary business holiday.") and 17 CFR 230.261(b) ("Business day [means] [a]ny day, except Saturdays, Sundays or United States federal holidays.").

rules.[36] Moreover, we believe that this definition provides market participants with the flexibility to determine which holidays are "legal holidays" for purposes of the portfolio reconciliation requirements in proposed Rule 15Fi-3, which should be particularly useful given the cross-border nature of the OTC derivatives market.[37] However, below we solicit comment on our approach.

4. Proposed Rule 15Fi-3(a): Resolution of Discrepancies with Other SBS Entities

Proposed Rule 15Fi-3(a) also would require each SBS Entity to take additional actions in the event of a discrepancy with a counterparty that is an SBS Entity. First, proposed Rule 15Fi-3(a)(4) would require the two SBS Entities to resolve immediately any discrepancy in a material term, whether identified directly as part of the portfolio reconciliation or otherwise. We preliminarily 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. We have not, however, proposed a fixed definition of "immediately" as we believe that the amount of time that will be needed to resolve a discrepancy will depend on the particular

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[36] By contrast, the applicable definition of "business day" for purposes of the CFTC's portfolio reconciliation rules is contained in CFTC Rule 1.3(b), and includes "any day other than a Sunday or holiday." That definition also provides instructions for computing time periods for CFTC rules that include notice requirements.

[37] As a reminder, the proposal would require SBS entities to agree in writing with each of their counterparties on the terms of the portfolio reconciliation pursuant to proposed 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). Accordingly, such agreement between an SBS Entity and its counterparty could include a determination as to which holidays would be considered "legal holidays" for purposes of any applicable portfolio reconciliation exercises involving those two parties.

facts and circumstances involved, including the complexity of the material term in question and the magnitude of the discrepancy. We have, however, solicited comment on this approach.

At the same time, we also recognize that discrepancies related to the valuation of a security-based swap could be particularly difficult to resolve in a short period of time. Accordingly, proposed Rule 15Fi-3(a)(5) would require SBS Entities to have policies and procedures reasonably designed to resolve valuation discrepancies no later than five business days from the date they were discovered, which we preliminarily believe to be both a reasonable and appropriate amount of time to resolve such discrepancies. As a condition to this requirement, however, proposed Rule 15Fi-3(a)(5) would require each SBS Entity to 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[38] and any related regulations pending resolution of the valuation discrepancy. Although we preliminarily believe that counterparties should be given sufficient time to resolve valuation discrepancies, 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.

Moreover, proposed Rule 15Fi-3(a)(5) provides 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. This 10% threshold would apply on a transaction-by-transaction basis and not on a portfolio level. As discussed in the immediately preceding

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38 15 U.S.C. 78o-10(e).

paragraph, the Commission recognizes that valuation discrepancies could be challenging and costly to resolve. Accordingly, we preliminarily believe that providing SBS Entities with a clear understanding of exactly which valuation discrepancies would need to be resolved within five business days will help focus the internal resources of both counterparties on the largest discrepancies. 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.[39]

5. Proposed Rule 15Fi-3(b): Portfolio Reconciliation with Other Counterparties

Proposed Rule 15Fi-3(b) would establish 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 proposed Rule 15Fi-3(b) and the rules applicable to security-based swap portfolios between two SBS Entities, we have preliminarily determined to take a more streamlined approach with respect to security-based swaps between an SBS Entity and its non-SBS Entity counterparties, similar to the CFTC's approach. This approach reflects our preliminary view that a dealer-to-dealer portfolio may be associated with a degree of market interconnectedness and volume that could potentially carry considerable market-wide risks, at least as compared to a security-based swap portfolio that involves only one SBS Entity.

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[39] For the avoidance of doubt, an SBS Entity that identifies a valuation discrepancy in excess of 10% would be in compliance with the proposed rule if it resolves such discrepancy to a level below 10%, even if the entire discrepancy is not completely eliminated. Thus, an SBS Entity would not be required to reduce an 11% valuation discrepancy down to zero, in contrast to an SBS Entity with a 9% valuation discrepancy, who would have no further obligations under proposed Rule 15Fi-3(a)(5).

Moreover, the Commission preliminarily believes it to be appropriate to impose more prescriptive requirements in cases where both entities are subject to the SEC's requirements for registered entities. Accordingly, there are differences in both the application of the portfolio reconciliation requirements with non-SBS Entity counterparties as well as in the thresholds governing the frequency of the required reconciliation exercises.

Specifically, the proposal would 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.[40] This is in contrast to proposed Rule 15Fi-3(a), which expressly requires portfolio reconciliation with respect to transactions where both counterparties are SBS Entities. In addition, the policies and procedures would 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.[41]

As we previously explained, the Commission preliminarily believes 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 to the benefits expected from reconciling a person's security-based swap portfolio at regular intervals. As we

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40 See proposed Rule 15Fi-3(b). Additionally, proposed 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 proposed rule Rule15Fi-3(b) and CFTC Rule 23.502(b).

41 See proposed Rule 15Fi-3(b)(3).

also noted above, all other things being equal a larger and more complex portfolio represents a greater potential for loss than a smaller, less complex portfolio. As before, in selecting the specific levels we recognize that the CFTC has adopted rules with identical thresholds and frequencies and that 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.[42]

In addition, paragraph (b)(1) of proposed Rule 15Fi-3 would require 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, and paragraph (b)(2) provides that under such required policies and procedures, the portfolio reconciliation may be performed on a bilateral basis by the counterparties or by one or more third parties selected by the counterparties.[43] 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 proposed Rule 15Fi-3(b)(1).[44]

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42 See supra note 31 (discussing how the CFTC arrived at setting the numerical thresholds for the requirement to engage in portfolio reconciliation as between two Swap Entities.).

43 See proposed Rules 15Fi-3(b)(1) and (2).

44 See proposed Rule 15Fi-3(b)(2). 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 proposed Rule 15Fi-5 would be required 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

Finally, proposed Rule 15Fi-3(b)(4) would require 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.[45] We are reluctant to provide a fixed definition of "timely fashion" in the context of resolving discrepancies with counterparties who are not SBS Entities due to the fact that 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. Accordingly, below we request comment on the amount of time SBS Entities should be provided to resolve discrepancies in the valuation or a material term with respect to transactions with a non-SBS Entity counterparty. Commenters are particularly encouraged to explain how any recommended time period appropriately balances the importance of quickly resolving valuation discrepancies to the greatest extent possible, with an understanding that more complex discrepancies could involve the need for additional discussion and time for resolution.

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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. See supra notes 32 and 33 and accompanying text.

45 Similar to the requirement in paragraph (a) of the proposed rule for portfolio reconciliation with counterparties that are also SBS Entities, proposed 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 39 and accompanying text (discussing the 10% threshold in the context of Rule 15Fi-3(a)(5)).

6. Reporting of Valuation Disputes

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 their 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 uncollaterialized credit exposure and a potential for loss in the event of a default.

Given those risks, proposed Rule 15Fi-3(c) would 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), at either the transaction or portfolio level,[46] 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. Such notification would be required to be in a form and manner acceptable to the Commission,[47]

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46 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). A detailed discussion of the NFA requirements, including with respect to whether notices of swap valuation disputes should be filed at either the transaction or portfolio level, is set forth at the end of this Section I.B.6.

47 With respect to the language addressing the form and manner of submitting such notices, our intention is to provide SBS Entities with flexibility to determine the most efficient

and would also be required to be sent to any applicable prudential regulator (i.e., in the case of any SBS Entity that is also a bank).[48]

We note that the CFTC has adopted a nearly identical requirement with the same $20,000,000 threshold and timeframes, and that divergence from those requirements could lead to additional costs and other inefficiencies for SBS Entities that are also registered with the CFTC as Swap Entities.[49] In addition, 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."[50] We preliminarily concur with that justification, and also note that such

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and cost-effective means of making such submissions, so long as it is deemed to be acceptable by the Commission. At the same time, 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, below we solicit comment on the form of notice that would be required to be submitted pursuant to the proposal.

48 Additionally, the Commission is proposing to amend Rule 15Fi-1 to add the term "prudential regulator," which would be defined to have the same meaning given to the term in Section 3(a)(74) of the Exchange Act, 15 U.S.C. 78c(a)(74), and would include 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. See proposed Rule 15Fi-1(m).

49 See CFTC Risk Mitigation Adopting Release 77 FR at 55914.

50 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

notifications could assist the Commission in identifying potential issues with respect to an SBS Entity's internal valuation methodology. That said, we also invite public comment as to whether the dollar threshold or reporting periods should be modified in any way.[51]

Finally, the Commission notes that on January 2, 2018, the NFA's Interpretive Notice entitled, "NFA Compliance Rule 2-49: Swap Valuation Dispute Filing Requirements" went into effect.[52] Among other things, that interpretive notice describes the types of disputes that would trigger a notice requirement. Specifically, if the swap dealer and its counterparty exchange collateral, NFA Interpretive Notice to Rule 2-49 provides that the swap dealer would be required to file notice of any dispute regarding (1) the amount of initial margin to be posted or collected pursuant to a collateralized eligible master netting agreement[53] if the dispute exceeds the $20 million reporting threshold and (2) the amount of variation margin to be posted or collected pursuant to such master netting agreement if the dispute exceeds the $20 million reporting

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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)), proposed Rule 15Fi-3(c) does not contain a requirement to provide notices of any security-based swap valuation disputes to the CFTC.

51 We have preliminarily determined not to provide 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.

52 See NFA Interpretive Notice to Rule 2-49, available at: https://www.nfa.futures.org/rulebook/rules.aspx?Section=9&RuleID=9072.

53 NFA Interpretive Notice to Rule 2-49 defines "collateralized eligible master netting agreement" to include an eligible master agreement, including any applicable schedule and credit support annex.

threshold. Because master netting agreements by definition operate at the portfolio level, such notices also would apply to the relevant swap portfolio.

To the extent that a swap dealer and its counterparty do not exchange collateral, NFA Interpretive Notice to Rule 2-49 requires the swap dealer to submit a notice to the NFA upon being notified by its counterparty that such counterparty is disputing any valuation provided by the swap dealer if the dispute exceeds the $20 million reporting threshold. Such notices would either be at the portfolio or transaction level, depending on the particular valuation in question. That is, if the counterparty disputes a valuation provided by the swap dealer related to a particular transaction, the notice provided by the swap dealer to the NFA also would need to be at the transaction level. By contrast, if the counterparty disputes a portfolio valuation provided by the swap dealer, the notice provided by the swap dealer to the NFA also would need to be at the portfolio level.[54]

NFA Interpretive Notice to Rule 2-49 also provides that swap dealers should not file a daily notice of a previously reported dispute even if the valuation dispute amount changes. Instead, swap dealers are required to notify the 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.[55] NFA Notice to Interpretive Rule 2-49 also requires swap

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54 See id. See also Transcript of the NFA Swap Valuation Dispute Notices and Swap Dealer Risk Data Reports Webinar (Oct. 12, 2017), available at: https://www.nfa.futures.org/members/member-resources/files/transcripts/svdwebinar-transcriptoct2017.pdf.

55 See NFA Interpretive Notice to Rule 2-49, supra note 52. NFA Interpretive Notice to Rule 2-49 provided an example of a swap dealer that filed a notice of a $30 million

dealers to file termination notices of disputes that are no longer reportable under CFTC Rule 23.502(c).[56] In addition, on July 20, 2017, NFA issued a Notice to Members (I-17-13) outlining the types of disputes that must be reported under the Interpretive Notice to Rule 2-49 and specifying the information that will be required in NFA's dispute form.[57] Below we solicit comment on whether the Commission should incorporate some or all of the NFA's approach, including with respect to any of the specific requirements described above, directly into proposed Rule 15Fi-3(c).

7. Application of Proposed Rule 15Fi-3 to Cleared Security-Based Swaps

Pursuant to proposed Rule 15Fi-3(d), the new requirements regarding portfolio reconciliation would not apply to a "clearing transaction" which, pursuant to existing Rule 15Fi-1(c) under the Exchange Act, is defined as a security-based swap that has a clearing agency as a

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dispute, noting that an amended notice updating the dispute amount would be required if that dispute increases to $40 million or more and each subsequent $20 million increment (i.e., the dispute amount increases to $60 million or more, $80 million or more, etc.), or if the amount decreases at these $20 million increments.

56 See id. Under NFA Interpretive Notice to Rule 2-49, the termination notice would be due 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.

57 See NFA Notice to Members I-17-30, available at: https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=4827. That notice provided that all swap valuation disputes must include: (1) the swap dealer's NFA ID and legal 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 would also be 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, the notice also would need to include the credit support annex/netting agreement ID.

direct counterparty.[58] Notwithstanding this provision, the Commission understands that some parties may offer portfolio reconciliation services with respect to OTC derivative transactions novated to a clearing agency. Although the Commission recognizes the importance of reconciling the terms of security-based swap transactions between a clearing member (either acting on its own behalf or for the benefit of a customer) and the clearing agency, we preliminarily believe that the issue 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.

8. Comments Requested

The Commission generally requests comments on all aspects of proposed Rule 15Fi-3, as well as any definitions in Rule 15Fi-1 that are used in proposed Rule 15Fi-3. In addition, the Commission requests comments on the following specific issues:

- Do commenters agree with the three activities comprising the scope of the Commission's proposed definition of "portfolio reconciliation"? Why or why not?
- Do you agree that the scope of the proposed definition of "material terms" for purposes of the portfolio reconciliation requirements in proposed Rule 15Fi-3 should be

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58 See proposed Rule 15Fi-3(d). Under existing Rule 15Fi-1(b) under the Exchange Act (which would be renumbered as Rule 15Fi-1(c) under the proposed rules), the term "clearing agency" means a clearing agency registered with the Commission pursuant to Section 17A of the Exchange Act and provides central counterparty services for security-based swap transactions. See also Trade Acknowledgement and Verification Adopting release, 81 FR at 39820-21 (explaining the agency and principal models of clearing in the context of providing a comparable exception from the trade acknowledgement and verification requirements).

coterminous with the terms of a security-based swap that must be reported to an SDR under Regulation SBSR? Why or why not? Do you believe that there are any terms that must be reported to an SDR that should not be subject to the proposed portfolio reconciliation requirements? If so, which term(s) and why?

- As opposed to using a fixed definition of "material terms," should the Commission adopt a more flexible definition? For example, are there other uses of materiality, such as with regard to the disclosure of information in registration statements (including accounting statements) or proxy solicitations that would be useful to include? Why or why not?
- Do you agree with the Commission's preliminary approach of allowing SBS Entities to exclude certain information from the definition of "material terms" after a transaction is reconciled the first time so long as the excluded terms are not relevant to the ongoing rights and obligations of the parties and the valuation of the security-based swap? Alternatively, should the definition be revised to conform to the corresponding CFTC definition, which excludes certain terms for purposes of all portfolio reconciliations? Why or why not? With respect to either approach, which terms should be excluded and why? For example, should the final definition include as rule text some or all of the specific data elements excluded from the CFTC's definition? Which ones and why? By contrast, are there any terms that would be excluded for purposes of subsequent reconciliations under the proposed approach that should also be excluded from the initial reconciliation? Which ones and why?
- Do commenters agree with the decision to use the existing definition of "business day" (as currently in effect for the security-based swap trade acknowledgement and verification requirements) for purposes of the portfolio reconciliation requirements in

proposed Rule 15Fi-3? If not, why not and how should that definition be modified for purposes of the proposed portfolio reconciliation requirements? For example, should the definition specify which jurisdiction's legal holidays are the default for specifying which holidays are not included in the definition of "business days"? Would the differences between the proposed definition of "business day" and the corresponding CFTC definition (which includes "any day other than a Sunday or holiday") create any practical difficulties for dual SEC-CFTC registrants? If so, what are they? Should the Commission instead adopt a definition of "business day" that mirrors the CFTC definition? Why or why not?

- Do commenters agree with the proposed approach of basing the required frequency of portfolio reconciliation in proposed Rule 15Fi-3 on the type of counterparty involved (i.e., its status as an SBS Entity) and on the size of the security-based swap portfolio? If not, why not? If commenters believe that the proposed approach should be retained, should any of the particular frequencies proposed (e.g., daily, weekly, quarterly, or annually) be modified to be either more or less frequent?
- Proposed Rule 15Fi-3 permits the portfolio reconciliation exercises required thereunder to be performed by a third party, with the only qualification being that the selection of that third party has been agreed to by both of the parties in writing. As an alternative approach, should the Commission instead establish specific requirements for qualifying third parties that offer portfolio reconciliation services used for compliance with the rule? If so, how should a third party be deemed to be qualified to provide portfolio reconciliation services and who should make such a determination?

- Should the Commission's rules require two SBS Entities to resolve a discrepancy in a material term "immediately"? Why or why not? Should the Commission define or provide an interpretation of the term "immediately," such as "without undue delay," or, as an alternative, specify a fixed period of time in the rule text within which SBS Entities would be required to comply with proposed Rule 15Fi-3(a)(4)? Why or why not and, if so, how much time should be provided?
- Are there any current industry practices that relate to how counterparties to swaps and security-based swaps resolve discrepancies in a material term in the case of a dealer-to-dealer transaction? If any such practices exist, please describe them, including with regard to the length of time that it typically takes to resolve these types of discrepancies. Are there particular material terms for which a discrepancy typically takes a longer (or shorter) amount of time to resolve? If so, which ones?
- Should the Commission require SBS Entities to have policies and procedures reasonably designed to resolve any discrepancy in a valuation (with another SBS Entity) 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? Why or why not? Should SBS Entities be provided with more days to resolve these discrepancies? Should they have fewer days?
- Are there any current industry practices that relate to how counterparties to swaps and security-based swaps resolve valuation discrepancies in the case of a dealer-to-dealer transaction? If any such practices exist, please describe them, including with regard to the length of time that it typically takes to resolve these types of discrepancies. Are there

particular circumstances that typically make valuation disputes more (or less) difficult and time-consuming to resolve? If so, which ones?

- Should the Commission require SBS Entities to have policies and procedures reasonably designed to resolve any discrepancy in a valuation or material term with a counterparty that is not an SBS Entity (identified either as part of a portfolio reconciliation or otherwise) in a timely fashion? Why or why not? Should the Commission define or provide an interpretation of the term "timely fashion," or, as an alternative, specify a fixed period of time in the rule text within which SBS Entities would be required to comply with proposed Rule 15Fi-3(b)(4)? Why or why not and, if so, how much time should be provided? In suggesting potential timeframes, we note that the period for resolving discrepancies in a valuation or material term with non-SBS Entities should likely not be shorter than the five business days provided in the parallel requirement applicable to valuation discrepancies between two SBS Entities. Should the Commission look at any other similar provisions under the federal securities laws addressing dispute resolution procedures as a guide for determining the amount of time that an SBS Entity should be provided to resolve discrepancies pursuant to proposed Rule 15Fi-3(b)(4)? If so, which ones?
- Are there any current industry practices that relate to how counterparties to swaps and security-based swaps resolve discrepancies in a valuation or material term in the case of a transaction between a dealer and a non-dealer? If any such practices exist, please describe them, including with regard to the length of time that it typically takes to resolve these types of discrepancies. Are there particular terms for which a discrepancy typically takes a longer (or shorter) amount of time to resolve? If so, which ones? In this context,

should valuation discrepancies be treated differently than discrepancies in some (or all) material terms? If so, which ones and why?

