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SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 201 and 240

[Release No. 34-84858; File No. S7-14-15]

RIN 3235-AL76

Applications by Security-Based Swap Dealers or Major Security-Based Swap Participants for Statutorily Disqualified Associated Persons to Effect or be Involved in Effecting Security-Based Swaps

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: Pursuant to Section 15F(b)(6) of the Securities Exchange Act of 1934 (“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”), the Securities and Exchange Commission (“Commission”) is adopting Rule of Practice 194. Rule of Practice 194 provides a process for a registered security-based swap dealer or major security-based swap participant (collectively, “SBS Entity”) to make an application to the Commission for an order permitting an associated person that is a natural person who is subject to a statutory disqualification to effect or be involved in effecting security-based swaps on behalf of the SBS Entity. Rule of Practice 194 also provides an exclusion for an SBS Entity from the prohibition in Exchange Act Section 15F(b)(6) with respect to associated persons that are not natural persons. Finally, Rule of Practice 194 provides that, subject to certain conditions, an SBS Entity may permit an associated person that is a natural person who is subject to a statutory disqualification to effect or be involved in effecting security-based swaps on its behalf, without making an application pursuant to the rule, where the Commission, the Commodity Futures Trading Commission (“CFTC”), a

self-regulatory organization (“SRO”), or a registered futures association has granted a prior application or otherwise granted relief from the statutory disqualification with respect to that associated person.

DATES: Effective [insert date 60 days after publication in the *Federal Register*].

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TEXT OF THE RULE

I. BACKGROUND

Exchange Act Section 15F(b)(6), as added by Section 764(a) of the Dodd-Frank Act, makes it unlawful for an SBS Entity to permit an associated person¹ who is subject to a statutory disqualification² to effect or be involved in effecting security-based swaps on behalf of the SBS Entity if the SBS Entity knew, or in the exercise of reasonable care should have known, of the statutory disqualification, “[e]xcept to the extent otherwise specifically provided by rule,

¹ Exchange Act Section 3(a)(70) generally defines the term “person associated with” an SBS Entity to include (i) any partner, officer, director, or branch manager of an SBS Entity (or any person occupying a similar status or performing similar functions); (ii) any person directly or indirectly controlling, controlled by, or under common control with an SBS Entity; or (iii) any employee of an SBS Entity. See 15 U.S.C. 78c(a)(70). The definition generally excludes persons whose functions are solely clerical or ministerial. *Id.* The definition of “person” under Exchange Act Section 3(a)(9) is not limited to natural persons, but extends to both entities and natural persons. See 15 U.S.C. 78c(a)(9) (“The term ‘person’ means a natural person, company, government, or political subdivision, agent, or instrumentality of a government.”).

² The term statutory disqualification as used in Exchange Act Section 15F(b)(6) parallels the definition of statutory disqualification in Exchange Act Section 3(a)(39)(A) through (F), 15 U.S.C. 78c(a)(39)(A) through (F). See Applications by Security-Based Swap Dealers or Major Security-Based Swap Participants for Statutorily Disqualified Associated Persons To Effect or Be Involved in Effecting Security-Based Swaps, Exchange Act Release No. 75612 (Aug. 5, 2015), 80 FR 51684, 51686, n.16 (Aug. 25, 2015) (“Proposing Release” or “proposal”).

regulation, or order of the Commission.”³ In this regard, Exchange Act Section 15F(b)(6) gives the Commission the discretion to determine, by order, that a statutorily disqualified associated person may effect or be involved in effecting security-based swaps on behalf of an SBS Entity, and/or to establish rules concerning the statutory prohibition in Exchange Act Section 15F(b)(6).⁴

On August 5, 2015,⁵ the Commission proposed Rule of Practice 194 to establish a

³ Exchange Act Section 15F(b)(6) provides: “Except to the extent otherwise specifically provided by rule, regulation, or order of the Commission, it shall be unlawful for a security-based swap dealer or a major security-based swap participant to permit any person associated with a security-based swap dealer or a major security-based swap participant who is subject to a statutory disqualification to effect or be involved in effecting security-based swaps on behalf of the security-based swap dealer or major security-based swap participant, if the security-based swap dealer or major security-based swap participant knew, or in the exercise of reasonable care should have known, of the statutory disqualification.” 15 U.S.C. 78o-10(b)(6). The statutory prohibition in Exchange Act Section 15F(b)(6), 15 U.S.C. 78o-10(b)(6), is parallel to a statutory provision for a swap dealer or major swap participant (collectively “Swap Entities”) set forth in Section 4s(b)(6) of the Commodity Exchange Act (“CEA”), 7 U.S.C. 6s(b)(6).

