



# RISK ALERT

DIVISION OF EXAMINATIONS

January 10, 2024

## Observations Related to Security-Based Swap Dealers

### I. Introduction

The Securities and Exchange Commission (the “Commission”)\* is responsible for regulating the security-based swap markets, including security-based swap dealers. Beginning in October 2021, security-based swap dealers were required to register with the Commission.<sup>1</sup>

In 2022, the Division began conducting examinations of registered security-based swap dealers with a focus on whether they have implemented reasonably designed policies and procedures for compliance with applicable Commission rules, including requirements related to accurate and timely reporting of security-based swap transactions to a registered security-based swap data repository. Accurate and complete security-based swap reporting that the Commission and investing public can rely upon is crucial for the regulation and transparency of the security-based swap markets. Accordingly, the Division also began conducting ad-hoc outreach to certain security-based swap dealers concerning their respective security-based swap reporting. This Risk Alert discusses the Division’s observations concerning compliance with rules applicable to security-based swap dealers.<sup>2</sup> In sharing these observations from its examinations and outreach, the Division seeks to remind security-based swap dealers of their obligations under relevant security-based swap rules.

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\* This Risk Alert represents the views of the staff of the Division of Examinations (the “Division”). This Risk Alert is not a rule, regulation, or statement of the Commission. The Commission has neither approved nor disapproved the content of this Risk Alert. This Risk Alert, like all staff statements, has no legal force or effect; it does not alter or amend applicable law, and it creates no new or additional obligations for any person.

<sup>1</sup> As of the date of publication of this Risk Alert, there are 51 security-based swap dealers registered with the Commission. See SEC, *List of Registered Security-Based Swap Dealers and Major Security-Based Swap Participants*, <https://www.sec.gov/tm/List-of-SBS-Dealers-and-Major-SBS-Participants> (last revised September 29, 2023).

<sup>2</sup> For the avoidance of doubt, this Risk Alert does not include the Division’s observations concerning compliance with substituted compliance orders. Rule 3a71-6 provides that a registered non-U.S. security-based swap dealer may satisfy certain requirements under Exchange Act section 15F by complying with comparable regulatory requirements of a foreign jurisdiction. The Commission has adopted substituted compliance determinations applicable to registered non-U.S. security-based swap dealers in France, Germany, Spain, Switzerland, and the United Kingdom. See <https://www.sec.gov/tm/Jurisdiction-Specific-Apps-Orders-and-MOU>.

## II. Relevant Regulation and Guidance

The Dodd-Frank Wall Street Reform and Consumer Protection Act created a regulatory framework for security-based swaps by adding, among other provisions, Section 15F to the Securities Exchange Act of 1934 (“Exchange Act”) requiring the registration and regulation of security-based swap dealers. The Commission has adopted a number of rules for security-based swap dealers, including rules related to security-based swap trade reporting, business conduct, security-based swap trading relationship documentation, portfolio reconciliation, and recordkeeping.

### A. Reporting of Security-Based Swap Transactions and Correction of Reporting Errors

Regulation SBSR governs the regulatory reporting and public dissemination of security-based swap transactions and requires market participants to report security-based swap information to a registered security-based swap data repository.<sup>3</sup> Information to be reported to the registered security-based swap data repository within the requisite timeframe generally falls into two categories: primary trade information and secondary trade information.<sup>4</sup> A time-limited Commission Statement with respect to Regulation SBSR provides that, if a registered security-based swap data repository and its participants follow the Commodity Futures Trading Commission’s (“CFTC”) swap reporting and public dissemination protocols and apply those protocols to security-based swap reporting, there will not be a basis for a Commission enforcement action with respect to certain provisions of Regulation SBSR that differ from the CFTC’s reporting and public dissemination rules (Parts 45 and 43, respectively).<sup>5</sup> Moreover, security-based swap dealers in particular are required to establish, maintain, and enforce written policies and procedures that are reasonably designed to ensure that it complies with any obligations to report information to a registered security-based swap data repository in a manner consistent with Regulation SBSR.<sup>6</sup>

### B. Business Conduct Standards

Exchange Act Rule 15Fh-3(h) requires security-based swap dealers to establish and maintain a system to supervise their business and the activities of their associated persons effecting or involved in effecting security-based swaps,<sup>7</sup> setting forth minimum requirements for such system including maintaining reasonably designed policies and procedures addressing the following:

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<sup>3</sup> 17 C.F.R. 242.900 to 242.909.

<sup>4</sup> 17 C.F.R. 242.901.

<sup>5</sup> Exchange Act Release No. 87780 (December 18, 2019), 85 FR 6270, 6346-49 (February 4, 2020).

<sup>6</sup> 17 C.F.R. 242.906.