- Do you agree with the Commission's proposed approach of deeming valuation differences of less than 10% not to be discrepancies for purposes of requiring resolution under either proposed Rule 15Fi-3(a)(5) or (b)(4)? If not, why not and how should the rules address the resolution of valuation differences? Should the threshold be based on the actual dollar amount of the valuation difference (or the related currency equivalent) instead of being expressed as a percentage of the difference of the two amounts?
- How has the 10% threshold functioned in the context of CFTC rules applicable to Swap Entities? Has that threshold been under-inclusive, in the sense that it may not identity a sufficient number of swap valuation discrepancies that could affect performance under the swap transaction? Why or why not? By contrast, has the CFTC's 10% threshold been over-inclusive, in the sense that it has captured swap valuation discrepancies that typically would not affect performance under the swap transaction? Why or why not?
- Proposed Rule 15Fi-3(c) would require SBS Entities to 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) if not resolved within either 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. Do commenters agree with this requirement? Why or why not? As an alternative, should the Commission instead require SBS Entities to make and keep records of these unresolved disputes? Why or why not? Is $20,000,000 the appropriate threshold for notifying the Commission of

unresolved disputes? If not, should the threshold be higher or lower? Should the threshold instead be expressed as a percentage? Do commenters agree with the proposed timeframes for submitting such a report? If not, should they be increased or decreased?

- Should the Commission 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)? If so, how should such notices be provided? For example, should the Commission require that such notices be submitted in electronic format through the EDGAR system (or any successor system thereto, as designated by the Commission)? Why or why not? Alternatively, should the Commission create a dedicated email box to accept such notices in letter format? Why or why not? Should these notices be submitted on a confidential basis? If so, how would that affect the potential delivery options?
- As discussed above, the NFA has issued an interpretive notice to NFA Compliance Rule 2-49 and a separate notice to its members that, together, specify the timing, frequency, and contents for submitting notices of swap valuation disputes pursuant to CFTC Rule 23.502(c).[59] Should the Commission consider incorporating some or all of those requirements into proposed Rule 15Fi-3(c) at adoption? If so, which ones and why, and should any of the requirements promulgated by the NFA be modified as part of the process of incorporating them into the Commission's rules to account for differences between the swap and security-based swap markets?
- Do commenters agree with the proposed exception from the reconciliation requirement for clearing transactions? Why or why not? Because the definition of "clearing

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[59] See supra notes 52-57 and accompanying text.

transactions" only includes transactions cleared at a clearing agency registered with the Commission pursuant to Section 17A of the Exchange Act, 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 proposed Rule 15Fi-3. Should the Commission modify the scope of the exception for cleared security-based swaps, 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? Why or why not?

- With respect to any Swap Entity that could potentially register with the Commission as an SBS Entity, would the portfolio reconciliation protocols (or any other applicable documentation) already in existence with respect to CFTC Rule 23.502 satisfy the requirements in proposed Rule 15Fi-3? Why or why not? Should proposed Rule 15Fi-3 be modified to account for the way that market participants have designed their existing protocols (or any other applicable documentation) to be compliant with the CFTC's rules? Why or why not? For the purposes of compliance with the proposed portfolio reconciliation rules, should the Commission allow compliance with the CFTC's parallel requirements for some period of time to allow dual SEC-CFTC registrants to conform their existing portfolio reconciliation protocols (or any other applicable documentation) following the adoption of proposed Rule 15Fi-3? If so, on what factors should that reliance be conditioned and how long of a compliance period should be provided? In the alternative, should the Commission delay compliance with, or establish phased compliance deadlines for, some or all of these requirements? Please explain the nature of

any compliance challenges (including any additional documentation requirements), and the basis for any suggested compliance period.

- As previously noted, proposed Rule 15Fi-3 has been designed to be as consistent as possible with CFTC Rule 23.502, which imposes portfolio reconciliation requirements on Swap Entities, in order to avoid requiring dual SEC-CFTC registrants to incur additional systems or compliance costs due to differences between the two agencies' approaches. To the extent that any such differences remain, should the Commission consider, for any firm dually-registered as both an SBS Entity and Swap Entity (regardless of whether such firm is also registered with the Commission as a broker-dealer or with the CFTC as a futures commission merchant), permitting such firm to comply with proposed Rule 15Fi-3 on an ongoing basis by complying with CFTC Rule 23.502, as if such rule applied to security-based swaps? If so, what conditions, if any, should be placed on such reliance?
- Should SBS dealers and major SBS participants be treated the same for purposes of the portfolio reconciliation requirements in proposed Rule 15Fi-3? Why or why not?

C. Rule 15Fi-4 (Portfolio Compression)

1. Overview of Portfolio Compression

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.[60] 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 replacement and remaining contracts is reduced, although the counterparty's net exposure typically remains the same.[61]

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 total notional value — reduces a market participant's gross exposure to its direct

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60 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.

61 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").

counterparties, including by eliminating all exposure to certain counterparties.[62] 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.[63] Accordingly, the Commission preliminarily believes that the use of portfolio compression by SBS Entities, where appropriate given the circumstances (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.[64]

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62 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 ("FRBNY OTC Derivatives Report") ("In 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.").

63 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").

64 See 15 U.S.C. 78o-8 (requiring SBS Entities 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").

2. Scope of Proposed Rule 15Fi-4 – Portfolio Compression Exercises

For purposes of proposed Rule 15Fi-4 under the Exchange Act, the phrase "portfolio compression exercise" would generally refer 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.[65] In order to incorporate that concept into the proposal, the Commission is proposing to amend Rule 15Fi-1 to create definitions for both "bilateral portfolio compression exercise"[66] and "multilateral portfolio compression exercise."[67] These two definitions are nearly identical, with the sole difference being that the former would apply to a portfolio compression exercise that includes only two security-based swap counterparties, while the latter would refer to a portfolio compression exercise that includes more than two security-based swap counterparties.[68]

Under proposed Rule 15Fi-4(a), SBS Entities would be required to establish, maintain, and follow written policies and procedures for periodically engaging in both bilateral portfolio

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65 The corresponding CFTC rule is 17 CFR 23.503. The structure of the CFTC rule, including the subsections, mirrors the structure of proposed Rule 15Fi-4.

66 See proposed Rule 15Fi-1(a). The corresponding CFTC definition is in 17 CFR 23.500(b).

67 See proposed Rule 15Fi-1(j). The corresponding CFTC definition is in 17 CFR 23.500(h).

68 As noted below in Section I.C.4, proposed Rule 15Fi-4 is applicable only to uncleared security-based swaps.

compression exercises and multilateral portfolio compression exercises, in each case when appropriate, with any counterparties that are SBS Entities.[69] To the extent that an SBS Entity transacts with counterparties that are not SBS Entities, proposed Rule 15Fi-4(b) provides that the policies and procedures required under the proposed rule would require that portfolio compression exercises occur when appropriate[70] and only to the extent requested by any such counterparty.[71]

The proposed 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 proposed Rule 15Fi-4, while also retaining the key elements necessary to achieve the important risk reducing benefits previously discussed — namely the reduction of counterparty and operational risk achieved by terminating offsetting security-based swap transactions. Accordingly, we are not proposing specific requirements as to the contents of the policies and procedures created to comply with these

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69 See proposed Rules 15Fi-4(a)(2) and (3).

70 CFTC Rule 23.503(b), which is the corresponding CFTC compression rule applicable to transactions with counterparties that are not SBS 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." Rather, we preliminarily believe it to be 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, recognizing of course that such discretion should not be used by the SBS Entity arbitrarily not to honor the request by its counterparty. Below we solicit comment on this difference.

71 See proposed Rule 15Fi-4(b). As we noted in discussing the proposed portfolio reconciliation requirements, the Commission preliminarily believes it to be appropriate to impose more prescriptive requirements in cases where both entities are subject to the SEC's requirements for registered entities.

rules.[72] In addition, for consistency with the rules applicable to Swap Entities, these definitions are substantively identical to the CFTC's corresponding definitions, which we preliminarily believe are appropriately scoped and clear for purposes of proposed Rule 15Fi-4.

Rather, 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 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

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[72] The one exception to this statement is the requirement in both proposed 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 preliminarily 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.

policies and procedures required pursuant to proposed Rules 15Fi-4(a) and (b), an SBS Entity would be in compliance with the proposed rules so long as it follows those policies and procedures, even if it determines not to engage in a particular compression exercise.

Finally, in comparing the requirements we are proposing today with respect to bilateral and multilateral compression exercises with those previously adopted by the CFTC, we note two differences that 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. We have preliminarily determined not to include a comparable requirement in proposed Rule 15Fi-4(a)(3). 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 are currently no Commission regulations or orders mandating participation in any particular type of portfolio compression exercise, and we are reluctant to include a requirement that could lead to confusion by suggesting that such regulations or orders exist.

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.[73] The CFTC did not, however, include such a requirement in the corresponding requirement related to policies and procedures addressing bilateral portfolio compression exercises.[74] Although the inclusion of a specific requirement in

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73 See 17 CFR 23.503(a)(3)(ii).

74 See 17 CFR 23.503(a)(2).

the rule should not be interpreted as creating an exhaustive list of what we would expect to see included in the 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 are proposing to expressly include a similar requirement in both proposed Rules 15Fi-4(a)(2) (policies and procedures regarding bilateral compression) and 15Fi-4(a)(3) (policies and procedures regarding multilateral compression).

3. Scope of Proposed Rule 15Fi-4 – Bilateral Offset

As we previously noted, the Commission has preliminarily made the determination not 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 and has, instead, proposed broad definitions of the terms "bilateral portfolio compression exercise" and "multilateral portfolio compression exercise." 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 proposed definitions.

In light of those considerations, proposed Rule 15Fi-4(a)(1) would 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.[75] To the extent that an SBS Entity transacts with a counterparty that

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[75] The Commission also is proposing to amend Rule 15Fi-1 to add the term "fully offsetting security-based swaps," which would be 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." See proposed Rule 15Fi-1(h). For consistency with the rules applicable to Swap Entities, this definition is substantively identical to the CFTC's

is not an SBS Entity, the requirements of proposed Rule 15Fi-4(b) would be identical to those in proposed Rule 15Fi-4(a)(1), except that the required policies and procedures would only need to address engaging in bilateral offset when appropriate and to the extent requested by the counterparty. The Commission preliminarily believes that by not proposing prescriptive requirements as to the form of bilateral offset that would need to be reflected in an SBS Entity's policies and procedures, the proposed rule would allow the 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.

In addition, the proposed rules regarding bilateral offset have been designed to reflect the Commission's understanding that firms may have legitimate business reasons for maintaining fully offsetting security-based swap transactions. As such, proposed Rules 15Fi-4(a)(1) and (b) would require a firm's policies and procedures to address the termination of fully offsetting security-based swaps only "when appropriate."

Finally, for purposes of proposed Rules 15Fi-4(a)(1) and (b), the Commission would 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.

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corresponding definition in 17 CFR 23.500(f), which we preliminarily believe is appropriately scoped and clear for purposes of proposed Rule 15Fi-4.

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

Pursuant to proposed Rule 15Fi-4(c), the new requirements regarding portfolio compression would not apply to a "clearing transaction" which, pursuant to existing Rule 15Fi-1(c) under the Exchange Act, is defined as a security-based swap that has a clearing agency as a direct counterparty.[76] Notwithstanding this provision, the Commission recognizes 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.[77] Although the risk-reducing benefits that could be realized through the compression of cleared security-based swaps, we preliminarily 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 relationship between the clearing agency and its members.[78]

5. Comments Requested

The Commission generally requests comments on all aspects of Proposed Rule 15Fi-4 (and any related definitions). In addition, the Commission requests comments on the following specific issues:

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76 See supra note 58 and accompanying text.

77 Notwithstanding the applicability of the requirements of proposed 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.

78 The corresponding CFTC rule is 17 CFR 23.503(c).

- Do commenters agree with the scope of the Commission's approach of proposing broad definitions of "bilateral portfolio compression exercise" and "multilateral portfolio compression exercise"? Why or why not?
- Should SBS Entities be required to have policies and procedures in place for terminating fully offsetting security-based swaps in a timely fashion? Why or why not? Do you agree with the proposed interpretation of the term "timely fashion" to mean that the relevant security-based swaps should be terminated within a period that is reasonable in light of the circumstances of each particular transaction (so long as the relevant SBS Entity is otherwise in compliance with its policies and procedures regarding bilateral offset)? Why or why not? Should the Commission instead specify a fixed period of time for the required termination of these security-based swaps? Why or why not?
- With respect to any Swap Entity that could potentially register with the Commission as an SBS Entity, would the portfolio compression protocols (or any other applicable documentation) already in existence with respect to CFTC Rule 23.503 satisfy the requirements in proposed Rule 15Fi-4? Why or why not? Should proposed Rule 15Fi-4 be modified to account for the way that market participants have designed their existing protocols (or any other applicable documentation) to be compliant with the CFTC's rules? Why or why not? For the purposes of compliance with the proposed portfolio compression rules, should the Commission allow compliance with the CFTC's parallel requirements for some period of time to allow dual SEC-CFTC registrants to conform their existing portfolio compression protocols (or any other applicable documentation) following the adoption of proposed Rule 15Fi-4? If so, on what factors should that reliance be conditioned and how long of a compliance period should be provided? In the

alternative, should the Commission delay compliance with, or establish phased compliance deadlines for, some or all of these requirements? Please explain the nature of any compliance challenges (including any additional documentation requirements), and the basis for any suggested compliance period.

- As previously noted, proposed Rule 15Fi-4 has been designed to be as consistent as possible with CFTC Rule 23.503, which imposes portfolio compression requirements on Swap Entities, in order to avoid requiring dual SEC-CFTC registrants to incur additional systems or compliance costs due to differences between the two agencies' approaches. To the extent that any such differences remain, should the Commission consider, for any firm dually-registered as both an SBS Entity and Swap Entity (regardless of whether such firm is also registered with the Commission as a broker-dealer or with the CFTC as a futures commission merchant), permitting such firm to comply with proposed Rule 15Fi-4 on an ongoing basis by complying with CFTC Rule 23.503, as if such rule applied to security-based swaps? If so, what conditions, if any, should be placed on such reliance?
- Do commenters agree with the proposed exception from the compression requirements in proposed Rule 15Fi-4 for clearing transactions? Why or why not? Because the definition of "clearing transactions" only includes transactions cleared at a clearing agency registered with the Commission pursuant to Section 17A of the Exchange Act, security-based swaps cleared at a foreign clearing agency that is not registered with the Commission would <u>not</u> be deemed to be "cleared" for these purposes, and would therefore be subject to proposed Rule 15Fi-4. Should the Commission modify the scope of the exception for cleared security-based swaps, 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? Why or why not?

- Proposed Rule 15Fi-4(b) requires each SBS Entity to 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 an SBS Entity, "when appropriate" and to the extent requested by any such counterparty. CFTC Rule 23.503(b) does not contain the "when appropriate" qualifier and provides only that a Swap Entity's policies and procedures address engaging in bilateral offset or compression exercises "to the extent requested" by a counterparty that is not a Swap Entity. Would the Commission's proposed approach create any practical difficulties for dual SEC-CFTC registrants? If so, what are they? Should the Commission instead strike the "when appropriate" qualifier in order to mirror the corresponding CFTC requirement? Why or why not? To the extent that the Commission were to follow the approach of CFTC Rule 23.503(b), should there be a reasonableness standard to address situations when a request by a non-SBS Entity counterparty to engage in bilateral offset or compression exercises would be not be reasonable, such as a situation when doing so could be detrimental to the SBS Entity? If so, under what conditions should an SBS Entity be able to refuse a request from a non-SBS Entity counterparty to engage in such activity pursuant to proposed Rule 15Fi-4(b)?
- What practices, if any, are currently being used (or are currently under consideration) by market participants with respect to the use of portfolio compression across asset classes?

For example, could a compression exercise occur with respect to two or more counterparties maintaining portfolios of both single-name credit default swaps ("CDS") and index CDS? If so, should the Commission modify proposed Rule 15Fi-4, or provide related interpretive guidance to accommodate portfolio compression across asset classes?

- Should SBS dealers and major SBS participants be treated the same for purposes of the portfolio compression requirements in proposed Rule 15Fi-4? Why or why not?

D. Rule 15Fi-5 (Trading Relationship Documentation)

1. Overview of Trading Relationship Documentation

Section 15F(i)(2) of the Exchange Act provides that the Commission shall adopt rules governing documentation standards for SBS Entities. Just as portfolio reconciliation is designed to allow counterparties to manage their internal risks by better ensuring agreement with respect to the terms of the transaction (and thereby avoiding complications at various points throughout the life of the transaction),[79] 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.[80]

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79 See supra Section I.B.1.

80 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 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.").

Having 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, as would be required under these proposed rules, in an efficient and cost-effective manner.

2. Scope of Proposed Rule 15Fi-5

In light of the important risk mitigating factors described above, the Commission is proposing 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.[81] Specifically, proposed Rule 15Fi-5(a)(2) would require 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.[82] The proposed rule would further require 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.[83]

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81 The corresponding CFTC rule is 17 CFR 23.504. The structure of the CFTC rule, including the subsections, mirrors the structure of proposed Rule 15Fi-5.

82 Among other exceptions discussed below in Section I.D.6, proposed Rule 15Fi-5 is applicable only to uncleared security-based swaps.

83 See proposed Rule 15Fi-5(b)(2). For purposes of this requirement, the Commission preliminarily 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

Pursuant to proposed Rule 15Fi-5(b)(1), the required policies and procedures would require that the security-based swap trading relationship documentation be in writing. The policies and procedures would also require that the documentation 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, allocation of any applicable regulatory reporting obligations (including pursuant to Regulation SBSR), governing law, valuation, and dispute resolution.[84]

For purposes of Rule 15Fi-5(b)(2), all trade acknowledgements and verifications of security-based swap transactions required under Rule 15Fi-2 would 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 proposed 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

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Entity Registration Adopting Release"). By contrast, CFTC Rule 23.504 uses the term "senior management," which is not further defined in either CFTC Rules 23.500 or 23.504. We preliminarily view this difference as a clarification and do not believe that it represents a substantive difference between the two sets of rules, but below we solicit comment on this issue.

84 We note that CFTC Rule 23.504 does not contain a comparable provision to the requirement in proposed Rule 15Fi-5(b)(1) that the trading relationship documentation address "applicable regulatory reporting obligations (including pursuant to Regulation SBSR)." The Commission is proposing this requirement not only because of our view that reporting arrangements should be clarified in advance, due to the importance of ensuring that the transaction is reported accurately and in a timely manner, but also because the inclusion of such provision could potentially help to address an issue related to how SDRs can verify the information that they receive, as discussed in detail in Section I.E below.

terms governing the relationship. The proposed rule is not intended to interfere with this practice. Accordingly, we preliminarily believe that the use of a "long-form confirmation" would comply with proposed 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.

The policies and procedures required by the proposed rule also would require that the security-based swap trading relationship documentation include credit support arrangements.[85] Such credit support would be required to contain, among other things and in accordance with applicable requirements under regulations adopted by the Commission or any prudential regulators,[86] 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 Section 3E(f) of the Exchange Act, if any.[87]

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85 See proposed Rule 15Fi-5(b)(3).

86 See supra note 48.

87 15 U.S.C. 78c-5(f).

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.[88] Accordingly, we preliminarily believe that policies and procedures 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.