⁴ On June 15, 2011, the Commission issued an order that, among other things, granted temporary relief from compliance with Exchange Act Section 15F(b)(6) for persons subject to a statutory disqualification who were, as of July 16, 2011, associated with an SBS Entity and who effected or were involved in effecting security-based swaps on behalf of such SBS Entity and allowed such persons to continue to be associated with an SBS Entity until the date upon which rules adopted by the Commission to register SBS Entities became effective. *See* Temporary Exemptions and Other Temporary Relief, Together With Information on Compliance Dates for New Provisions of the Securities Exchange Act of 1934 Applicable to Security-Based Swaps, Exchange Act Release No. 64678 (June 15, 2011), 76 FR 36287, 36301, 36305-07 (June 22, 2011) (“June 2011 Temporary Exemptions Order”). *See also* Order Extending Certain Temporary Exemptions and a Temporary and Limited Exception Related to Security-Based Swaps, Exchange Act Release No. 75919 (Sept. 15, 2015), 80 FR 56519 (Sept. 18, 2015) (extending the June 2011 Temporary Exemptions Order).

⁵ Concurrent with the issuance of the Rule of Practice 194 proposal, the Commission adopted registration requirements for SBS Entities, including certain rules relating to the statutory prohibition in Exchange Act Section 15F(b)(6). *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 (Aug. 14, 2015) (“Registration

process by which an SBS Entity could apply to the Commission to permit an associated person who is subject to a statutory disqualification to effect or be involved in effecting security-based swaps on behalf of the SBS Entity.⁶ As discussed in the Commission's proposal,⁷ the federal securities laws provide various procedural avenues that allow certain registered entities to associate, where warranted, with persons subject to a statutory disqualification or other bar, including the Commission's Rule of Practice 193⁸ and the Financial Industry Regulatory

Adopting Release"). *See also* 17 CFR 240.15Fb6-1 (providing that an SBS Entity, when it files an application to register with the Commission, may permit an associated person that is not a natural person who is subject to a statutory disqualification to effect or be involved in effecting security-based swaps on the SBS Entity's behalf, provided that the statutory disqualification(s) occurred prior to the compliance date set forth in the Registration Adopting Release and that the SBS Entity identifies each such associated person on its registration form); 17 CFR 240.15Fb6-2 (requiring a Chief Compliance Officer of an SBS Entity to certify that it has performed background checks on all of its associated persons that are natural persons who effect or are involved in effecting security-based swaps on its behalf, and neither knows, nor in the exercise of reasonable care should have known, that any of its associated persons that effect or are involved in effecting security-based swaps on its behalf are subject to a statutory disqualification, unless otherwise specifically provided by rule, regulation, or order of the Commission). As discussed in Section III.K below, the Commission is making a technical amendment that deletes Rule 15Fb6-1 as well as Schedule C to Forms SBSE, SBSE-A and SBSE-BD and also conforms the instructions in those forms to take into account the associated person entity exclusion that the Commission is adopting in final Rule of Practice 194(c).

⁶ *See* Proposing Release, 80 FR 51684-722.

⁷ *See id.* at 51687-89.

⁸ 17 CFR 201.193. Rule of Practice 193 provides a process by which individuals that are associated with entities that are not regulated by an SRO (*e.g.*, employees of an investment adviser, an investment company, or a transfer agent) can seek to reenter the securities industry despite previously being barred by the Commission. *See* Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, Exchange Act Release No. 65543 (Oct. 12, 2011), 76 FR 65784, 65797 (Oct. 24, 2011) ("Registration Proposing Release"). *See also* Applications by Barred Individuals for Consent to Associate With a Registered Broker, Dealer, Municipal Securities Dealer, Investment Adviser or Investment Company, Exchange Act Release No. 20783, Investment Company Act Release No. 13839, Investment Advisers Act Release No. 903, 49 FR 12204 (Mar. 29, 1984).