<sup>7</sup> See Registration Process for Security-Based Swap Dealers and Major Security-Based Swap Participants, Exchange Act Release No. 34-75611, 80 Fed. Reg. 48964, 48976 (Aug. 14, 2015), available at <https://www.govinfo.gov/content/pkg/FR-2015-08-14/pdf/2015-19661.pdf>.

- Review by a designated supervisor of security-based swap transactions for which registration as a security-based swap dealer is required;
- Supervisory review of external communications with counterparties and internal communications concerning the security-based swap dealer's business;<sup>8</sup>
- On at least an annual basis, an internal review of security-based swap business reasonably designed to detect and prevent violations of applicable securities laws, rules, and regulations;
- Reasonable investigation of the good character, business repute, qualifications, and experience of any person prior to their association with the security-based swap dealer;
- Reviews of associated persons' trading relationships or activity in permitted, external personal trading accounts; and
- Conflicts of interest arising from an associated person or supervising a person who determines the compensation or continued employment of the associated person.

### C. Security-Based Swap Trading Relationship Documentation and Portfolio Reconciliation

Exchange Act Rule 15Fi-5 requires each security-based swap dealer to establish, maintain, and follow written policies and procedures reasonably designed to ensure the execution of written security-based swap trading relationship documentation with each counterparty that complies with the requirements of the Rule. Those requirements include that trading relationship documentation be executed prior to, or contemporaneously with, executing any security-based swap transaction. In addition, a senior officer of a security-based swap dealer must approve in writing its trading relationship documentation policies and procedures and the security-based swap dealer must retain a record thereof. Further, each security-based swap dealer is required to have an independent auditor conduct periodic audits sufficient to identify any material weaknesses in the security-based swap dealer's trading relationship documentation policies and procedures. An internal auditor is not ordinarily considered independent for purposes of the audit requirement under Exchange Act Rule 15Fi-5(c).<sup>9</sup>

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<sup>8</sup> While Exchange Act Rule 15Fh-3(h) exclusively addresses written communications, the minimum requirements for a supervisory system listed in the rule are not an exhaustive list. Security-based swap dealers have an overarching obligation in Rule 15Fh-3(h)(1) to establish and maintain a supervisory system that is reasonably designed to prevent violations of applicable federal securities laws and the rules and regulations thereunder relating to the security-based swap dealer's business as a security-based swap dealer. Therefore, if a security-based swap dealer records oral communications with counterparties or potential counterparties, the security-based swap dealer generally should consider providing for the supervisory review of such communications. Similarly, if a security-based swap dealer chooses to provide certain disclosures required by Rule 15Fh-3(b) orally, the security-based swap dealer should consider how it will supervise these oral communications. *See* Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, Exchange Act Release No. 34-77617, 81 Fed. Reg. 29960, 30005 (May 13, 2016), available at <https://www.govinfo.gov/content/pkg/FR-2016-05-13/pdf/2016-10918.pdf>.

<sup>9</sup> *See* Risk Mitigation Techniques for Uncleared Security-Based Swaps, Exchange Act Release No. 34-87782, 85 Fed. Reg. 6359, 6375 (Feb. 4, 2020), available at <https://www.govinfo.gov/content/pkg/FR-2020-02-04/pdf/2019-27762.pdf>.

Exchange Act Rule 15Fi-3 sets forth requirements for security-based swap dealers regarding portfolio reconciliation, including that each security-based swap dealer agree in writing with each of its counterparties on the terms of the portfolio reconciliation.

#### D. Recordkeeping

Exchange Act Rules 17a-3 and 18a-5 require security-based swap dealers to make and keep current certain books and records. For example, security-based swap dealers must make and keep current blotters (or other records of original entry) containing an itemized daily record of purchases and sales of securities (including security-based swaps). Security-based swap dealers must also make and keep current, for each security-based swap transaction, a record of the unique identification code of the counterparty. Security-based swap dealers are also required to make and keep current, for each security-based swap account, the name and address of the counterparty, and a record of the authorization of each person the counterparty has granted authority to transact business in the security-based swap account. Further, security-based swap dealers must make and keep current a record listing every associated person, including every office where the associated person regularly conducts business of handling funds or securities or effecting any transactions in, or inducing or attempting to induce, the purchase or sale of any security for the security-based swap dealer, the associated person's Central Registration Depository number, if any, and every internal identification number or code assigned to that person by the security-based swap dealer.

### III. **Staff Observations from Examinations and Outreach**

This section provides the Division staff's observations and views concerning compliance with applicable rules based on examinations of, and outreach to, security-based swap dealers. In general, the Division observed that certain security-based swap dealers did not establish, maintain, or enforce reasonably designed policies and procedures addressing applicable Exchange Act requirements. Further, the Division observed that certain security-based swap dealers did not comply with Exchange Act requirements, including applicable requirements under Regulation SBSR.