3. Proposed Rule 15Fi-5(b)(4): Documenting Valuation Methodologies

As mentioned throughout this release, 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.[89] Accordingly, proposed Rule 15Fi-5(b)(4) would require 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),[90] and the risk management requirements under

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88 See supra Section I.B.1.

89 See id.

90 See 15 U.S.C. 78o-10(e). For the avoidance of doubt, the requirements in proposed 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

Section 15F(j) of the Exchange Act (and applicable regulations).[91] To the maximum extent practicable, such valuations would need to be based on recently-executed transactions, valuations provided by independent third parties, or other objective criteria.[92]

The requirements in proposed Rule 15Fi-5(b)(4) regarding valuation methodology would 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 proposing to amend Rule 15Fi-1 to add a definition of "financial counterparty," which would include 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

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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.

91 See 15 U.S.C. 78o-10(j).

92 See proposed Rule 15Fi-5(b)(4)(i).

- 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).[93]

Further, proposed Rule 15Fi-5(b)(4)(ii) has been designed 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 proposed Rule 15Fi-5(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 (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.[94]

To the extent that the prescribed valuation documentation needs to be updated, revised, or otherwise modified, proposed Rule 15Fi-5(b)(4)(iv) provides that the parties may agree on

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93 See proposed Rule 15Fi-1(g). 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 proposed definition of "financial counterparty."

94 See proposed Rule 15Fi-5(b)(4)(ii).

changes or procedures for modifying or amending such documentation at any time.[95] Finally, in recognition of the fact that valuation data and methodologies often include, or may be based on, private information, proposed 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.

4. Proposed Rule 15Fi-5(b)(5) and (6): Other Disclosure Requirements

Proposed Rule 15Fi-5 also would 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 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.[96] As background, Title II of the Dodd-Frank Act provides for an alternative insolvency regime for the "orderly liquidation" of large financial companies,[97] including broker-

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95 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." Proposed 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 proposed Rule 15Fi-5(b)(4).

96 See 12 U.S.C. 5382; 12 U.S.C. 5383.

97 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 —

dealers, that meet specified criteria (each a "covered financial company") as set forth in Title II of the Dodd-Frank Act.[98] 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

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(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;

(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).

98 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).

receiver.[99] 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[100] or by the U.S. Bankruptcy Code,[101] the Commission preliminarily 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, proposed Rule 15Fi-5(b)(5) would require that each SBS Entity's policies and procedures require that the security-based swap trading relationship documentation contain a statement as to whether it or its counterparty is an insured depository institution or financial company. Further, the documentation also would need to contain a statement that the orderly liquidation provisions of the Dodd-Frank Act and the Federal Deposit Insurance Act [102] 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 would further be required 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 of certain rights of the FDIC to transfer security-based swaps of the covered party. Finally, the policies and procedures would

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99 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).

100 15 U.S.C. 78aaa et seq.

101 11 U.S.C. 101 et seq.

102 12 U.S.C. 1811 et seq.

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.[103]

Second, the policies and procures required pursuant to proposed Rule 15Fi-5(b)(6) would require the security-based swap trading relationship documentation of each SBS Entity disclose certain information regarding the status of a security-based swap accepted for clearing by a clearing agency. Specifically, such documentation would need to contain a notice that, upon acceptance of a security-based swap by a clearing agency:

- The original security-based swap is extinguished;

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[103] Specifically, proposed Rule 15Fi-5(b)(5) would require that an SBS Entity's policies and procedures require that the applicable security-based swap trading relationship documentation contain:

(A) 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));

(B) A statement of whether the counterparty is an insured depository institution or financial company;

(C) 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

(D) 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.

- 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 preliminarily believes that this disclosure should provide important information to counterparties regarding the effects of clearing a trade at a clearing agency and clarify the status of the contract following its acceptance and novation at the clearing agency.

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

Proposed Rule 15Fi-5(c) would require 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 proposal also would require that a record of the results of each audit be retained for a period of three years after the conclusion of the audit.[104] The Commission preliminarily 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 proposed requirement differs slightly from CFTC Rule 23.504(c), which references an independent "internal or external" auditor.[105]

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104 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 proposed Rule 15Fi-5(c) itself.

105 See 17 CFR 23.504(c). In the Commission's 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 would be inconsistent with the Commission's auditor independence rules.

6. Exceptions to the Trading Relationship Documentation Requirements

Proposed Rule 15Fi-5(a)(1) would establish 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, proposed Rule 15Fi-5(a)(1)(i) would provide 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 proposed rules, particularly when weighing any potential benefits of doing so against the potential costs. Accordingly, we preliminarily believe that those transactions should be excepted from the proposed documentation requirements.[106]

See Rule 2-01(c)(2) of Regulation S-X (Employment Relationships). 17 CFR 210.2-01(c). At the same time, we are not foreclosing the possibility that there could be alternative structures to the typical "internal" auditor employment relationship that could, if structured properly, not be inconsistent with the Commission's auditor independence rules and request comment below identifying and describing such potential structures.

106 As discussed in detail in Section I.F.1 of this release, the Commission also is proposing amendments to Rule 17a-4 and to proposed Rule 18a-6 that would, among other things, require SBS Entities to retain all security-based swap trading relationship documentation with counterparties required to be created under proposed Rule 15Fi-5. Because security-based swaps executed prior to the date on which an SBS Entity is required to be in compliance with proposed 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 proposed Rule 15Fi-5.

To the extent that an SBS Entity maintains an existing security-based swap portfolio with a counterparty that pre-dates the compliance date, proposed Rule 15F-5(a)(1)(i) would provide 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 the counterparty, the exception would not apply to those new trades, even if trading relationship documentation already existed. Under those circumstances, the SBS Entity's policies and procedures would be need to be reasonably designed to ensure that the existing documentation complies with the proposed rule before using it as the basis to enter into any new security-based swaps with that counterparty.

Second, proposed Rule 15Fi-5(a)(1)(ii) would provide an exception for any "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.[107] This exception is intended to recognize 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).

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107 See supra note 58 and accompanying text.

Finally, proposed Rule 15Fi-5(a)(1)(iii) would provide an exception for security-based swaps executed anonymously on a national securities exchange or a security-based swap execution facility ("SBSEF"), 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 proposed 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 by virtue of the fact that, 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 proposed 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 SBSEF, 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 (or had no reasonable basis to 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.

Under those circumstances, the Commission preliminarily believes that 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, the Commission is proposing that if an SBS Entity that is relying on the exception in proposed 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 applicable policies and procedures would need to require that the SBS Entity be in compliance with the requirements of proposed Rule 15Fi-5 in all respects promptly after receipt of such notice.[108]

The Commission notes that 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 SBSEF, national

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[108] The provisions in proposed 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 proposed Rule 15Fi-5 due to a transaction being rejected for clearing for reasons which the SBS Entity did not know (or have a reasonable basis to know) prior to when the transaction was submitted to the clearing agency.

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.

7. Comments Requested

The Commission generally requests comments on all aspects of Proposed Rule 15Fi-5 (and any related definitions). In addition, the Commission requests comments on the following specific issues:

- Do commenters agree with the scope of the proposed exception from the trading relationship documentation requirements in proposed Rule 15Fi-5 for clearing transactions? Why or why not? Because the definition of "clearing transactions" only includes transactions cleared at a clearing agency registered with the Commission pursuant to Section 17A of the Exchange Act, 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 proposed Rule 15Fi-5. Should the Commission modify the scope of the exception for cleared security-based swaps, 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 Exchange Act does not cover the activities of the clearing agency? Why or why not?

- Do commenters agree with the proposed exception from the trading relationship documentation requirements for security-based swaps executed anonymously on a national securities exchange or an SBSEF? Is it sufficiently comprehensive? Why or why not? The proposed exception also provides that if a security-based swap executed anonymously on a platform is subsequently rejected for clearing, the SBS Entity would then be required to come into compliance with the documentation requirements "promptly" after receipt of the notice of rejection. Do you agree with this approach? Why or why not? Should the Commission define or provide an interpretation of the word "promptly" for these purposes or, as an alternative, specify a fixed period of time in the rule text in which SBS Entities would be required to comply with proposed Rule 15Fi-5? Why or why not and, if so, how much time should be provided?
- Are there any current industry practices that relate to how counterparties to swaps and security-based swaps treat transactions executed anonymously on a trading platform, but subsequently rejected for clearing? If any such practices exist, please describe them, including with regard to the length of time that it typically takes to document these transactions, if they remain in effect.
- With respect to any Swap Entity that could potentially register with the Commission as an SBS Entity, would the documentation protocols (or any other applicable documentation) already in existence with respect to CFTC Rule 23.504 satisfy the requirements in proposed Rule 15Fi-5? Why or why not? Should proposed Rule 15Fi-5 be modified to account for the way that market participants have designed their existing protocols (or any other applicable documentation) to be compliant with the CFTC's rules? Why or why not? For the purposes of compliance with the proposed

documentation rules, should the Commission allow compliance with the CFTC's parallel documentation rules for some period of time to allow dual SEC-CFTC registrants to conform their existing documentation protocols (or any other applicable documentation) following the adoption of proposed Rule 15Fi-5? If so, on what factors should that reliance be conditioned and how long of a compliance period should be provided? In the alternative, should the Commission delay compliance with, or establish phased compliance deadlines for, some or all of these requirements? Please explain the nature of any compliance challenges (including any additional documentation requirements), and the basis for any suggested compliance period.

- As previously noted, proposed Rule 15Fi-5 has been designed to be as consistent as possible with CFTC Rule 23.504, which imposes trading relationship documentation requirements on Swap Entities, in order to avoid requiring dual SEC-CFTC registrants to incur additional systems or compliance costs due to differences between the two agencies' approaches. To the extent that any such differences remain, should the Commission consider, for any firm dually-registered as both an SBS Entity and Swap Entity (regardless of whether such firm is also registered with the Commission as a broker-dealer or with the CFTC as a futures commission merchant), permitting such firm to comply with proposed Rule 15Fi-5 on an ongoing basis by complying with CFTC Rule 23.504, as if such rule applied to security-based swaps? If so, what conditions, if any, should be placed on such reliance?
- In addition to the exceptions set forth in the proposed rule, are there other types of security-based swaps that should not be subject to the underlying trading relationship documentation requirements?

- Should the Commission require that the policies and procedures governing the required written security-based swap trading relationship documentation be approved by a senior officer of the SBS Entity, as is currently contemplated pursuant to proposed Rule 15Fi-5? Why or why not? As an alternative to requiring action by a senior officer, should such approval come instead from the governing body of the SBS Entity? Why or why not? As an additional alternative, should the Commission consider requiring approval of those policies and procedures by someone below the senior officer level? If so, who within an SBS Entity should approve them?
- For purposes of the requirement that a senior officer approve the policies and procedures required by proposed Rule 15Fi-5, the Commission has preliminarily interpreted 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. Do commenters agree with such interpretation? Why or why not? Does the proposed interpretation create any differences with respect to the manner in which Swap Entities are required to comply with CFTC Rule 23.504(a)(2), which uses the term "senior management"? Should the explanation included in the Commission's proposed interpretation instead be included in the rule text?
- Proposed Rule 15Fi-5 does not contain a comprehensive list of all of the terms that should be addressed in the required security-based swap trading relationship documentation. Rather, it provides that the documentation must include "all terms governing the trading relationship" between the SBS Entity and its counterparty and also contains a non-exclusive list of terms that must be included. Do commenters agree with

that approach? Why or why not? Should the Commission consider modifying the list of terms specifically identified in proposed Rule 15Fi-5(b)(1)?

- Should the Commission provide any additional specificity and/or guidance as it relates to one or more of the terms identified in proposed Rule 15Fi-5(b)(1) as required to be included in the trading relationship documentation? For example, should the rule specify the types of payment obligation terms that should be addressed in the documentation? Are there any particular details regarding potential events of default or termination events that should be specified in the documentation? Should the information requirements regarding the terms of the credit support arrangements between the two parties be modified in any way? In each case, why or why not and what additional details or guidance should be provided?
- Proposed Rule 15Fi-5(b)(1) requires that the security-based swap trading relationship documentation that SBS Entities execute with the counterparties include terms addressing dispute resolution. Should the Commission provide any additional specificity with respect to this proposed requirement, including by identifying what particular aspects of the dispute resolution process should be addressed in the documentation? For example, should the documentation include specific requirements regarding the methods for identifying, recording, and monitoring disputes? Should the terms governing dispute resolution identify specific time periods applicable to the process? Are there particular aspects regarding communications between the counterparties that should be specified in connection with the terms related to dispute resolution, such as the method for providing notice of a potential or actual dispute? In each case, why or why not, and what additional details or guidance should be provided?

- Proposed Rule 15Fi-5(b)(4) would require SBS Entities to include in their security-based swap trading relationship documentation with certain counterparties written agreement on the terms for valuing security-based swaps for the purposes of complying with the margin and risk management requirements. Do you agree with the scope of that requirement? Why or why not? Should these requirements apply to an SBS Entity's transactions with all counterparties, including non-financial counterparties, without regard to whether they are requested? Why or why not? Is there any additional information that should be included in this requirement, or should any of the proposed requirements be modified or deleted? Do the provisions related to valuation discrepancies provide a sufficient basis for helping to ensure that disputes related to the value of a security-based swap are resolved in as efficient a manner as possible, or should any changes be made to these requirements? Should the requirements regarding valuation be modified in any way to account for the use of internal and/or proprietary inputs and models? In each case, why or why not, and how and why should the proposed rule be modified?
- Are the protections in the proposed rule regarding the treatment of confidential, proprietary information in connection with the required valuation agreement sufficient to meet the needs of both the party providing the information and the party receiving it? If not, how should the proposal be revised to address any such concerns?
- In addition to the terms governing the valuation agreement in proposed Rule 15Fi-5(b)(4), are there any other requirements that should be limited to, or modified for, certain types of counterparties (e.g., financial counterparties)? If so, which ones, and what particular requirements should apply?

- Do the disclosure requirements in paragraphs (5) and (6) of proposed Rule 15Fi-5(b), as they relate to the "insured depository institution" or "financial company" status of the SBS Entity or its counterparty and to the status of a security-based swap accepted for clearing, respectively, provide useful and relevant information to counterparties to security-based swaps? Why or why not? Should any other disclosure requirements be modified or deleted? If so, which ones and how? Should any additional disclosure requirements be added to the proposed rule? If so, what should be added and why?
- Do commenters agree with the scope of the proposed definition of "financial counterparty" in proposed Rule 15Fi-1(g), which is used for determining when the required security-based swap trading relationship documentation would need to include the valuation methodology set forth in proposed Rule 15Fi-5(b)(4)? Should that definition be expanded to include other types of financial entities, such as SEC-registered broker-dealers, investment companies, or investment advisers? If so, which types of entities should be added to the definition and why?
- Do commenters agree with the proposed requirements related to the performance of periodic audits of the SBS Entity's security-based swap relationship documentation, as set forth in proposed Rule 15Fi-5(c)? Why or why not? If not, how should they be clarified? Should the Commission provide any additional specificity regarding what constitutes "independence" for these purposes? If so, how should that standard be measured and evaluated? For example, the Commission has extensive experience with respect to determining what constitutes "independence" in the context of accountants that audit and review financial statements and prepare attestation reports filed with the Commission, including in connection with rules adopted pursuant to Title II of the

Sarbanes-Oxley Act of 2002. Should the Commission consider leveraging particular aspects of that experience in connection with refining the requirements in proposed Rule 15Fi-5(c)? If so, please explain.

- Are there any circumstances under which an internal auditor could be considered to be "independent" for purposes of proposed Rule 15Fi-5(c)? If so, please explain. If not, should the Commission consider eliminating the requirement that the auditor be independent in order to allow for internal audits of the SBS Entity's security-based swap relationship documentation? If so, are there particular conditions that should be included in the requirement in order to maintain the integrity of the audit process?
- Should the person performing the audit of the SBS Entity's security-based swap relationship documentation pursuant to proposed Rule 15Fi-5(c) be subject to any qualification requirements, such as the requirement to be registered with the Public Company Accounting Oversight Board ("PCAOB")? If so, which qualifications should be required and why? If not, should proposed Rule 15Fi-5(c) be clarified to state explicitly that PCAOB registration is not a condition of the rule?
- Should SBS dealers and major SBS participants be treated the same for purposes of the portfolio reconciliation requirements in proposed Rule 15Fi-5? Why or why not?

E. Verification of Transaction Data by SDRs

In light of certain of the rules we are proposing today, the Commission believes it to be an appropriate time to revisit and request comment on an issue previously identified in connection with the rules applicable to the registration and ongoing regulation of SDRs. As

background, Section 13(n) of the Exchange Act establishes a regulatory regime for the operation of and governance of SDRs.[109] Among other things, Section 13(n)(5)(B) requires each registered SDR to "confirm with both counterparties to the security-based swap the accuracy of the data that was submitted."[110] On February 15, 2015, the Commission adopted Rules 13n-1 to 13n-12, which govern the SDR registration process, duties, and core principles.[111] Among other core principles governing the registration and ongoing obligations of SDRs, Rule 13n-4(b)(3) implements the statutory requirement set forth in Section 13(n)(5)(B) by requiring SDRs to confirm, as prescribed in Rule 13n-5, with both counterparties to the security-based swap the accuracy of the data that was submitted.[112]

As part of the process of implementing the SDR rules, at least one former SDR applicant expressed reservations and concerns about the burdens of requiring SDRs to reach out to counterparties who are not its members to verify accuracy of the data.[113] The Commission

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109 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." 15 U.S.C. 78c(a)(75).

110 See 15 U.S.C. 78m(n)(5).

111 See Security-Based Swap Data Repository Registration, Duties, and Core Principles, Exchange Act Release No. 74246 (Feb. 11, 2015), 80 FR 14437 (Mar. 19, 2015) ("SDR Adopting Release").

112 See 17 CFR § 240.13n-4(b)(3).

113 See, e.g., Letter from Michael C. Bodson, President and Chief Executive Officer, The Depository Trust & Clearing Corporation, and Larry E. Thompson, Chairman, DTCC Data Repository (U.S.) LLC ("DDR"), Managing Director and Vice Chairman, The Depository Trust & Clearing Corporation, dated Sept. 22, 2017, regarding DDR's application for registration as an SDR (withdrawn on Mar. 27, 2018), available at: https://www.sec.gov/comments/sbsdr-2016-02/sbsdr201602-2590214-161092.pdf (noting the difficulty an SDR faces with respect to outreach to the non-reporting side of a

understands these concerns and the difficulty SDRs could face when attempting to contact counterparties to a security-based swap transaction with whom the SDR has no existing relationship. At the same time, however, the Commission also recognizes the importance of ensuring that the security-based swap data reported to an SDR is complete and accurate.

Accordingly, the Commission preliminarily believes that certain provisions in proposed Rules 15Fi-3 and 15Fi-5, if adopted and taken together, could be relevant to SDRs in seeking to meet their obligations under Section 13(n)(5)(B) and Rule 13n-4(b)(3). As we explained in connection with adopting the SDR rules, SDRs may be able to reasonably rely on certain third parties to address the accuracy of the transaction data.[114] For example, the Commission previously stated that if an SDR develops reasonable policies and procedures that rely on confirmations completed by another entity, such as a third-party confirmation provider, as long as such reliance is reasonable the SDR could use such confirmation to fulfill its obligations under certain SDR rules.[115] Because the two relevant provisions that we are proposing today generally relate to the obligation of SBS Entities to take certain steps in the reconciliation and documentation processes related specifically to the reporting of the relevant security-based swap data to an SDR, including by clarifying the reporting obligations of the counterparties, the Commission believes that, like the previous example, these measures, taken together, could provide an SDR with a set of factors to assess the reasonableness of relying on an SBS Entity's

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security-based swap when that non-reporting counterparty is not a member of an SDR and proposing that Section 13(n)(5)(B) and corresponding Rule 13n-4(b)(3) be interpreted as requiring SDRs to confirm the accuracy of the security-based swap solely with counterparties who are its members).