Authority's ("FINRA") eligibility proceedings (under the process set forth in Exchange Act Rule 19h-1).⁹ The Commission modeled proposed Rule of Practice 194 on these existing processes where persons can make an application to reenter the industry despite previously being barred by the Commission or subject to a statutory disqualification with respect to membership or participation in, or association with a member of, an SRO.¹⁰ Accordingly, the Commission proposed to establish a procedural framework that is similar to processes that are familiar to market participants.¹¹

⁹ 17 CFR 240.19h-1. The FINRA Rule 9520 Series sets forth procedures for a person to become or remain associated with a member, notwithstanding the existence of a statutory disqualification, and for a current member or person associated with a member to obtain relief from the eligibility or qualification requirements of the FINRA By-Laws and rules. A member (or new member applicant) seeking to associate with a natural person subject to a statutory disqualification must seek approval from FINRA by filing a Form MC-400 application. See FINRA Form MC-400, *Membership Continuance Application*, <http://www.finra.org/web/groups/industry/@ip/@enf/@adj/documents/industry/p011542.pdf>. Members (and new member applicants) that are themselves subject to a disqualification that wish to obtain relief from the eligibility requirements are required to submit a Form MC-400A application. See FINRA Form MC-400A, *Membership Continuance Application: Member Firm Disqualification Application*, <http://www.finra.org/web/groups/industry/@ip/@enf/@adj/documents/industry/p013339.pdf>. Where required, FINRA sends a notice or notification to the Commission of its proposal to admit or continue the membership of a person or association with a member notwithstanding statutory disqualification in accordance with Exchange Act Rule 19h-1.

¹⁰ "Self-regulatory organization" is defined in Section 3(a)(26) of the Exchange Act, 15 U.S.C. 78c(a)(26), as "any national securities exchange, registered securities association, or registered clearing agency, or (solely for the purposes of sections 19(b), 19(c) and 23(b) of [the Exchange Act]) the Municipal Securities Rulemaking Board established by section 15B of this title."

¹¹ In the proposal, the Commission also discussed, for example, the CFTC's approach with respect to the statutory prohibition for swap dealers or major swap participants (collectively "Swap Entity") as set forth in CEA Section 4s(b)(6), 7 U.S.C. 6s(b)(6). See Proposing Release, 80 FR at 51688-89. The CFTC, with respect to statutorily disqualified associated persons of Swap Entities, limits the definition of associated persons of Swap Entities to natural persons. See 17 CFR 1.3(aa). As a result, the prohibition in CEA Section 4s(b)(6), 7 U.S.C. 6s(b)(6), applies to natural persons (not entities) associated with a Swap Entity. For further discussion on the CFTC's approach

The Commission requested comment on all aspects of the proposal as well as two alternative approaches,¹² and received comments in response.¹³

II. SUMMARY OF FINAL RULE OF PRACTICE 194

The Commission is adopting Rule of Practice 194 largely as proposed, with certain modifications.¹⁴ As adopted, Rule of Practice 194 provides a process by which an SBS Entity may apply to the Commission for an order permitting an associated person to effect or be involved in effecting security-based swaps on behalf of the SBS Entity where the associated person that is a natural person who is subject to a statutory disqualification and is thereby otherwise prohibited from effecting or being involved in effecting security-based swaps on behalf of an SBS Entity under Exchange Act Section 15F(b)(6). Rule of Practice 194 also provides an exclusion for an SBS Entity from the prohibition in Exchange Act Section 15F(b)(6) with respect to associated persons that are not natural persons (defined herein as “associated person entities”).

In particular, as explained more fully in Section III below, the Commission is adopting the following provisions in Rule of Practice 194:

- Paragraph (a) of Rule of Practice 194, which defines the scope of the rule and provides a process for submitting applications by an SBS Entity seeking an order of the Commission

to Swap Entities, see Section II.B.3 of the Proposing Release, 80 FR at 51688-89.

¹² See Proposing Release, 80 FR at 51701-05.

¹³ These comment letters are available at: <https://www.sec.gov/comments/s7-14-15/s71415.shtml>.

¹⁴ If any of the provisions of these amendments, or the application thereof to any person or circumstance, is held to be invalid, such invalidity shall not affect other provisions or application of such provisions to other persons or circumstances that can be given effect without the invalid provision or application.

to permit an associated person who is subject to a statutory disqualification to effect or be involved in effecting security-based swaps on behalf of the SBS Entity.