#### A. Reporting of Security-Based Swap Transactions and Correction of Reporting Errors

In examinations and other outreach to security-based swap dealers, the Division observed that certain security-based swap dealers failed to:

- Report certain security-based swap trade data to a registered security-based swap data repository within the required timeframes;
- Accurately report primary trade information, including by reporting:
  - inaccurate notional amounts, including miscalculated notional amounts and notional amounts that are not economically possible; and
  - incorrect underlying asset information, such as an incorrect International Securities Identification Number ("ISIN") or an underlying asset of "Basket,"

without identifying specific underlying reference asset(s), reference issuer(s), or reference index as required under Rule 901(c)(1)(i);<sup>10</sup> and

- Accurately and completely report all secondary trade information, such as:
  - counterparty identifications, including reporting an internal identifier for security-based swap transactions that did not involve privacy laws or natural persons; and
  - buyer, seller, receiver, or payer fields.<sup>11</sup>

In many instances, the failures identified above were the result of weak internal controls and processes for ensuring that information reported was accurate. In addition, examinations of security-based swap dealers revealed that certain security-based swap dealers did not employ procedures that were reasonably designed to identify and correct the trade reporting errors noted above.

#### B. Business Conduct Standards

The Division observed that certain security-based swap dealers failed to identify all associated persons, including those effecting security-based swap transactions or involved in effecting security-based swap transactions, often resulting in failure to satisfy supervisory obligations for all associated persons pursuant to Exchange Act Rule 15Fh-3(h).

The Division observed that certain security-based swap dealers did not establish a system to address the minimum requirements set forth in Exchange Act Rule 15Fh-3(h), including failing to establish:

- Procedures prohibiting a supervisor from supervising his or her own activities or reporting to, or having the supervisor's compensation or continued employment to be determined by, a person he or she supervises;
- Procedures reasonably designed to prevent the supervisory system from being compromised due to the conflicts of interest that may be present with respect to the associated person being supervised, including the position of such person, the revenue such person generates for the security-based swap dealer, or any compensation that the associated person conducting the supervision may derive from the associated person being supervised (*e.g.*, failing to address identification of conflicts of interest or management of conflicts of interest or potential conflicts of interest identified);
- Procedures for review by a supervisor of incoming and outgoing written (including electronic) correspondence with counterparties or potential counterparties and internal

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<sup>10</sup> See Frequently Asked Questions on Regulation SBSR, Division of Trading and Markets, available at <https://www.sec.gov/tm/faqs-reg-sbs> (providing Commission staff's responses to questions regarding the timeliness of SBS reporting under Rule 901(j) and reporting underlying reference assets under Rule 901(c)(1), among other topics).

<sup>11</sup> For a list of data quality issues, refer to the Appendix of the Commission's Report on Security-Based Swaps Pursuant to Section 13(m)(2) of the Securities Exchange Act of 1934 (Mar. 20, 2023), available at <https://www.sec.gov/files/report-security-based-swaps-032023.pdf>.

- written communications relating to the security-based swap dealer's business involving security-based swaps that were not reasonably designed and did not address the types of security-based swap business in which a security-based swap dealer and its associated persons engaged (*e.g.*, failed to account for recorded telephone conversations of associated persons or used generic search terms to identify communications for review);
- Procedures to supervise associated persons' trading at another financial institution;
  - Procedures for a periodic review, at least annually, of the security-based swap business in which the security-based swap dealer engages that is reasonably designed to assist in detecting and preventing violations of applicable federal securities laws and the rules and regulations thereunder; and
  - Procedures for review by a supervisor of transactions for which registration as a security-based swap dealer is required.

#### C. Security-Based Swap Trading Relationship Documentation and Portfolio Reconciliation

The Division observed that certain security-based swap dealers failed to:

- Have an independent auditor perform periodic audits of security-based swap trading relationship documentation policies and procedures;
- Retain the required record of a Senior Officer's written approval of security-based swap trading relationship documentation policies and procedures, and any amendments thereto; and
- Agree in writing with counterparties on the terms for portfolio reconciliation, including terms relating to the method of reconciliation, such as negative consent.

#### D. Recordkeeping

The Division observed that certain security-based swap dealers failed to consistently make and keep current complete and accurate records such as trade blotters, counterparty listings, and associated person listings.

### **IV. Conclusion**

Security-based swap dealers play a critical role in our capital markets. In sharing the information in this Risk Alert, the Division encourages security-based swap dealers to consider improvements in their compliance programs, as may be appropriate, to further compliance with Exchange Act requirements. The Division further encourages security-based swap dealers to review and strengthen their policies, procedures, internal controls, and security-based swap reporting capabilities.

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*This Risk Alert is intended to highlight for firms risks and issues that Division staff has identified. In addition, this Risk Alert describes risks that firms may consider to (1) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (2) make any changes, as may be appropriate, to address or strengthen such systems. Other risks besides those described in this Risk Alert may be appropriate to consider, and some issues discussed in this Risk Alert may not be relevant to a particular firm's business. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.*

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