114 Cf. SDR Adopting Release, 80 FR at 14491.

115 See id.

ability to independently provide the definitive report of a given security-based swap position, thereby providing a basis for the SDR to satisfy its statutory and regulatory obligations to verify the accuracy of the reported data when the SBS Entity's counterparty is not a member of the SDR. The Commission requests comment on whether this preliminary analysis is accurate.

1. Reconciliation of Terms Submitted to an SDR

As described above in Section I.B.2, the definition of "material terms" in proposed Rule 15Fi-1(i), which identifies the information that SBS Entities would be required to reconcile with their counterparties, differs based on whether a security-based swap transaction had previously been included in a security-based swap portfolio for purposes of the portfolio reconciliation requirements in proposed Rule 15Fi-3. With respect to any security-based swap that has not yet been reconciled as part of, a security-based swap portfolio, "material terms" would be defined to mean each term that is required to be reported to a registered SDR under Rule 901 under the Exchange Act.[116] With respect to all other security-based swaps within a security-based swap portfolio, the definition of "material terms" 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 we also previously noted in Section I.B.2, the Commission preliminarily believes that there are potential benefits, both to SBS Entities and potentially to the security-based swap market as a whole, of requiring firms to initially reconcile all of the information required to be reported to an SDR. Specifically, doing so helps to ensure that the data reported to an SDR, and ultimately disseminated to the public, is accurate and complete. Section 13(n)(5)(B) of the Exchange Act and Rule 13n-4(b)(3) are both intended to accomplish the same objective of

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116 See proposed Rule 15Fi-1(i)(1) (referencing 17 CFR 242.901).

transparency regarding complete and accurate security-based swap data. Accordingly, like the previous example involving the third-party confirmation process, it may be appropriate to allow an SDR to meet its obligations by reasonably relying on an SBS Entity. Such reliance could be based, at least in part, on that fact that the SBS Entity would be subject to the portfolio reconciliation requirements in proposed Rule 15Fi-3 using the proposed definition of "material terms" in Rule 15Fi-1(i), were it to be adopted, to initially reconcile all of the terms of a transaction required to be reported to an SDR or the Commission pursuant to Rule 901, particularly in cases when the SBS Entity's counterparty is not onboarded to the SDR. [117] The Commission seeks comment on whether this preliminary analysis is accurate.

2. Documentation of Regulatory Reporting Obligations

As discussed above in Section I.D, proposed Rule 15Fi-5 would require 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. Paragraph (b)(1) of that rule requires that the trading relationship documentation be in writing and also sets forth the minimum set of items that must be addressed by the

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[117] The Commission also notes that Rule 905(a) of Regulation SBSR, which was adopted in 2015, generally imposes a duty to correct on any counterparty to a security-based swap (or any other person having a duty to report the security-based swap) that discovers an error in the information reported with respect to that security-based swap. See 17 CFR 242.905(a). Accordingly, if any discrepancies are identified in the course of satisfying the portfolio reconciliation requirements contained in proposed Rule 15F-3 that resulted in incorrect information having been reported to an SDR, then the SBS Entity would be required to follow the procedures set forth in Rule 905(a) to correct any erroneous information with the SDR.

documentation including, among other things, the allocation of any applicable regulatory reporting obligations (including pursuant to Regulation SBSR).[118]

Rule 901(a) of Regulation SBSR establishes a "reporting hierarchy" that specifies which counterparty to a security-based swap has the duty to report the transaction. Where possible, the rule assigns the reporting duty to the side that is registered with the Commission as an SBS Entity. Thus, if only one of the counterparties to a security-based swap transaction is an SBS Entity, then such SBS Entity will be the reporting side. In addition, if one counterparty to a security-based swap transaction is an SBS dealer and the other is a major SBS participant, the SBS dealer will be the reporting side. However, if both counterparties to a security-based swap transaction are SBS dealers (or both are major SBS participants), the sides are required to select the reporting side. The selection of the reporting side is an example of the type of "applicable reporting obligation" that proposed Rule 15Fi-5(b)(1) would cover.

Accordingly, the Commission preliminarily believes that requiring SBS Entities to address any applicable regulatory reporting obligations in the written trading relationship documentation that it executes with their counterparties also could be relevant to SDRs in seeking to meet their obligations under Section 13(n)(5)(B) and Rule 13n-4(b)(3). For example, to the extent that only one counterparty to a security-based swap is an SBS Entity, the trading relationship documentation could be used to memorialize the fact that the SBS Entity is the reporting party for purposes of Rule 901(a), and that such SBS Entity will be responsible for verifying the accuracy of each security-based swap transaction with the SDR.

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118 See 17 CFR 242.901(a).

3. Comments Requested

The Commission generally requests comments on the issues described above. In addition, the Commission requests comments on the following specific issues:

- Do you agree with the analysis described above, particularly as to how parts of proposed Rules 15Fi-3 (including the definition of "material terms" in proposed Rule 15Fi-1(i)) and 15Fi-5 could help address the concerns raised by former SDR applicants with respect to their obligations, pursuant to Section 13(n)(5)(B) of the Exchange Act and Rule 13n–4(b)(3), to confirm with both counterparties to a security-based swap the accuracy of the data that was submitted to the SDR?
    - Specifically, do those aspects of the proposed rules 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 requirements of Section 13(n)(5)(B) and Rule 13n-4(b)(3)? Why or why not?
    - If not, should the Commission provide an exemption from the verification requirements described above to SDRs that reasonably rely on SBS Entities? Why or why not? If so, what specific terms and conditions should be included in such exemption and why?
    - Are there other regulatory actions the Commission should consider to address the issue? If so, which ones and why?
- Should any aspect of the proposed analysis be modified in any way to account for other situations that may not be fully addressed here? If so, how and why? For example, would an SDR be able to reasonably rely on an SBS Entity to independently provide the definitive report of a given security-based swap position for both counterparties in

situations when the SBS Entity is acting as agent for one of the two counterparties and is not itself a counterparty? Why or why not, and how should the analysis be revised to address that situation?

F. Recordkeeping Requirements

1. Proposed Amendments to Recordkeeping Rules

The Commission also is proposing rule amendments that would modify certain proposed requirements contained in its April 2014 release proposing rules for the recordkeeping, reporting, and notification requirements applicable to SBS Entities.[119] Those rule amendments would require each SBS Entity 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 proposed Rule 15Fi-3(c), all security-based swap trading relationship documentation required to be created under proposed 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 proposed Rule 15Fi-5(c), and each policy and procedure created pursuant to proposed Rules 15Fi-3 through 15Fi-5.

Specifically, the Commission is proposing to amend: (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) proposed Rule 18a-5 under the Exchange Act, which applies to SBS Entities that are not also

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[119] See supra note 2. Although we are proposing books and records requirements that would be additive to an existing proposal, we are not re-opening the comment period for the entirety of the SBS Books and Records Proposing Release. Rather, our request for comment in this section is limited solely to the recordkeeping requirements related to the rules we are proposing today.

registered with the Commission as broker-dealers under Section 15(b) of the Exchange Act ("stand-alone and bank SBS Entities"). These proposed amendments would require each SBS Entity to make and keep current records of each security-based swap portfolio reconciliation, whether conducted pursuant to proposed Rule 15Fi-3 or otherwise,[120] a copy of each valuation dispute notification required to be provided to the Commission pursuant to proposed Rule15Fi-3(c),[121] 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 proposed Rule 15Fi-4 or otherwise.[122]

With respect to the reconciliation requirement, the proposed rules would 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.[123] With respect to the valuation notification requirement, the proposed rules would require the retention of each notification required to be provided to the Commission pursuant to proposed Rule 15Fi-3(c).[124]

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120 See proposed amendments to Rules 17a-3(a)(31)(i), 18a-5(a)(18)(i), and 18a-5(b)(14)(i).

121 See proposed amendments to Rules 17a-3(a)(31)(ii), 18a-5(a)(18)(ii), and 18a-5(b)(14)(ii).

122 See proposed amendments to Rules 17a-3(a)(31)(iii), 18a-5(a)(18)(iii), and 18a-5(b)(14)(iii).

123 See proposed amendments to Rules 17a-3(a)(31)(i), 18a-5(a)(18)(i), and 18a-5(b)(14)(i).

124 See proposed amendments to Rules 17a-3(a)(31)(ii), 18a-5(a)(18)(ii), and 18a-5(b)(14)(ii).

With respect to compression, the proposed rules would 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.[125] The Commission preliminarily believes that requiring SBS Entities to make and retain such records will, among other things, promote compliance with proposed 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.

In addition, the Commission is proposing to amend (1) existing 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) proposed Rule 18a-6 under the Exchange Act, which imposes parallel preservation requirements on stand-alone and bank SBS Entities. In particular, the proposed amendments to Rule 17a-4 and to proposed Rule 18a-6 would require SBS Entities to retain all of the records required to be made and kept under the proposed amendments to Rule 17a-3 and proposed Rule 18a-5 for at least three years, the first two years in an easily accessible place.[126] The proposed amendments also would require each SBS Entity to retain the following:

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125 See proposed amendments to Rules 17a-3(a)(31)(iii), 18a-5(a)(18)(iii), and 18a-5(b)(14)(iii).

126 See proposed amendments to Rules 17a-4(b)(1), 18a-6(b)(1)(i), and 18a-6(b)(2)(i).

- the written policies and procedures required pursuant to proposed Rules 15Fi-3 through 15Fi-5 until three years after termination of the use of the policies and procedures;[127]
- each written agreement with counterparties on the terms of portfolio reconciliation with those counterparties as required to be created under proposed Rules 15Fi-3(a)(1) and (b)(1) until three years after the termination of the agreement and all transactions governed thereby; [128]
- security-based swap trading relationship documentation with counterparties required to be created under proposed Rule 15Fi-5 until three years after the termination of such documentation and all transactions governed thereby;[129] and
- a record of the results of each audit required to be performed pursuant to proposed Rule 15Fi-5(c) until three years after the completion of the audit.[130]

The Commission preliminarily 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.

2. Comments Requested

The Commission generally requests comments on all aspects of the proposed amendments to Rules 17a-3 and 17a-4 and to proposed Rules 18a-5, and 18a-6. In addition, the Commission requests comments on the following specific issues:

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127 See proposed amendments to Rules 17a-4(e)(10) and 18a-6(d)(4).

128 See proposed amendments to Rules 17a-4(e)(11)(i) and 18a-6(d)(5)(i).

129 See proposed amendments to Rules 17a-4(e)(11)(ii) and 18a-6(d)(5)(ii).

130 See proposed amendments to Rules 17a-4(e)(11)(iii) and 18a-6(d)(5)(iii).

- Has the Commission provided sufficient guidance regarding the scope of the proposed recordkeeping amendments? Are there aspects of the proposed amendments for which the Commission should consider providing additional guidance? If so, please explain.
- How do the types of records that would need to be made and kept current under Rule 17a-3 and proposed Rule 18a-5, in each case as proposed to be amended in this release, align with the types of records that a futures commission merchant or a swap dealer is required to make pursuant to CFTC regulations?

II. Cross-Border Application of Rules 15Fi-3 Through 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.[131] In that proposal, the Commission preliminarily interpreted the Title VII requirements associated with registration to apply generally to the activities of registered entities.[132] The Commission further proposed a taxonomy to classify requirements under Section 15F of the Exchange Act as applying at either the transaction-level or at the entity-level.[133] The Commission took the preliminary view that transaction-level requirements under Section 15F of the Exchange Act are

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131 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).

132 See id. at 30986 ("We are proposing to apply the Title VII requirements associated with registration (including, among others, capital and margin requirements and external business conduct requirements) to the activities of registered entities to the extent we have determined that doing so advances the purposes of Title VII.") (footnotes omitted).

133 See id. at 31009-10.

those that primarily focus on protecting counterparties to security-based swap transactions by requiring SBS dealers to, among other things, provide certain disclosures to counterparties, adhere to certain standards of business conduct, and segregate customer funds, securities, and other assets.[134]

In contrast to transaction-level requirements, the Commission preliminarily took the view that entity-level requirements under Section 15F of the Exchange Act are those that are expected to play a role in ensuring the safety and soundness of the entity and thus relate to the SBS Entity as a whole.[135] Entity-level requirements include capital and margin requirements, as well as other requirements relating to a firm's identification and management of its risk exposure, such as the requirements in Section 15F(i) of the Exchange Act, which provides the statutory basis for the rules the Commission is proposing in this release.[136] Because these requirements relate to the entire entity, the Commission proposed to apply them to SBS Entities on a firm-wide basis, without exception.[137]

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134 Id.

135 See id. at 31011.

136 See id. at 31011-16 (addressing the classification of capital and margin requirements, as well as of the documentation standard requirements of Section 15F(i) of the Exchange Act and other risk management requirements applicable to SBS dealers).

137 See id. at 31011, 31024-25. See also id. at 31035 (applying the analysis to major SBS participants). In reaching this conclusion, the Commission explained that it "preliminarily believes that entity-level requirements are core requirements of the Commission's responsibility to ensure the safety and soundness of registered security-based swap dealers," and that "it would not be consistent with this mandate to provide a blanket exclusion to foreign security-based swap dealers from entity-level requirements applicable to such entities." Id. at 31024 (footnotes omitted). The Commission further expressed the preliminary view that concerns regarding the application of entity-level requirements to foreign SBS dealers would largely be addressed through the proposed approach to substituted compliance. See id.

The Commission first applied this taxonomy with respect to the rules adopted pursuant to Section 15F(i) of the Exchange Act in 2016 when we adopted rules to implement business conduct standards for SBS Entities.[138] The Commission subsequently determined that the trade acknowledgment and verification rules would apply at the entity-level.[139] The Commission has not, however, proposed or adopted a cross-border interpretation with respect to the portfolio reconciliation, portfolio compression, and trading relationship documentation requirements that we are now proposing.

B. Proposed Cross-Border Interpretation

Consistent with its approach in both the Cross-Border Proposing Release and the Trade Acknowledgement and Verification Adopting Release, the Commission believes that the requirements being proposed in this release pursuant to Section 15F(i) of the Exchange Act — as they relate to portfolio reconciliation, portfolio compression, and trading relationship documentation — should be treated 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.

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138 See Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, Release No. 77617 (Apr. 14, 2016), 81 FR 29960, 30061-69 (May 13, 2016) ("Business Conduct Standards Adopting Release"). Under this framework, rules relating to diligent supervision pursuant to Section 15F(h)(1)(B), those relating to the chief compliance officer under Section 15F(k) of the Exchange Act, and those relating to certain risk management requirements under Section 15F(j) of the Exchange Act were determined to be entity-level requirements that apply to an SBS Entity's business with foreign counterparties to the same extent that they apply to the SBS dealer's or major SBS participant's U.S. business. The remaining rules were determined to apply at the transaction-level.

139 See Trade Acknowledgment and Verification Adopting Release, 81 FR at 39826.

The Commission preliminarily believes that 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 proposed rules, providing SBS Entities and their counterparties to security-based swap transactions with the ability to identify and resolve discrepancies involving key terms of their transactions — which is a key consideration underpinning both the proposed portfolio reconciliation and trading relationship documentation requirements — serves as an important mechanism for allowing SBS Entities and their counterparties to manage their internal risks.[140] Similarly, portfolio compression is intended to help SBS Entities and their counterparties in security-based swap transactions manage their post-trade risks in a number of important ways, including by eliminating redundant uncleared derivatives 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.[141]

An alternative approach that does not require 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

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140 See supra note 14 and accompanying text.

141 See supra notes 62-63 and accompanying text.

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 preliminarily believes that it is appropriate to apply the proposed requirements to the entirety of an SBS Entity's security-based swap business.[142]

C. Comments Requested

The Commission generally requests comments on its interpretative guidance regarding the cross-border application of Proposed Rules15Fi-3 through 15Fi-5. In addition, the Commission requests comments on the following specific issues:

- Does the proposed approach appropriately treat the proposed portfolio reconciliation, portfolio compression, and trading relationship documentation requirements as entity-level requirements applicable to the entire business conducted by foreign SBS Entities? If not, please identify any particular aspects of those proposed rules that should not be

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142 We recognize that the CFTC has taken a different position with regard to corresponding 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).

applied to a foreign SBS Entity, or applied only to specific transactions, and explain how such an approach would be consistent with the goals of Title VII.

- Should the Commission apply the same cross-border approach to the application of the proposed portfolio reconciliation, portfolio compression, and trading relationship documentation requirements for both SBS dealers and major SBS participants? If you believe that the approach should vary based on the type of SBS Entity involved, please describe how the cross-border approach for SBS dealers should differ from the cross-border approach for major SBS participants, and explain the justification for any potential differences in approach.
- What types of conflicts might a foreign SBS Entity face if subjected to the proposed portfolio reconciliation, portfolio compression, and trading relationship documentation requirements in more than one jurisdiction? In what situations would compliance with more than one of these requirements be difficult or impossible?
- As an alternative to treating the proposed requirements as entity-level requirements, should the Commission instead follow the approach taken by the CFTC and treat the proposed portfolio reconciliation, portfolio compression, and trading relationship documentation requirements (or some combination of the three) as transaction-level requirements? If so, to which cross-border security-based swap transactions should these requirements apply and why? Please describe how these requirements would apply differently if classified as transaction-level requirements instead of as entity-level requirements. Please also describe any practical challenges that would be presented by classifying them differently from the CFTC.

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

A. Existing Substituted Compliance Rule

In 2016, the Commission adopted Rule 3a71-6 under the Exchange Act to provide that non-U.S. SBS Entities could satisfy applicable business conduct requirements under Section 15F by complying with comparable regulatory requirements of a foreign jurisdiction, subject to certain conditions. The rule in part provides that the Commission shall not make a determination providing for substituted compliance unless the Commission determines, among other things, that the foreign regulatory requirements are comparable to otherwise applicable requirements.[143] In adopting that substituted compliance rule, the Commission addressed a range of issues and concerns that commenters had raised in response to the substituted compliance proposal that was set forth in the Cross-Border Proposing Release.

When the Commission adopted this substituted compliance rule that solely addressed the business conduct rules, it stated that it expected to assess the potential availability of substituted compliance in connection with other requirements when the Commission considers final rules to implement those requirements.[144] Consistent with that statement, the Commission subsequently amended Rule 3a71-6 in the Trade Acknowledgment and Verification Adopting Release to

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143 See Business Conduct Standards Adopting Release, 81 FR at 30074.

144 The Commission first addressed the potential for allowing market participants to satisfy certain Title VII requirements by complying with comparable foreign rules as a substitute in 2013 as part of the Cross-Border Proposing Release. Pursuant to that release, the Commission proposed making substituted compliance potentially available in connection with the requirements applicable to SBS dealers pursuant to Section 15F of the Exchange Act, other than the registration requirements applicable to dealers. See Cross-Border Proposing Release, 78 FR at 31088, 31207-08 (proposed Rule 3a71-5).

provide SBS Entities with the potential to avail themselves of substituted compliance to satisfy the Title VII trade acknowledgment and verification requirements.[145]

B. Proposed Amendment to Rule 3a71-6

The Commission is proposing to further amend Rule 3a71-6 to provide SBS Entities that are not U.S. persons (as defined in Rule 3a71-3(a)(4) of the Exchange Act) with the potential to avail themselves of substituted compliance to satisfy the Title VII portfolio compression, portfolio reconciliation, and trading relationship documentation requirements. In proposing to amend the rule, the Commission has preliminarily concluded that the principles associated with substituted compliance, as previously adopted in connection with both the business conduct requirements and the trade acknowledgement and verification requirements, in large part should similarly apply to the portfolio compression, portfolio reconciliation, and trading relationship documentation requirements we are proposing today. Accordingly, except as discussed below, the proposed substituted compliance rule would apply to the portfolio compression, portfolio reconciliation, and trading relationship documentation requirements in the same manner as it already applies to the business conduct requirements and the trade acknowledgement and verification requirements.[146]

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145 See Trade Acknowledgment and Verification Adopting Release, 81 FR at 39827-28.

146 The discussions in the Business Conduct Standards Adopting Release, including those regarding consideration of supervisory and enforcement practices (see id. 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 proposed portfolio compression, portfolio reconciliation, and trading relationship documentation 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 compression, portfolio reconciliation, 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 generally, to reduce competition and market efficiency.[147]

To address those effects, the Commission preliminarily believes that under certain circumstances it may be appropriate to allow the possibility of substituted compliance, whereby market participants may satisfy the proposed portfolio compression, portfolio reconciliation, and trading relationship documentation requirements by complying with 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, the Commission is proposing to amend paragraph (d) of Rule 3a71-6 to identify the portfolio

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147 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).

compression, portfolio reconciliation, and trading relationship documentation requirements of Title VII as being potentially eligible for substituted compliance.[148]

2. Comparability Criteria, and Consideration of Related Requirements

As discussed when we first adopted Rule 3a71-6 — and reiterated when we amended the rule pursuant to the Trade Acknowledgement and Verification Adopting Release — 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 a requirement-by-requirement comparison.[149] Under the proposed rule, the Commission's comparability assessments associated with the portfolio compression, portfolio reconciliation, and trading relationship documentation rules 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.

Proposed new paragraph (d)(4) of Rule 3a71-6 would also provide 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

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148 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.

149 See Business Conduct Standards Adopting Release, 81 FR at 30078-79. See also Trade Acknowledgment and Verification Adopting Release, 81 FR at 39828.

counterparties pursuant to the requirements of the foreign financial regulatory system, are comparable to those required pursuant to the applicable Exchange Act provisions.

In application, 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 we are proposing today, 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.[150]

3. Comments Requested

The Commission generally requests comments on all aspects of the proposed amendment to Rule 3a71-6. In addition, the Commission requests comments on the following specific issues:

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150 We have not proposed rules making substituted compliance available specifically with respect to the amendments we are proposing to proposed Rules 18a-5 and 18a-6, which specify the recordkeeping, reporting, and notification requirements applicable to SBS Entities. Rather, 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, reporting, and notification requirements for SBS Entities including any amendments that we ultimately adopt with respect to the portfolio reconciliation, portfolio compression, and trading relationship document requirements.

- Should the Commission provide SBS Entities with the potential to avail themselves of substituted compliance to satisfy the Title VII portfolio reconciliation, portfolio compression, and trading relationship requirements? Why or why not? If you believe that substituted compliance should not be available with respect to these requirements, how would you distinguish this policy decision from the Commission's previous determination to make substituted compliance potentially available with respect to other Title VII requirements (i.e., the business conduct rules and the trade acknowledgment and verification rules)?
- Do commenters agree with the scope and language of the proposed amendment to Rule 3a71-6? Why or why not? Are there aspects of the scope of the proposed rule for which the Commission should consider providing additional guidance? If so, what additional guidance should be provided and why?
- Are the items identified in the proposed amendment to Rule 3a71-6 as factors the Commission will consider prior to making a substituted compliance determination in connection with the portfolio reconciliation, portfolio compression, and trading relationship documentation requirements appropriate? Why or why not? Should any of those items be modified or deleted? Should additional considerations be added? If so, please explain.

IV. General Request for Comment

We request and encourage any interested person to submit comments regarding the proposed rules, specific issues discussed in this release, and other matters that may have an effect on the proposed rules. With regard to any comments, we note that such comments are of particular assistance to our rulemaking initiative if accompanied by supporting data and analysis

of the issues addressed in those comments. In addition, we would appreciate any comments related to the comparability of the rules we are proposing today and the corresponding CFTC rules already in effect, including whether certain aspects of the proposed rules should be modified to more fully conform to the CFTC's rules. In comparing the two sets of rules, commenters are encouraged to identify any areas where the proposed rules may not be sufficiently aligned with the corresponding CFTC rules, such that they could impose unnecessary burdens (with respect to documentation or otherwise) on persons likely to register with the Commission as SBS Entities who are also registered with the CFTC as Swap Entities.

V. Paperwork Reduction Act

The Paperwork Reduction Act of 1995 ("PRA")[151] imposes certain requirements on federal agencies in connection with the conducting or sponsoring of any "collection of information."[152] For example, 44 U.S.C. 3507(a)(1)(D) provides that before adopting (or revising) a collection of information requirement, an agency must, among other things, publish a notice in the Federal Register stating that the agency has submitted the proposed collection of information to the Office of Management and Budget ("OMB") and setting forth certain required information, including: (1) a title for the collection information; (2) a summary of the collected information; (3) a brief description of the need for the information and the proposed use of the information; (4) a description of the likely respondents and proposed frequency of response to the collection of information; (5) an estimate of the paperwork burden that shall result from the

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151 44 U.S.C. 3501 et seq.

152 See 44 U.S.C. 3502(3).

collection of information; and (6) notice that comments may be submitted to the agency and director of OMB.[153]

Certain provisions of the proposed rules contain "collection of information" requirements within the meaning of the PRA. The Commission is submitting these collections of information to OMB for review in accordance with 44 U.S.C. 3507 and 5 CFR 1320.11. 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, proposed Rules 15Fi-3, 15Fi-4, and 15Fi-5 would 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 proposals to amend Rules 3a71-6, 17a-3 and 17a-4 would amend already-existing collection of information requirements. Finally, the proposals to amend proposed Rules 18a-5 and 18a-6 would amend proposed collection of information requirements that were previously submitted to OMB for review in connection with the SBS Books and Records Proposing Release. 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);

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153 See 44 U.S.C. 3507(a)(1)(D); see also 5 CFR 1320.5(a)(1)(iv).

(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).

A. Summary of Collections of Information

1. Proposed Rule 15Fi-3: Portfolio Reconciliation

Proposed Rule 15Fi-3 generally would require 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.[154] Among other things, proposed Rule 15Fi-3 would specify 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 would be required to exchange as part of the reconciliation process,[155] (2) the frequency by which an SBS Entity would be required to reconcile its security-based swap portfolios with its counterparties,[156] (3) the required policies and procedures specifying the means and timeframes by which an SBS Entity would be required to resolve discrepancies with

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154 Proposed Rule 15Fi-3 would not apply to any security-based swap that has a clearing agency as a direct counterparty.

155 See supra Section I.B.2.

156 See supra Sections I.B.3 and I.B.5.

respect to either the valuation or a material term of a security-based swap,[157] 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.[158] Finally, proposed Rule 15Fi-3(c) would require 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.[159]

2. Proposed Rule 15Fi-4: Portfolio Compression

Proposed Rule 15Fi-4 would require 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, proposed Rules 15Fi-4(a)(2) and (3) would require 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.[160] Similarly, proposed Rule 15Fi-4(a)(1) would 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

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157 See supra Sections I.B.4 and I.B.5.

158 See supra Sections I.B.3 and I.B.5.

159 See supra Section I.B.6.

160 See supra Section I.C.2.

fashion, when appropriate.[161] To the extent that an SBS Entity transacts with a counterparty that is not an SBS Entity, proposed Rule 15Fi-4(b) provides that such policies and procedures would 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.[162]

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

Proposed Rule 15Fi-5 would require that each SBS Entity enter into 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.[163] The proposed 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[164] and (2) agreements regarding the means by which the counterparties would determine the value of each security-based swap.[165] The proposal also contains requirements for SBS Entities and their counterparties to disclose to each other certain information regarding their legal and bankruptcy

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161 See supra Section I.C.3.

162 See supra Section I.C.2 and I.C.3.

163 See supra Section I.D.2. The proposed rule would require 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, allocation of any applicable regulatory reporting obligations, governing law, valuation and dispute resolution.

164 See id.

165 See supra Section I.D.3.

status, and to include a statement regarding the status of a security-based swap if accepted for clearing by a CCP.[166] Finally, the proposal would require 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.[167]

4. Proposed 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.[168] The Commission is proposing to amend 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 proposing to amend proposed Rules 18a-5 and 18a-6 – which were first proposed in 2014 and are themselves modeled on Rule 17a-3 and 17a-4 – to account for these same risk mitigation requirements.[169]

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

The proposed amendment to Rule 3a71-6 would permit non-U.S. SBS Entities to comply with the proposed portfolio reconciliation, portfolio compression, and written trading

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166 See supra Section I.D.4.

167 See supra Section I.D.5.

168 17 CFR 240.17a-3; 17 CFR 240.17a-4.

169 See supra Section I.F.1.

relationship documentation requirements by following the comparable regulatory requirements of a foreign financial regulatory system. Specifically, the proposal would add proposed Rules 15Fi-3 through 15Fi-5 to the list of Commission requirements eligible for a substituted compliance determination and would set forth the standard by which the Commission would make such determination.[170]

B. Proposed Use of Information

1. Proposed Rule 15Fi-3: Portfolio Reconciliation

As previously noted, the Commission preliminarily believes that the information shared by counterparties to a security-based swap transaction periodically during the portfolio reconciliation process, as contemplated by proposed 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

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170 See supra Sections III.B.1 and III.B.2.

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. Proposed Rule 15Fi-4: Portfolio Compression

As previously discussed, the Commission preliminarily believes that proposed Rule 15Fi-4 would 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 preliminarily believe that the proposed collection of information is expected to 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. Proposed Rule 15Fi-5: Written Trading Relationship Documentation

The Commission preliminarily believes that the information required to be contained in the written trading relationship documentation pursuant to proposed 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. Proposed Amendments to Rules 17a-3, 17a-4, 18a-5, and 18a-6: Books and Records Requirements

The Commission preliminarily expects that the information contained in the records required to be made and kept pursuant to the proposed amendments to Rules 17a-3, 17a-4, 18a-5, and 18a-6 would be used to assist the Commission in conducting effective examinations and 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. Proposed Amendment to Rule 3a71-6: Substituted Compliance

Under the proposed 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

Proposed Rules 15Fi-3 through 15Fi-5 and Rules 17a-3, 17a-4, 18a-5, and 18a-6 would apply only to SBS Entities, each of which will be registered with the Commission. In a number of prior releases, including the release adopting the rules by which SBS Entities can register (and withdraw from registration) with the Commission, we estimated that approximately 50 entities

may meet the definition of SBS dealer, and up to five entities may meet the definition of major SBS participant.[171] The Commission continues to believe that these estimates are appropriate. Thus, the Commission preliminarily 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.

With regard to the requirements under Rule 3a71-6, as proposed to be 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 authorities, or by non-U.S. SBS Entities. Consistent with prior estimates, the Commission expects that there may be approximately 22 non-U.S. entities that may potentially register as SBS dealers, out of approximately 50 total entities that may register as SBS dealers.[172]

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.[173] In practice,

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171 See SBS Entity Registration Adopting Release, 80 FR at 48990. See also Trade Acknowledgement and Verification Adopting Release, 81 FR at 39830.

172 See Application of the Title VII Security-Based Swap Dealer De Minimis Counting Requirements to Activity in the United States," Exchange Act Release No. 77104 (Feb. 10, 2016), 81 FR 8598, 8605 (Feb. 19, 2016) ("U.S. Activity Adopting Release"); see also Business Conduct Standards Adopting Release, 81 FR at 30090.

173 Consistent with prior estimates, the Commission further believes that there may up to five major SBS participants. See SBS Entity Registration Adopting Release, 80 FR at 49000; see also Business Conduct Standards Adopting Release, 81 FR at 30089. 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.

however, the Commission expects that the greater portion of any such requests will be submitted by foreign financial authorities, given their expertise in connection with the relevant substantive requirements, and 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

Under proposed Rule 15Fi-3(a), the approximately 55 respondent SBS Entities would 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 preliminarily 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 preliminarily 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).[174] The Commission therefore estimates that each

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[174] 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).

SBS Entity will engage in an average of 760 portfolio reconciliations with other SBS Entities per year.[175]

The Commission preliminarily believes that each portfolio reconciliation is likely to be conducted through an automated process.[176] As a result, we preliminarily 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.[177] Using these figures, the Commission preliminarily estimates that compliance with proposed 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.

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175 This estimate uses 252 business days for purposes of the daily portfolio reconciliation requirement, which is consistent with the definition of "business day" in proposed Rule 15Fi-1(b).

176 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 welcomes comments on this approach, including regarding the likelihood and cost of using third-party providers.

177 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.

PRA Table 1 – Proposed Rule 15i-3(a): Portfolio Reconciliations with Other SBS Entities

No. of Counterparties Per Respondent	No. of Annual Reconciliations	Hourly Burden Per Reconciliation	Total Annual Burden
2 (≥500 transactions)	252 (daily)	.25 hours	126 hours
4 (>50<500 transactions)	52 (weekly)	.25 hours	52 hours
12 (≤50 transactions)	4 (quarterly)	.25 hours	12 hours
		Total per respondent	190 hours
		Total Aggregate Annual Burden for all 55 respondents	**10,450 hours**

In addition, proposed Rule 15Fi-3(b) would require 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.[178] In calculating the burden of performing the portfolio reconciliations required by these policies and procedures, the Commission preliminarily estimates that (1) there are currently 13,082 market participants in security-based swaps who will not be required to register as SBS Entities,[179] and (2) each SBS Entity will have an average of approximately 350 of these non-SBS Entity market participants as counterparties.[180] Further, the Commission preliminarily believes that

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178 The Commission's estimate for the hourly burden for preparing these policies and procedures is discussed below.

179 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.

180 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

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).[181]

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).[182] Using these figures, the Commission preliminarily estimates that compliance with proposed 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.

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follows: ((13,082 non-SBS Entity market participants/55 SBS Entities) x 1.5 SBS Entities per non-SBS market participants) = approximately 350 non-SBS Entity counterparties per SBS Entity.

181 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.

182 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 174 and 177 and accompanying text.

PRA Table 2 – Proposed Rule 15i-3(b): Portfolio Reconciliations with Non-SBS Entities

No. of Counterparties Per Respondent	No. of Annual Reconciliations	Hourly Burden Per Reconciliation	Total Annual Burden
35 (>100 transactions)	4 (quarterly)	.5 hours	70 hours
315 (≤100 transactions)	1 (annual)	.5 hours	157.5 hours
Total per respondent			227.5 hours
Total Aggregate Annual Burden for all 55 respondents			**12,512.5 hours**

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

Proposed 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 the Commission explained in the Business Conduct Standards Adopting Release, the Commission estimates that of the estimated 55 persons that may register with the Commission as SBS Entities, approximately 35 will be dually-registered with the CFTC as Swap Entities.[183] In addition, other than as expressly noted above in Section I.B, the CFTC's adopted final rules on portfolio reconciliation written policies and procedures are substantively identical to those proposed by Rule 15Fi-3. Accordingly, these 35 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 upon adoption of proposed Rule 15Fi-3,

183 See Business Conduct Standards Adopting Release, 81 FR at 30098.

we preliminarily 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 35 hours in the aggregate. With respect to the remaining 20 SBS Entities that will not be dually-registered with the CFTC, the Commission preliminarily 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 1,600 hours in the aggregate.[184] 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),[185] for an estimated average annual burden of 2,200 hours in the aggregate for all 55 respondents.[186]

3. Reporting of Certain Valuation Disputes

Proposed Rule 15Fi-3(c) would require each SBS Entity to promptly notify the Commission (and any applicable prudential regulator for an SBS Entity that is also a bank), in a

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184 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.

185 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 preliminarily decided to conservatively assume that all of the estimated hours would be incurred in connection with compliance with the collection of information associated with proposed Rule 15Fi-3.

186 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.

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.[187] Accordingly, we preliminarily do not expect there to be any initial burden of designing a system for submitting these notices.[188] We also preliminarily believe that the associated ongoing hourly burden of preparing and submitting such notices would be minimal. In addition, until 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. As such, and consistent with the estimate the CFTC provided when it first proposed a similar requirement, we preliminarily estimate that each SBS Entities will spend on average of 24 hours each year complying with this requirement, for an estimated average annual burden of 1,320 hours in the aggregate for all 55 respondents.[189] We also recognize, however, that there are differences between the markets for swaps and security-based swaps and welcomes comment from the public on this estimate.

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187 See supra note 47.

188 In the request for comments, we asked whether we should require such notices to be submitted in a particular manner, such as having them sent to a dedicated email box or using the EDGAR system (or any successor system thereto, as designated by the Commission). As SBS Entities will already have access to EDGAR (and a Form ID) by virtue of having used the system to register with the Commission, we would not expect there to be any initial burden associated with either approach.

189 See Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 76 FR 6715, 6723 (Feb. 8, 2011).

Combining all of the estimated burdens described above, the Commission preliminarily estimates that proposed Rule 15Fi-3 would impose an estimated one-time initial burden of 1,635 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 preliminarily estimates that proposed Rule 15Fi-3 would impose an estimated ongoing burden of 26,482.5 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) 1,320 hours for all SBS Entities to report certain large valuation disputes to the Commission and any applicable prudential regulator.[190] These calculations are summarized in PRA Tables 3 and 4, below.

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[190] Rule 15Fi-3(a)(1) and 15Fi-3(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 proposed 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.

PRA Table 3 – Proposed Rule 15Fi-3: Total Estimated Initial Burdens

Requirement	Hourly Burden	Total One-Time Burden
Preparation of New Written Policies and Procedures (35 dual SEC-CFTC registrants)	1 hour	35 hours
Preparation of New Written Policies and Procedures (20 SEC-only registrants)	80 hours	1,600 hours
Total Aggregate One-Time Burden for all 55 respondents		1,635 hours

PRA Table 4 – Proposed Rule 15Fi-3: Summary of Annual Burdens

Requirement	Aggregate Hourly Burden (all 55 respondents)
Portfolio Reconciliations with Other SBS Entities	10,450 hours
Portfolio Reconciliations with Non-SBS Entities	12,512.5 hours
Revise and Maintain Written Policies and Procedures	2,200 hours
Prepare and Submit Notices of Valuation Disputes >$20 million	1,320 hours
Total Aggregate Annual Burden for all 55 respondents	**26,482.5 hours**

4. Proposed Rule 15Fi-4: Portfolio Compression

With regard to the written policies and procedures, the Commission continues to believe that of the estimated 55 persons that may register with the Commission as SBS Entities, approximately 35 will be dually-registered with the CFTC as Swap Entities. In addition, and as we previously noted, the CFTC's adopted final rules requiring Swap Entities to establish, maintain, and follow written policies and procedures on bilateral offsets and portfolio compression exercises are, other than as expressly noted above in Section I.C, substantively identical to those proposed by Rule 15Fi-4. Accordingly, these 35 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 simply need to be amended to apply to security-based swap transactions upon adoption of proposed Rule 15Fi-4, we preliminarily 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 35 hours in the aggregate.

With respect to the remaining 20 SBS Entities that are not dually-registered with the CFTC, the Commission preliminarily 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 1,600 hours in the aggregate.[191] 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. 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 preliminarily estimates that (1) each SBS Entity will

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191 See supra note 184.

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 preliminarily believes that each bilateral offset and portfolio compression exercise is likely to be conducted through an automated process. As a result, we preliminarily 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,[192] (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,[193] 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

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192 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.

193 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.

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	No. of Counterparties	No. of Annual Exercises	Hourly Burden Per Exercise	Total Annual Burden
Bilateral Offset (w/non-SBS Entities)	350	1	.0833 hours	29.16 hours
Bilateral Offset (w/SBS Entities)	18	1	.0417 hours	.75 hours
Bilateral Compression (w/non SBS-Entities)	350	1	.25 hours	87.5 hours
Bilateral Compression (w/SBS Entities)	6	1	.125 hours	.75 hours
Multilateral Compression	N/A	12	.5 hours	6 hours
Total per respondent				124.16 hours
Total Aggregate Annual Burden for all 55 respondents				6,828.8 hours

Combining all of the estimated burdens described above, the Commission preliminarily estimates that proposed Rule 15Fi-4 would impose an estimated one-time initial burden of 1,635 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 preliminarily estimates that proposed Rule 15Fi-4 would 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 – Proposed Rule 15Fi-4: Total Estimated Initial Burden

Activity	Hourly Burden	Total One-Time Burden
Preparation of New Written Policies and Procedures (35 dual SEC-CFTC registrants)	1 hour	35 hours
Preparation of New Written Policies and Procedures (20 SEC-only registrants)	80 hours	1,600 hours
Total Aggregate One-Time Burden for all 55 respondents		**1,635 hours**

PRA Table 7 – Proposed Rule 15Fi-3: Summary of Annual Burdens

Requirement	Aggregate Hourly Burden (all 55 respondents)
Bilateral Offsets with non-SBS Entities	1603.8 hours
Bilateral Offsets with SBS Entities	41.25 hours
Bilateral Compression with non-SBS Entities	4,812.5 hours
Bilateral Compression with SBS Entities	41.25 hours
Multilateral Compression	330 hours
Revise and Maintain Written Policies and Procedures	2,200 hours
Total Aggregate Annual Burden for all 55 respondents	**9028.8 hours**

5. Proposed 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 this proposed rule. With this in mind, the Commission preliminarily estimates that (1) the initial burden per respondent to negotiate and draft written trading relationship documentation with non-SBS Entities that is compliant with proposed 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 proposed Rule 15Fi-5 will be approximately 15 hours.[194] These estimates are averages, and both account for the fact that some SBS Entities may lack appropriate documentation in 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 proposed 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 preliminarily believes that the requirement to prepare written relationship documentation in accordance with proposed Rule 15Fi-5 will result in an estimated one-time initial burden of 9,540 hours for each of the 55 SBS

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194 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.

Entity respondents, for an estimated average one-time burden of 524,700 hours in the aggregate. The Commission also preliminarily 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.

With regard to the written policies and procedures required pursuant to proposed Rule 15Fi-5, the Commission continues to believe that of the estimated 55 persons that may register with the Commission as SBS Entities, approximately 35 will be dually-registered with the CFTC as Swap Entities. In addition, and as we previously noted, the CFTC's adopted final rules requiring Swap Entities to establish, maintain, and follow written policies and procedures requiring the execution of written trading relationship documentation are, other than as expressly noted above in Section I.D, substantively identical to those proposed by Rule 15Fi-5. Accordingly, these 35 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 upon adoption of proposed Rule 15Fi-5, we preliminarily 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 35 hours in the aggregate.

With respect to the remaining 20 SBS Entities that are not dually-registered with the CFTC, the Commission preliminarily 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 1,600 hours in the aggregate.[195] 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 preliminarily estimates that proposed Rule 15Fi-5 would impose an estimated one-time initial burden of 593,985 hours in the aggregate for all SBS Entities, which consists of (1) 1,635 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 preliminarily estimates that proposed Rule 15Fi-5 would 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

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195 See supra note 184.

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.

PRA Table 8 – Proposed Rule 15Fi-5: Total Estimated Initial Burdens

Activity	Hourly Burden	Total One-Time Burden
Preparation of New Written Policies and Procedures (35 dual SEC-CFTC registrants)	1 hour	35 hours
Preparation of New Written Policies and Procedures (20 SEC-only registrants)	80 hours	1,600 hours
Negotiate and Execute Trading Relationship Documentation with 350 non-SBS Entities (all 55 respondents)	30 hours	577,500 hours
Negotiate and Execute Trading Relationship Documentation with 18 SBS Entities (all 55 respondents)	15 hours	14,850 hours
Total Aggregate One-Time Burden for all 55 respondents		**593,985 hours**

PRA Table 9 – Proposed Rule 15Fi-3: Summary of Annual Burdens

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

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

The proposed amendments to Rules 17a-3, 17a-4, 18a-5, and 18a-6 would impose collection of information requirements that result in initial and annual time burdens for SBS Entities. The proposed amendments to Rules 17a-3 and 18a-5 would 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 proposed Rules 15Fi-3 and 15Fi-4, the burden imposed by these proposed new requirements is 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 through 15Fi-5 and written agreements with counterparties regarding the terms of portfolio reconciliation. The Commission estimates that these recordkeeping requirements, as proposed to be amended, would 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 proposed 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 proposed 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. Proposed Amendment to Rule 3a71-6: Substituted Compliance

Proposed amended Rule 3a71–6 would require 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 would 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.[196]

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 x $400 per hour).[197] The Commission is currently of the belief that this prior estimate is sufficient to cover a combined substituted compliance request that also seeks a determination for the portfolio reconciliation, portfolio compression, and written trading relationship documentation rules proposed in this release. 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.

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196 See Business Conduct Standards Adopting Release, 81 FR at 30097 n. 1582.

197 See Business Conduct Standards Adopting Release, 81 FR at 30097 n. 1583.

E. Collection of Information is Mandatory

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

F. Confidentiality

Proposed Rule 15Fi-3(c) would require 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. We have requested comment as to whether these notices should be submitted to the Commission on a confidential basis. No other information would be submitted directly to the Commission under proposed Rules 15Fi-3 through 15Fi-5 or under the proposed 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, that information will be kept confidential, subject to applicable law.

With regard to the proposed amendment 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.

G. Request for Comment

We request comment on whether our estimates for burden hours and any external costs as described above are reasonable. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments in order to: (1) evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility; (2) evaluate the accuracy of the Commission's estimate of the burden of the proposed collections of information; (3) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (4) determine whether there are ways to minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

In addition, would we would appreciate any comments related to our Paperwork Reduction Act estimates with respect to the following:

- The number of counterparties with whom an SBS Entity would maintain a security-based swap portfolio.
- The number and proportion of security-based swap portfolios that would fall under each of the proposed thresholds for determining the frequency of the required portfolio reconciliations, with respect to both SBS Entity and non-SBS Entity counterparties.
- The hourly burden of conducting each portfolio reconciliation and the use of automated systems to perform this function, including those offered by third parties.
- The use of third parties to perform portfolio reconciliation and portfolio compression exercises, any upfront burdens associated with engaging a third party to perform these services, and the ongoing burdens associated with each exercise.

- The burdens associated with establishing and routinely updating all required policies and procedures.

The agency has submitted the proposed collections of information to OMB for approval. Persons wishing to submit comments on the collection of information requirements should direct the comments to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and send a copy to Brent J. Fields, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090, with reference to File No. S7-28-18. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication of this release. Consequently, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-28-18, and be submitted to the Securities and Exchange Commission, Office of FOIA Services, 100 F Street, NE, Washington, DC 20549-2736.

VI. 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)[198] 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

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198 15 U.S.C. § 78c(f).

addition, Section 23(a)(2)[199] 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.[200]

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

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199 15 U.S.C. § 78w(a)(2).

200 See id.

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.[201]

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.[202] Shortcomings in the documentation of portfolio valuation methods and reconciliation of portfolio values were also

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201 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.

202 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.

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.[203]

Among other things, effective risk management requires the existence of sound documentation, periodic reconciliation of portfolios, rigorously tested valuation methodologies, and sound collateralization practices.[204] 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 enhanced ability to manage counterparty risk through "netting and collateral agreements by promoting portfolio reconciliation and accurate valuation of trades."[205]

The rules we are proposing today 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

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203 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 15 and accompanying text.

204 See PriceWaterhouseCoopers, Lehman Brothers' Bankruptcy: Lessons learned for the survivors, Informational presentation for clients, (Aug. 2009), at 12–24, available at: http://www.pwc.com/en_JG/jg/events/Lessons-learned-for-thesurvivors.pdf.2009), at 12–24, available at http://www.pwc.com/en_JG/jg/events/Lessons-learned-for-thesurvivors.pdf.

205 See The President's Working Group on Financial Markets, Policy Statements on Financial Market Developments, (Mar. 2008) ("PWG Report"), available at: http://www.treasury.gov/resource-center/fin-mkts/Documents/pwgpolicystatemktturmoil_03122008.pdf.2008) ("PWG Report"), available at http://www.treasury.gov/resource-center/fin-mkts/Documents/pwgpolicystatemktturmoil_03122008.pdf.

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. The proposed rules also would 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.[206] In proposing these rules, the Commission preliminarily believes that they will promote effective risk management practiced by security-based swap market participants in a number of important ways, which we discuss 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

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206 The proposed rules also would (1) address the potential availability of substituted compliance in connection with those portfolio reconciliation, portfolio compression, and trading relationship documentation requirements and (2) add corresponding requirements to the Commission's recordkeeping rules that would require SBS Entities to make and keep records demonstrating compliance with the new risk mitigation requirements.

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. The Commission requests data from commenters to help quantify these effects.

B. Economic Baseline

To assess the economic impact of the proposed risk mitigation rules, the Commission is using as a baseline the security-based swap market as it exists today, 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[207] and the Trade Acknowledgment and Verification Adopting Release.[208] 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. Our understanding of the market is informed by available data on security-based swap transactions, though we acknowledge the data available to us limits the extent to which we can quantitatively characterize the market. Because this data does not cover the entire market, we have developed an understanding of market activity using a sample that includes only certain portions of the market.

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207 See supra note 138.

208 See supra note 6.

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 proposed rules. For example, the proposed rules 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 ultimately adopted under the proposal, 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 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 Depository Trust and Clearing Corporation ("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.[209] Although the definition of "security-based swap" is not limited to single-name CDS,[210] 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,[211] in multi-name index CDS was approximately $4.4 trillion, and in multi-name, non-index CDS was approximately $343 billion.[212] The total gross market value outstanding in single-name CDS was approximately $130 billion, and in multi-name CDS instruments was approximately $174 billion.[213] The global notional amount outstanding in

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209 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.

210 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.

211 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.

212 See BIS, Semi-annual OTC derivatives statistics at December 2017, Table 10.1, available at: https://www.bis.org/statistics/d10_1.pdf (last accessed May 18, 2018).

213 See id.

equity forwards and swaps as of December 2017 was $3.21 trillion, with total gross market value of $197 billion.[214]

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;[215] 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

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214 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 May 18, 2018). 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.

215 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).

participants active in the security-based swap market and the general pattern of dealing within that market.[216]

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,[217] and 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 trigger registration requirements for intermediated transactions with a gross notional amount of approximately $2.9 trillion, approximately 55% of the gross notional intermediated by the top five dealer accounts.[218]

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216 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.

217 See, e.g., Registration Adopting Release, 80 FR at 49000.

218 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.

These dealers transact with hundreds or thousands of counterparties. Approximately 21% of accounts of firms expected to register as security-based dealers and observable in TIW have entered into security-based swaps with over 1,000 unique counterparty accounts as of year-end 2017.[219] Another 25% of these 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 that engaged directly in trading between November 2006 and December 2017.[220]

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219 Many dealer entities and financial groups transact through numerous accounts. Given that 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.

220 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

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

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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., Dealing Activity Adopting Release, 81 FR 8602, fn.43. 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.

221 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.

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	1635	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[222]	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.[223] 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.[224] For instance, banks in Table 1 allocated transactions across

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222 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.

223 "Accounts" as defined in the TIW context are not equivalent to "accounts" in the definition of "U.S. person" provided by Exchange Act rule 3a71-3(a)(4)(i)(C). 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.

224 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.

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.[225]

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225 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.

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[226]	
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%

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

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[226] This column reflects the number of participants who are also trading for their own accounts.

market.[227] 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.[228] Currently, security-based swap transactions are generally negotiated and executed bilaterally, typically with

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227 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.

228 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.

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.[229]

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 central counterparty ("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.[230] 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 175,660 transactions, 75,119 transactions ($1.695 trillion) were

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229 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.https://www.bis.org/publ/qtrpdf/r_qt1806b.pdf, Graph 2.

230 See supra Section VI.B.1.b for current estimates of the number of SBS Entities.

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 proposed 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;[231] 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.[232] 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

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231 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 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 47277, 47303 (Aug. 12, 2014 (republication)) ("Cross-Border Adopting Release").

232 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.

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,[233] 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 also registered with the CFTC as Swap Entities are 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.[234] The Commission has reviewed these rules and preliminarily believes that, other than as expressly noted above in Section I.B, they are substantively identical to the rules we are proposing today.[235]

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233 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.

234 See 17 CFR 23.502 (Portfolio reconciliation).

235 See, e.g., supra Section I.B.2 for a discussion of similarities and differences in approach to the definition of material terms that must be reconciled.

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 under the proposed 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 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.[236] These 'best practices' include written agreement between counterparties as to the terms of the reconciliation and reconciliation tolerances, and also recognize both the CFTC and EU rules pertaining to portfolio reconciliation.

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236 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").

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 preliminarily believes that they are, other than as expressly noted above in Section I.C, substantively identical to the rules we are proposing today.

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 these proposed rules 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 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. [237]

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.[238] 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.[239] Using data from TriOptima, the BIS reports CDS portfolio compression rates as high as 25% of notional outstanding in the first half of 2008.[240] Compression volumes fell steadily over the following years due, in part, to falling transaction volumes and the rise of central clearing.[241] TriOptima, as well as other firms, continue to offer

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237 See ISDA Collateral Best Practices, supra note 236, Best Practice 8.4.

238 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.

239 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.

240 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. 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 62.

241 Id.

compression services, and the Commission preliminarily 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.[242] 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 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.[243]

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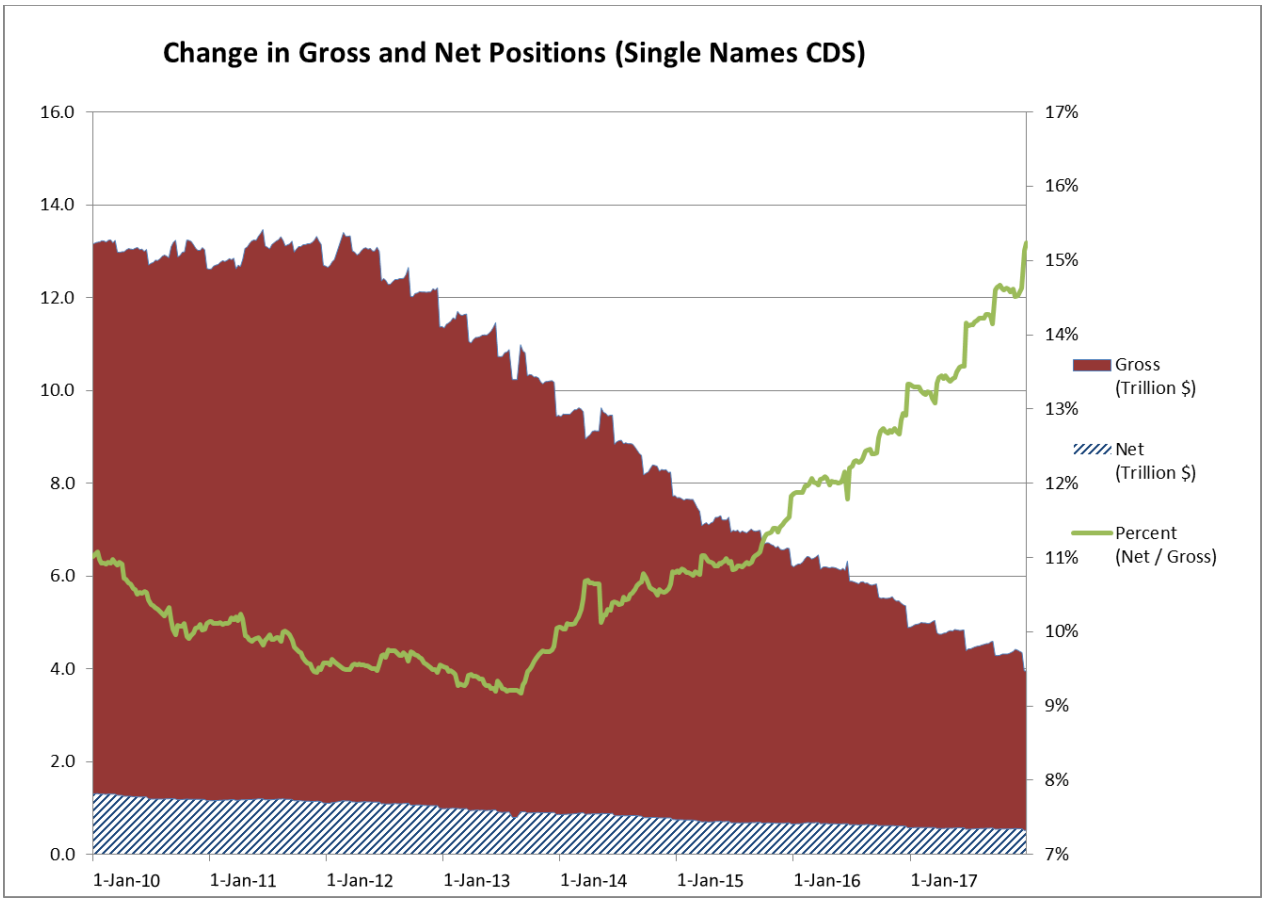
242 The chart below includes only gross and net notional of single-name security-based swaps. The inclusion of index security-based swaps could expand potential compression opportunities available to SBS Entities.

243 The result is likely driven by banks and securities firms. See Aldasoro, Inaki, and Torsten Ehlers, 2018, supra note 240, Graph 5.



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 proposed rules in the ordinary course of their businesses, including documentation that contains several of the terms that would be required by the proposed rules.

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 preliminarily believes that they are, other than as expressly noted above in Section I.D, substantively identical to the rules we are proposing today.

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

In this section we first discuss the expected effects of the proposed rules 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 the proposed 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 our proposed rules.

a. Broad Market Effects

In the release adopting 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."[244,245] In this regard,

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244 See Trade Acknowledgment and Verification Adopting Release, 81 FR at 39833.

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.[246]

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

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245 See supra Section I.B.1.

246 See id.

extent that the proposed rules 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, the proposed 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 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.[247]

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247 The Commission does not expect that this effect would 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.

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 proposing to amend 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 preliminarily 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 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 preliminarily 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.[248] 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 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.[249]

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248 See ISDA Collateral Best Practices, supra note 236, Section 10.

249 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 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; See also Financial Crisis Inquiry Commission, The Financial Crisis Inquiry Report: Final

a. Requirements

The Commission is proposing rules and interpretations that generally would require each SBS Entity (1) to engage in portfolio reconciliation with counterparties who are also SBS Entities at periodic intervals 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 based on the number of outstanding transactions with the counterparty.[250]

The Commission is proposing to vary the proposed portfolio reconciliation requirement based on the particular type of counterparty with which the SBS Entity transacts. For transactions between two SBS Entities, the proposed rules would 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.[251] In addition to the requirements regarding the frequency of the reconciliation, proposed Rule 15Fi-3(a)(1) would require the two 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.

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.

250 Pursuant to proposed Rule 15Fi-3(d), the new requirements regarding portfolio reconciliation would not apply to a clearing transaction (i.e., a security-based swap that has a clearing agency as a direct counterparty). See supra note 58 and accompanying text.

251 See proposed Rule 15Fi-3(a).

To the extent that the two SBS Entities identify a discrepancy, the proposed rule would require the parties to take certain steps. First, proposed Rule 15Fi-3(a)(4) would require the two sides to resolve immediately any discrepancy in a material term, whether identified directly as part of the portfolio reconciliation or otherwise. Second, proposed Rule 15Fi-3(a)(5) would require each SBS Entity to 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. As a condition to this requirement, however, proposed Rule 15Fi-3(a)(5) would require 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[252] and any related regulations pending resolution of the valuation discrepancy. Finally, proposed Rule 15Fi-3(a)(5) would clarify 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.[253]

Separately, with respect to transactions between an SBS Entity and a counterparty that is not an SBS Entity, proposed Rule 15Fi-3(b) would require 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.[254] This is in contrast to proposed Rule

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252 15 U.S.C. § 78o-10(e).

253 This 10% threshold would apply on a transaction-by-transaction basis, and not on a portfolio level.

254 See proposed Rule 15Fi-3(b).

15Fi-3(a), which expressly requires portfolio reconciliation with respect to transactions where both counterparties are SBS Entities.

Proposed 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 proposed Rule 15Fi-3(a). Specifically, proposed 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, proposed 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 counterparty that is not an SBS Entity within five days.[255]

Finally, proposed Rule 15Fi-3(c) would 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:

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255 Similar to the requirement in paragraph (a) of the proposed rule for portfolio reconciliation with counterparties that are either SBS dealers or major SBS participants, proposed 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 39 and accompanying text (discussing the 10% threshold in the context of Rule 15Fi-3(a)(5)).

- 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 would be required to be in a form and manner acceptable to the Commission, and would 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).[256]

For the security-based swap market to operate efficiently and to reduce credit and operational risk between counterparties, the Commission preliminarily 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 markets 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

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256 See supra Section I.B.6.

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 preliminarily believes that the proposed tiering of obligations, whereby the frequency of the portfolio reconciliation would be 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 would be 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 preliminarily 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 proposed by the Commission in this release.

The Commission preliminarily 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, proposed 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 proposed 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.[257] 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.[258] 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.

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257 See supra note 14.

258 See supra note 203.

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 proposed rules 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 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, we preliminarily believe 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 proposed Rule 15Fi-3(c) would 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.[259] Finally, as discussed above, the Commission preliminarily believes reconciliation may provide indirect benefits by improving the accuracy of SDR data.[260] As described above in Section I.B.2, the information that SBS Entities would initially be required to reconcile with their

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259 See supra Section I.B.6.

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

counterparties would include each term that is required to be reported to a registered SDR under Rule 901 under the Exchange Act.[261]

c. Costs

The portfolio reconciliation rules the Commission is proposing today 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 proposed rules 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 proposed 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.[262] 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,

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261 See proposed Rule 15Fi-1(i)(1) (referencing 17 CFR 242.901).

262 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 55952-3.

the Commission preliminarily 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 already regularly reconcile their portfolios with each other and with other entities and that the increased frequency and inclusion of smaller portfolios as proposed should prove no obstacle to such entities.[263] If SBS Entities have similar business practices, then this comment suggests start-up and on-going portfolio reconciliation costs could be small.

The Commission preliminarily 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.

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

The proposed 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 would incur an upfront cost in implementing this requirement, particularly since the Commission would 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 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 35 will be dually-registered with the CFTC and may already have automated portfolio reconciliation systems in place. 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 20 SBS Entities which are not expected be dually-registered with the CFTC, the anticipated personnel costs associated with setting up an automated portfolio reconciliation system per SBS Entity is $58,795, or $1,175,900 in

aggregate.[264, 265] The Commission preliminarily believes that these costs would be a component of the upfront cost estimate of $5-10 million discussed above.[266] 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.[267] 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 would be needed for automated portfolio reconciliation with these counterparties.[268]

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264 This estimate is based on the following: [(Sr. Programmer (80 hours) X $314 per hour)+(Sr. Systems Analyst (80 hours) X $269 per hour)+(Compliance Manager (10 hours) X $293 per hour)+(Director of Compliance (5 hours) X $461 per hour)+(Compliance Attorney (20 hours) X $346 per hour)] = $58,795 per SBS Entity, or ($58,795 X 20 SBS Entities) = $1,175,900 in aggregate.

265 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.

266 See supra note 262 and associated text.

267 Each SBS Entity is anticipated to have counterparty relationships with approximately one-third of the other SBS market participants (1/3 X 55 = 18.333), which is rounded to 18 participants. Of 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 X 252 trading days X 0.25 hours)+(4 counterparties X 52 weeks X 0.25 hours)+(12 counterparties X 4 quarters X 0.25 hours)] = 190 hours per SBS Entity, or (190 X 55 SBS Entities) = 10,450 hours in aggregate.

268 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 179. 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

The Commission further estimates that the development and implementation of written policies and procedures as required under proposed Rule 15Fi-3 would impose an initial cost of $702,232.50. Of the total 55 SBS Entities that would be subject to Rule 15Fi-3, 35 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 35 hours, costing $429.50 per SBS Entity or $15,032.50 in aggregate.[269] For the remaining 20 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 $687,200, or $34,360 per SBS Entity.[270] Once established, the Commission estimates that it would cost SBS Entities approximately $944,900 or $17,180 per SBS Entity to revise and

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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 X 4 quarters X 0.5 hours)+(315 counterparties X 1 time per year X 0.5 hours)] = 227.5 hours per SBS Entity, or (227.5 X 55 SBS Entities) = 12,512.5 hours in aggregate.

269 The estimate is based on the following: [((Compliance Attorney (30 minutes) at $346 per hour)+((Director of Compliance (15 minutes) at $461 per hour)+((Deputy General Counsel (15 minutes) at $565 per hour)] = $429.50 per hour per SBS Entity or ($429.50 per hour x 35 SBS dually-registered Entities) = $15,032.50.

270 The estimate is based on the following: [((Compliance Attorney (40 hours) at $346 per hour)+((Director of Compliance (20 hours) at $461 per hour)+((Deputy General Counsel (20 hours) at $565 per hour)] = $34,360 per SBS Entity or ($34,360 x 20 SBS Entities that are not dually-registered) = $687,200 in aggregate.

maintain these policies and procedures.[271] Resolution of valuation discrepancies can be labor intensive. One objective of the proposed rule is to reduce the incidence of valuation discrepancies through the periodic reconciliations between security-based swap counterparties. It is unlikely, however, that the proposed 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 preliminarily 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.[272] The Commission notes, however, that this 10% threshold is at the transaction level, rather than

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271 The estimate is based on the following: [((Compliance Attorney (20 hours) at $346 per hour)+((Director of Compliance (10 hours) at $461 per hour)+((Deputy General Counsel (10 hours) at $565 per hour)] = $17,180 per SBS Entity or ($17,180 x 55 SBS Entities) = $944,900 in aggregate.

272 See 17 CFR § 23.502 (portfolio reconciliation).

the entity level. While discrepancies could be random in nature, the risk exists that one 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 35 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 preliminarily 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 proposed 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 24 hours per year to comply with the notification requirement of proposed Rule 15Fi-3(c) costing $8,304 per SBS Entity or $456,720 in aggregate.[273]

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273 The estimate is based on the following: [Compliance Attorney (24 hours) at $346 per hour]= $8,304 per entity x 55 SBS entities = $456,720.

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 preliminarily 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.[274] 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.[275]

d. Alternatives

The proposed rule 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, but then permits SBS Entities to exclude any term that is not relevant to the ongoing rights and obligations of the parties and the valuation of the security-based swap during subsequent reconciliations. The Commission considered not providing a specific definition of "material terms" and allowing SBS Entities

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274 See supra Section I.B.7.

275 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.

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 has preliminarily 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 proposed Rule 15Fi-3. The Commission also preliminarily 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 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 35 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 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 preliminarily believes that the proposed 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 proposed 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 preliminarily believes that the proposed five business day horizon is sufficient and serves as an upper-bound for which market participants to address and correct any material discrepancies that arise 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, proposed Rule 15Fi-3(c) would 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 would be required to be in a form and manner acceptable to the Commission, and would 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).[276]

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 preliminarily 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.

Proposed Rule 15Fi-3(d), the new requirements regarding portfolio reconciliation would not apply to a "clearing transaction" which is defined as a security-based swap that has a clearing agency as a direct counterparty.[277] A clearing agency means a clearing agency that is registered with the Commission pursuant to Section 17A of the Exchange Act and that provides central counterparty services for security-based swap transactions. The Commission considered as an alternative including transactions cleared at a foreign clearing agency that is not registered with the Commission within its definition of "clearing transaction" for the purposes of the proposed

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276 See supra Section I.B.6.

277 See supra Section I.B.7.

rule. The Commission preliminarily concluded that an approach that is similar to that taken by the Commission in other rules,[278] as well as the approach taken by the CFTC,[279] would reduce implementation and compliance costs.

The Commission has considered as an alternative, an alternative compliance mechanism that would allow a SBS Entity to be deemed in compliance with certain proposed 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 preliminarily concludes that differences between its proposed 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 proposed 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 an alternative compliance mechanism given that CFTC portfolio reconciliation rules do not require all of this information to be reconciled.[280]

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278 See, e.g., Trade Acknowledgement and Verification Adopting Release, 81 FR at 39839

279 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(c).

280 See supra Section I.E for a discussion of the proposed reconciliation rules and the verification of transaction data by SDRs. See also supra note 32 for a discussion of differences between CFTC and proposed Commission requirements concerning third party reconciliation.

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 useful risk management tool.[281]

a. Requirements

The Commission is proposing rules and interpretations that generally would 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 proposed Rule 15Fi-4(a), SBS Entities would be required to establish, maintain, and follow written policies and procedures for periodically engaging in both bilateral portfolio

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281 See http://www2.isda.org/news/isda-publishes-paper-highlighting-achievements-in-portfolio-compression.

compression exercises and multilateral portfolio compression exercises, when appropriate, with each counterparty that is also an SBS Entity.[282] For transactions with non-SBS Entities, the policies and procedures required under the proposed rule would require only that portfolio compression exercise would have to occur when appropriate and only if requested by any such counterparty.[283]

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.[284] By expanding the universe of participants required to maintain portfolio compression policies and procedures, credit risk in

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282 See proposed Rules 15Fi-4(a)(2) and (3).

283 See proposed Rule 15Fi-4(b). See also supra notes 70 and 71 and associated text.

284 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 205. 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 62. 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 240.

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 proposed Rule 15Fi-4(a), SBS Entities would be 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.[285] To the extent that an SBS Entity transacts with a counterparties that are not SBS Entities, the policies and procedures required under the proposed rule would require only that

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285 See supra Section I.C.

portfolio compression exercises occur when appropriate and only if requested by any such counterparty. In the absence of the proposed 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-party vendors to provide additional portfolio compression opportunities for these firms.

The proposed rule provides flexibility to security-based swap market participants with respect to portfolio compression. The Commission preliminarily believes that by not proposing prescriptive requirements, an SBS Entity would allow the 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 proposed 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. Certain portfolio compression exercises could result in adverse credit exposures to certain counterparties. For example, 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 preliminarily 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, proposed Rules 15Fi-4(a)(1) and (b) would 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 proposed by the Commission in this release.[286] By closely aligning portfolio compression requirements through consultation with the CFTC and with ESMA, the Commission preliminarily 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 preliminarily 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 preliminarily 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

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286 See supra note 7 and accompanying text.

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.[287] 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.[288] As that standardization continues, we would 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[289] 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 written policies and procedures as required under proposed Rule 15Fi-4 would impose an initial cost of

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287 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.

288 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 ("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.").

289 See http://www2.isda.org/asset-classes/credit-derivatives/single-name-cds-roll/.

$702,232.50 in aggregate. 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 35 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 35 hours, costing $429.50 per SBS Entity or $15,032.50 in aggregate.[290] For the remaining 20 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 $687,200, or $34,360 per SBS Entity.[291] Once established, the Commission estimates that it would cost SBS Entities approximately $944,900 or $17,180 per SBS Entity to revise and maintain these policies and procedures.[292]

The Commission further estimates that an SBS Entity will devote approximately 124.17 hours per year for portfolio offsets and compression exercises (6,829.35 aggregate hours), a substantial portion of which will be automated, and some of which may be handled by third-

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290 The estimate is based on the following: [((Compliance Attorney (30 minutes) at $346 per hour)+((Director of Compliance (15 minutes) at $461 per hour)+((Deputy General Counsel (15 minutes) at $565 per hour)] = $429.50 per hour per SBS Entity or ($429.50 per hour x 35 SBS dually-registered Entities) = $15,032.50.

291 The estimate is based on the following: [((Compliance Attorney (40 hours) at $346 per hour)+((Director of Compliance (20 hours) at $461 per hour)+((Deputy General Counsel (20 hours) at $565 per hour)] = $34,360 per SBS Entity or ($34,360 x 20 SBS Entities that are not dually-registered) = $687,200 in aggregate.

292 The estimate is based on the following: [((Compliance Attorney (20 hours) at $346 per hour)+((Director of Compliance (10 hours) at $461 per hour)+((Deputy General Counsel (10 hours) at $565 per hour)] = $17,180 per SBS Entity or ($17,180 x 55 SBS Entities) = $944,900 in aggregate.

party vendors.[293] Similar to our discussion for portfolio reconciliation (Section VIII.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 20 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 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

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293 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 X 18 + 5/60*350) or 29.92 hours 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 X 6)+(15/60 X 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 (29.92+88.25+6) = 124.17 hours, or 6829.35 hours (124.17 hours X 55 SBS Entities).

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 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 proposed 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 is not proposing to mandate the specific contents of the policies and procedures created to comply with these rules.[294] However, a

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[294] There is one exception to this statement, see supra note 72.

number of more specific requirements for portfolio compression could be included. For example, the current proposal only requires policies and procedures that address compression to the extent requested by the counterparty rather than a more prescriptive requirement.[295]

Pursuant to the proposed 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 has 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.[296] Given that 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.

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 in proposed rule 15Fi-3). For instance, if

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295 See supra Section I.C.3.

296 See EU Regulation 149/2013, art. 14, 2013 O.J. 11, 22.

counterparties have portfolios in excess of 500 transactions, an analysis of portfolio compression could be conducted quarterly, while 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 has 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.

Proposed Rule 15Fi-4(c), the new requirements regarding portfolio compression, would not apply to a "clearing transaction", which is defined as a security-based swap that has a clearing agency as a direct counterparty.[297] A clearing agency means a clearing agency that is registered with the Commission pursuant to Section 17A of the Exchange Act and that provides central counterparty services for security-based swap transactions. The Commission considered as an alternative including transactions cleared at a foreign clearing agency that is not registered with the Commission within its definition of "clearing transaction" for the purposes of the proposed rule. The Commission preliminarily concluded that an approach that is similar to that

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297 See supra Section I.C.4.

taken by the Commission in other rules,[298] as well as the approach taken by the CFTC,[299] would reduce implementation and compliance costs.

The Commission has considered as an alternative, an alternative compliance mechanism that would allow a SBS Entity to be deemed in compliance with certain proposed 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 preliminarily concludes 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 preliminarily believes that the differences that do exist (such as the proposed 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[300]) 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).[301]

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298 See supra note 278.

299 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).

300 See supra note 70 and accompanying text.

301 The corresponding CFTC compression rule applicable to transactions with counterparties that are not SBS 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 note 70. We solicit comment on this difference. See supra Section I.C.5.

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.[302] 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 proposing rules and interpretations that generally would 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.

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302 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.

Further, the proposed rule would also require that the security-based swap trading relationship documentation include credit support arrangements.[303] 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.[304]

The proposed rules also would 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 proposed 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 proposed 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 disclose 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, proposed Rule 15Fi-5 requires a periodic independent audit to identify any material deficiencies in the trading relationship documentation policies and procedures.

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303 See supra Section I.C.2

304 15 U.S.C. 78c-5(f).

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, the proposed rule provides particular guidance with respect to policies and procedures documenting the valuation of security-based swaps. Although 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 proposed 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 proposed 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 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 proposed rule.

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 $4,741,680 per SBS Entity, or $260,792,400 in aggregate across the 55 SBS Entities.[305] The Commission further estimates that the development and implementation of written policies and procedures as required under proposed Rule 15Fi-5 would impose an initial cost of $702,232.50 in aggregate. Of the total 55 SBS Entities as

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[305] 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 30 hours per counterparty. The estimation is as follows: [((Compliance Manager (15 hours) X $346)+(Director of Compliance (7.5 hours) X $461)+(Deputy General Counsel (7.5 hours) X $565)) X 368 counterparties] = $4,741,680 per SBS Entity, or ($4,741,680 X 55 SBS Entities) = $260,792,400 in aggregate.

expected by the Commission that would be subject to Rule 15Fi-5, 35 are anticipated to be registered concurrently 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 Entities is expected to be one hour per Entity, for a cumulative 35 hours, costing $429.50 per Entity or $15,032.50 in aggregate.[306] For the remaining 20 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 $687,200, or $34,360 per SBS Entity.[307] Once established, the Commission estimates that it would cost SBS Entities approximately $944,900 or $17,180 per SBS Entity to revise and maintain these policies and procedures.[308] Lastly, proposed Rule 15Fi-5 requires periodic independent audits of the trading relationship documentation. The Commission estimates that the costs associated with these audits will be $794,880 per SBS Entity, or $43,718,400 in aggregate.[309]

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306 The estimate is based on the following: [((Compliance Attorney (30 minutes) at $346 per hour)+((Director of Compliance (15 minutes) at $461 per hour)+((Deputy General Counsel (15 minutes) at $565 per hour)] = $429.50 per hour per SBS Entity or ($429.50 per hour x 35 SBS dually-registered Entities) = $15,032.50.

307 The estimate is based on the following: [((Compliance Attorney (40 hours) at $346 per hour)+((Director of Compliance (20 hours) at $461 per hour)+((Deputy General Counsel (20 hours) at $565 per hour)] = $34,360 per SBS Entity or ($34,360 x 20 SBS Entities that are not dually-registered) = $687,200 in aggregate.

308 The estimate is based on the following: [((Compliance Attorney (20 hours) at $346 per hour)+((Director of Compliance (10 hours) at $461 per hour)+((Deputy General Counsel (10 hours) at $565 per hour)] = $17,180 per SBS Entity or ($17,180 x 55 SBS Entities) = $944,900 in aggregate.

309 The estimate is based on the following: [368 counterparties X 10 hours per Audit X Auditor ($216 per hour)] = $794,880 per SBS Entity, or ($794,880X 55 SBS Entities) = $43,718,400 in aggregate.

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.[310] Accordingly, the Commission preliminarily 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 the proposed rules in the ordinary course of their businesses, including documentation that contains several of the terms that would be required by the proposed 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 proposed 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.[311]

Proposed 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 proposed rule would 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

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310 As noted in Section VI.B.4, as of 2015, the DTCC-TIW data shows that over 99% of SBS Entities use the ISDA Master Agreement.

311 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/.

Entities to bring existing transactions into compliance with the proposed 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 proposed Rule 15Fi-3 even though they are not subject to the documentation requirements of proposed Rule 15Fi-5. Such disputes could be costly to resolve and may lead to greater uncertainty with respect to counterparty credit risk.

The proposed rule further provides exceptions for any "clearing transaction", which, pursuant to existing Rule 15Fi-1(c) under the Exchange Act, is defined as a security-based swap that has a clearing agency as a direct counterparty. 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 proposed rule would provide an exception for security-based swaps executed anonymously on a national securities exchange or an SBSEF, 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 recognize that documentation requirements may be nearly impossible to fulfill within the context of cleared anonymous transactions.[312]

d. Alternatives

The Commission has evaluated reasonable alternatives to the proposed rule 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

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312 The exception with respect to security-based swap transactions on national exchanges or SBSEF is limited. See Section I.D.6 for a complete discussion of those limitations.

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 proposed rule requires that SBS Entities undertake a periodic, independent audit to identify material weaknesses in its documentation policies and procedures. As proposed, 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.

Proposed Rule 15Fi-5(a)(1)(ii) would provide an exception to the trading relationship documentations requirements for any "clearing transaction" which is defined as a security-based swap that has a clearing agency as a direct counterparty.[313] A clearing agency means a clearing agency that is registered with the Commission pursuant to Section 17A of the Exchange Act and that provides central counterparty services for security-based swap transactions. The Commission considered as an alternative including transactions cleared at a foreign clearing agency that is not registered with the Commission within its definition of "clearing transaction" for the purposes of the proposed rule. The Commission preliminarily concluded that an

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313 See supra Section I.D.6.

approach that is similar to that taken by the Commission in other rules, [314] as well as the approach taken by the CFTC,[315] would reduce implementation and compliance costs.

The Commission has considered as an alternative, an alternative compliance mechanism that would allow a SBS Entity to be deemed in compliance with certain proposed 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 preliminarily concludes 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 preliminarily 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 SBSEF that is then rejected for clearing but continues to exist, the Commission preliminarily believes that the counterparties to the ongoing security-based swap should have in place a written agreement on the terms of that transaction.[316]

5. Recordkeeping Requirements

The Commission is also proposing rules that would modify existing Rules 17a-3 and 17a-4, as well as proposed Rules 18a-5 and 18a-6 for the recordkeeping and reporting requirements

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314 See supra note 278.

315 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).

316 See supra Section I.D.6.

applicable to SBS Entities. The proposed amendments would 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 proposed Rule 15Fi-5, as well as each policy and procedure created pursuant to proposed Rules 15Fi-3, 15Fi-4, and 15Fi-5.

a. Requirements

The Commission is proposing to amend Rule 17a-3 (which applies to SBS Entities that are also registered with the Commission as broker-dealers) and proposed Rule 18a-5 (which applies to SBS Entities that are not registered with the Commission as broker-dealers). Under these amendments, each SBS Entity would 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 proposed 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 proposed amendments would 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 proposing to amend Rule 17a-4 (which applies to SBS Entities that are also registered with the Commission as broker-dealers) and proposed 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 proposed amendments to Rule 17a-3 and proposed Rule 18a-5 would need to be retained for at least three years. Further, all policies and procedures related to proposed 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 would need to be retained until at least three years following the termination of said 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 proposed Rules 18a-5 and 18a-6 are intended to facilitate effective oversight of SBS Entities, thus the benefits associated with the proposed 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 proposed 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 proposed 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. Those costs include the costs of creating procedures to ensure that records are kept as required by the proposed rule amendments, and costs associated with ongoing record maintenance. As the recordkeeping requirements would be amendments to Rules 17a-3 and 17a-4, and proposed Rules 18a-5 and 18a-6; however, the incremental costs of compliance with these amendments is likely to be minimal.

The proposed Rules 15Fi-3 through 15Fi-5 would require that SBS Entities would 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 would need to be made in order to make the systems compliant with the proposed 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 proposed 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 proposed rule amendments.[317]

d. Alternatives

The Commission has considered reasonable alternatives to the proposed 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

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317 See supra Section I.F.1.

requirements. However, longer record preservation would reduce the likelihood that historical records are unavailable if needed at some point in the future.

Proposed Rule 15Fi-5(c) requires each SBS Entity to have an independent auditor conduct periodic audits sufficient to identify any material weakness in it 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.[318] However, because the proposed rule would still encompass any auditor, whether external or internal, that is in fact independent, the Commission preliminarily believes that the practical differences between the Commission's proposed rule and the corresponding CFTC rule are negligible.

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.[319] At the time of the substituted compliance rule, it applied solely to business conduct standards; however, Rule 3a71-6 was amended in the Trade Acknowledgement and Verification Adopting

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318 See supra Section I.D.5.

319 See Business Conduct Standards Adopting Release, 81 FR at 30074.

Release to provide foreign SBS Entities with the potential to rely on substituted compliance to satisfy Title VII trade confirmation requirements.[320]

a. Requirements

The Commission is proposing to amend further 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 proposed Rules 15Fi-3 through 15Fi-5. The Commission has preliminarily 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 proposed herein.

b. Benefits

The Commission proposed amendments to Rule 3a71-6 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 proposed Rules 15Fi-3 through 15Fi-5, in particular as it

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320 See Trade Acknowledgement and Verification Adopting Release, 81 FR at 39827-28.

reduces legal uncertainty, counterparty credit risk exposure, and operational risk for market participants.

Further, the Commission anticipates broader market implications of substituted compliance, as well, 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 preliminarily believes that the availability of substituted compliance for portfolio reconciliation, portfolio compression, and trading relationship documentation would not substantially alter the benefits intended by the proposed 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 by either a foreign regulatory jurisdiction on behalf of its market participants, or by the registered market participant itself.[321] 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.

D. Request for Comment

The Commission requests comment on all aspects of this initial economic analysis, including whether the analysis has: (i) identified all benefits and costs, including all effects on efficiency, competition, and capital formation; (ii) given due consideration to each benefit and cost, including each effect on efficiency, competition, and capital formation; and (iii) identified and considered reasonable alternatives to the proposed regulations. We request and encourage any interested person to submit comments regarding the proposed regulations and our analysis of the potential effects of the proposed regulations. We request that commenters identify sources of

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321 See Cross-Border Adopting Release, 79 FR at 47277.

data and information as well as provide data and information to assist us in analyzing the economic consequences of the proposed rule and proposed amendments. We also are interested in comments on the qualitative benefits and costs we have identified and any benefits and costs we may have overlooked. In addition to our general request for comment on the economic analysis associated with the proposed rule and proposed amendments, we request specific comment on certain aspects of the proposal:

- We request comment on our characterization of current portfolio reconciliation practices. Do commenters agree that the proposed portfolio reconciliation rules are similar to current best practices? If not, how are they different? Are there third party service providers that offer portfolio reconciliation services? If so, what are the costs associated with using such services?
- We request comment on our characterization of current portfolio compression practices. Do commenters agree that the proposed portfolio compression rules are similar to current best practices? If not, how are they different? The Commission understands that there are third party service providers that offer portfolio compression services. What are the direct and indirect costs of using such service providers?
- We request comment on our characterization of current trading relationship documentation practices. Do commenters agree with our characterization? If not, how are they different?
- We request comment on our characterization of the benefits of the proposed regulations concerning portfolio reconciliation. The Commission preliminarily believes that the main benefit of portfolio reconciliation is improved management of market and credit risks associated with particular transactions. Do commenters agree with this characterization of the benefits? Are there other benefits of the proposed rule that have not been identified in our

discussion and that warrant consideration? Are the assumptions that form the basis of our analysis of the benefits appropriate? Can commenters provide data that supports or opposes these assumptions? Can commenters provide data that would help the Commission quantify the magnitude of the benefits identified in our discussion or other benefits that we did not identify in our discussion and that warrant consideration?

- We request comment on our characterization of the costs of the proposed regulations concerning portfolio reconciliation. The Commission preliminarily believes that making its rules as similar as practicable to those of the CFTC will mitigate compliance costs for SBS entities. The Commission also preliminarily believes that ongoing portfolio reconciliation costs would likely be a function of portfolio size and the availability of third party service providers. Do commenters agree with our characterization of the costs? Are there other costs of the proposed rule that have not been identified in our discussion and that warrant consideration? Are the assumptions that form the basis of our analysis of the costs appropriate? Can commenters provide data that supports or opposes these assumptions? Can commenters provide data that would help the Commission quantify the magnitude of the costs identified in our discussion or other costs that we did not identify in our discussion and that warrant consideration?
- We request comment on our characterization of the benefits of the proposed rules concerning portfolio compression. The Commission preliminarily believes that the main benefit of the proposed portfolio compression rule is the potential for reducing the overall risk, cost, and inefficiencies associated with maintaining offsetting transactions. Do commenters agree with this characterization of the benefits? Are there other benefits of the proposed rule that have not been identified in our discussion and that warrant consideration? Are the assumptions

that form the basis of our analysis of the benefits appropriate? Can commenters provide data that supports or opposes these assumptions? Can commenters provide data that would help the Commission quantify the magnitude of the benefits identified in our discussion or other benefits that we did not identify in our discussion and that warrant consideration?

- We request comment on our characterization of the costs of the proposed regulations concerning portfolio compression. The Commission preliminarily believes the making its rules as similar as practicable to those of the CFTC will mitigate compliance costs for SBS entities. Do commenters agree with our characterization of the costs? Are there other costs of the proposed rule that have not been identified in our discussion and that warrant consideration? Are the assumptions that form the basis of our analysis of the costs appropriate? The Commission preliminarily believes third-party service providers often facilitate multilateral portfolio compression but lacks data on the costs to participants of using these services. Can commenters provide data that supports or opposes these assumptions? Can commenters provide data that would help the Commission quantify the magnitude of the costs identified in our discussion or other costs that we did not identify in our discussion and that warrant consideration?
- We request comment on our characterization of the benefits of the proposed rules concerning trading relationship documentation. The Commission preliminarily believes that the main benefit of the proposed trading relationship documentation rule is the potential for reducing the likelihood of collateral and legal disputes between counterparties that might expose each side to significant counterparty credit risk. Do commenters agree with this characterization of the benefits? Are there other benefits of the proposed rule that have not been identified in our discussion and that warrant consideration? Are the assumptions that form the basis of

our analysis of the benefits appropriate? Can commenters provide data that supports or opposes these assumptions? Can commenters provide data that would help the Commission quantify the magnitude of the benefits identified in our discussion or other benefits that we did not identify in our discussion and that warrant consideration?

- We request comment on our characterization of the costs of the proposed regulations concerning trading relationship documentation. The Commission preliminarily believes the widespread use of standard documentation mitigates the costs of the proposed rule. Do commenters agree with our characterization of the costs? Are there other costs of the proposed rule that have not been identified in our discussion and that warrant consideration? Are the assumptions that form the basis of our analysis of the costs appropriate? Can commenters provide data that would help the Commission quantify the magnitude of the costs identified in our discussion or other costs that we did not identify in our discussion and that warrant consideration?
- Are there any effects on efficiency, competition, and capital formation that are not identified or are misidentified in our economic analysis? Please be specific and provide data and analysis to support your views.
- Do commenters believe that the alternatives the Commission considered are appropriate? Are there other reasonable alternatives that the Commission should consider? If so, please provide additional alternatives and how their costs and benefits would compare to the proposal.
- We request and encourage any interested person to submit comments regarding any aspect of the economic analysis of the proposed rule, specific issues discussed in the economic analysis, and other matters that may have an effect on the costs or benefits of the proposed

rule. With regard to any comments, we note that such comments are of particular assistance to our rulemaking initiative if accompanied by supporting data and analysis of the issues addressed in those comments.

VII. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996 ("SBREFA")[322] the Commission requests comment on the potential impact of the proposed rules and amendments on the economy on an annual basis. The Commission also requests comment on any potential increases in costs or prices for consumers or individual industries, and any potential effect on competition, investment, or innovation. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

VIII. Regulatory Flexibility Act Certification

The Regulatory Flexibility Act of 1980 ("RFA")[323] requires the Commission, in promulgating rules, to consider the impact of those rules on small entities. Section 603(a)[324] of the Administrative Procedure Act,[325] as amended by the RFA, generally requires the Commission to undertake a regulatory flexibility analysis of all proposed rules to determine the impact of such rulemaking on "small entities." Section 605(b) of the RFA[326] provides that this requirement shall not apply to any proposed rule or proposed rule amendment which, if adopted, would not have a significant economic impact on a substantial number of small entities.

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322 Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

323 5 U.S.C. 601 et seq.

324 5 U.S.C. 603(a).

325 5 U.S.C. 551 et seq.

326 5 U.S.C. 605(b).

For purposes of Commission rulemaking in connection with the RFA,[327] a small entity includes: (1) when used with reference to an "issuer" or a "person," other than an 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;[328] or (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,[329] 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.[330] 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;[331] (ii) for entities engaged in non-depository credit intermediation and certain other activities, entities with $7 million or less in annual receipts;[332] (iii) for entities engaged in financial investments and related activities, entities with $7 million or

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327 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 proposed 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)

328 See 17 CFR 240.0-10(a).

329 17 CFR 240.17a-5(d).

330 See 17 CFR 240.0-10(c).

331 See 13 CFR 121.201 (Subsector 522).

332 See id. at Subsector 522.

less in annual receipts;[333] (iv) for insurance carriers and entities engaged in related activities, entities with $7 million or less in annual receipts;[334] and (v) for funds, trusts, and other financial vehicles, entities with $7 million or less in annual receipts.[335]

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 would 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 "small entities" for purposes of the RFA.[336]

For the foregoing reasons, the Commission certifies that neither proposed Rules 15Fi-3 through 15Fi, nor the proposed amendments to Rules 3a71-6, 15Fi-1, 17a-3, 17a-4, 18a-5 (proposed) and 18a-6 (proposed) would, if adopted, have a significant economic impact on a substantial number of small entities. The Commission encourages written comments regarding this certification. The Commission solicits comment as to whether the proposed rules could have an effect on small entities that has not been considered. The Commission requests that

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333 See id. at Subsector 523.

334 See id. at Subsector 524.

335 See id. at Subsector 525.

336 See 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)

commenters describe the nature of any impact on small entities and provide empirical data to support the extent of such impact.

IX. Statutory Basis and Text of Proposed Rules

The Commission is proposing to revise Rules 3a71-6, 15Fi-1, 17a-3, and 17a-4 under the Exchange Act (17 CFR 240.3a71-6, 17 CFR 240.15Fi-1, 17 CFR 240.17a-3 [as proposed to be amended at 79 FR 25193, May 2, 2014], and 17 CFR 240.17a-4 [as proposed to be amended at 79 FR 25193, May 2, 2014]), to revise proposed Rules 18a-5 and 18a-6 under the Exchange Act (17 CFR 240.18a-5 [as proposed to be adopted at 79 FR 25193, May 2, 2014] and 17 CFR 240.18a-6 [as proposed to be adopted at 79 FR 25193, May 2, 2014]) and to add new Rules 15Fi-3, 15Fi-4, and 15Fi-5 under the Exchange Act (17 CFR 240.15Fi-3, 17 CFR 240.15Fi-4, and 17 CFR 240.15Fi-5) pursuant to the authority conferred by the Exchange Act, as amended, and particularly sections 3(b), 15F, 17, and 23(a).[337]

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 proposes to amend 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:

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337 15 U.S.C. 78c(b), 78o-10, 78q, 78w(a), and 78mm.

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 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, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, 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; and Pub. L. 111-203, 939A, 124 Stat. 1376 (2010), unless otherwise noted.

2. Section 240.3a71-6 is amended by adding paragraph (d)(4) to read as follows:

§ 240.3a71–6 Substituted compliance for security-based swap dealers and major security-based swap participants.

* * * * *

(d) * * *

(4) 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 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) 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:

(1) With respect to any security-based swap that has not yet been included in a security-based swap portfolio and reconciled pursuant to § 240.15Fi-3, each term that is required to be reported to a registered swap data repository or the Commission pursuant to §242.901 of this chapter; and

(2) With respect to all other security-based swaps within a security-based swap portfolio, each term that is required to be reported to a registered 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 regulations thereunder pending resolution of the discrepancy in valuation. For purposes of this paragraph, 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, 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. 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:

(1) Three business days, if the dispute is with a counterparty that is a security-based swap dealer or major security-based swap participant; or

(2) Five business days, if the dispute is with a counterparty that is not a security-based swap dealer or major security-based swap participant.

(d) Reconciliation of cleared security-based swaps. Nothing in this section shall apply to any clearing transaction.

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 clearing transaction.

6. Section 240.15Fi-5 is added to read as follows:

§ 240.15Fi-5 Security-based swap trading relationship documentation.

(a)(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 clearing transaction; 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, allocation of any applicable regulatory reporting obligations (including pursuant to §§ 242.900 to 242.909) of this chapter, 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 section 3E(f) of the Act (15 U.S.C. 78c-5(f)), 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 regulations thereunder, and the risk management requirements under section 15F(j) of the Act (15 U.S.C. 78o-10(j)) of the Act and regulations thereunder. 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 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, as proposed to be amended at 79 FR 25193, May 2, 2014 is further amended by adding paragraph (a)(31) to read as follows:

§ 240.17a-3 -- Records to be made by certain 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, as proposed to be amended at 79 FR 25193, May 2, 2014 is amended by revising paragraph (b)(1) and adding paragraphs (e)(10) and (11) 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), (a)(6), (a)(7), (a)(8), (a)(9), (a)(10), (a)(11), (a)(16), (a)(18), (a)(19), (a)(20), (a)(24), (a)(25), (a)(26), (a)(27), (a)(28), (a)(29), (a)(30), and (a)(31), and analogous records created pursuant to §240.17a-3(e).

* * * * *

(e) * * *

(10) 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.

(11) (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, as proposed to be added at 79 FR 25193, May 2, 2014, is further 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, as proposed to be added at 79 FR 25193, May 2, 2014, is further amended by revising paragraphs (b)(1)(i) and (b)(2)(i) and adding paragraphs (d)(4) and (d)(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), (a)(6), (a)(7), (a)(8), (a)(9), (a)(11), (a)(12), (a)(13), (a)(14), (a)(15), (a)(16), (a)(17), and (a)(18).

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(2) * * *

(i) All records required to be made pursuant to § 240.18a–5(b)(4), (b)(5), (b)(6), (b)(7), (b)(9), (b)(10), (b)(11), (b)(12), (b)(13), and (b)(14).

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(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.

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By the Commission.

Dated: December 19, 2018.

Brent J. Fields,
Secretary.