- Paragraph (b) of Rule of Practice 194, which specifies the required showing for an application. For the Commission to issue an order granting relief under Rule of Practice 194, an SBS Entity is required to make a showing that it would be consistent with the public interest to permit the associated person to effect or be involved in effecting security-based swaps on behalf of the SBS Entity, notwithstanding the statutory disqualification.
- Paragraph (c) of Rule of Practice 194, which establishes an exclusion from the general prohibition in Exchange Act Section 15F(b)(6) with respect to all associated person entities.¹⁵
- Paragraphs (d) and (e) of Rule of Practice 194, which specify the form of the application with respect to an associated person that is a natural person and the items to be addressed in the written statement within the application.
- Paragraph (f) of Rule of Practice 194, which requires an applicant to provide as part of any application any order, notice or other applicable document reflecting the grant, denial or other disposition (including any dispositions on appeal) of any prior application concerning the associated person under Rule of Practice 194 and other similar processes.
- Paragraph (g) of Rule of Practice 194, which provides for notice to the applicant in cases

¹⁵ In conjunction with adopting in Rule of Practice 194(c), the Commission is also making technical amendments to: (1) delete Exchange Act Rule 15Fb6-1; (2) remove Schedule C to Forms SBSE, SBSE-A and SBSE-BD; and (3) remove all references to Schedule C in the instructions in the above-mentioned forms. See Section III.K, *infra*, for a further discussion of the technical amendments.

where the Commission staff anticipates making an adverse recommendation to the Commission with respect to an application made pursuant to this rule. In such cases, the applicant will be provided with a written statement of the reasons for the Commission staff's preliminary recommendation, and the applicant will have 30 days to submit a written statement in response.

- Paragraph (h) to Rule of Practice 194, which provides that, where certain conditions are met, an SBS Entity does not need to file an application under Rule of Practice 194 to permit a statutorily disqualified associated person to effect or be involved in effecting security-based swaps on behalf of the SBS Entity. Specifically, paragraph (h) of Rule of Practice 194 allows an SBS Entity, subject to certain conditions, to permit a statutorily disqualified associated person to effect or be involved in effecting security-based swaps on behalf of the SBS Entity without making an application to the Commission, where the Commission, CFTC, an SRO (*e.g.*, FINRA) or a national securities exchange), or a registered futures association (*e.g.*, the National Futures Association ("NFA")) has granted a prior application or otherwise granted relief from a statutory disqualification with respect to that associated person. In such cases where an SBS Entity meets the requirements of paragraph (h), the SBS Entity will be permitted to file a notice with the Commission (in lieu of an application).

III. DISCUSSION

A. Rule of Practice 194(a) – Scope of the Rule

Proposed Rule of Practice 194 would have defined the scope of the rule, namely providing a process for an SBS Entity to seek relief from the Commission to permit an associated person who is subject to a statutory disqualification to effect or be involved in effecting security-

based swaps on behalf of the SBS Entity or to seek relief to change the terms and conditions of a previously issued Commission order pursuant to Rule of Practice 194.¹⁶ The Commission proposed to allow an SBS Entity to voluntarily submit an application to the Commission to request an order where an associated person of an SBS Entity is subject to a statutory disqualification and consequently prohibited from effecting or being involved in effecting security-based swaps on behalf of the SBS Entity under Exchange Act Section 15F(b)(6).¹⁷

Although no commenters specifically commented on this provision of proposed Rule of Practice 194, the Commission received general comments regarding the scope of the rule as proposed.¹⁸

A commenter suggested that rather than permit SBS Entities to voluntarily submit an application to the Commission to request an order providing relief from Exchange Act Section 15F(b)(6), the Commission should instead reaffirm what the commenter viewed as the Congressional mandate by issuing a rule that prohibits, on a blanket basis, associated persons that are subject to a statutory disqualification from effecting or being involved in effecting security-based swaps on behalf of SBS Entities.¹⁹

Section 15F(b)(6) of the Exchange Act provides that, except where otherwise specifically provided by rule, regulation, or order of the Commission, it shall be unlawful for an SBS Entity

¹⁶ See Proposing Release, 80 FR at 51689, 51719; proposed Rule of Practice 194(a).

¹⁷ 15 U.S.C. 78o-10(b)(6); see proposed Rule of Practice 194(a).

¹⁸ See Letter from Americans for Financial Reform, dated October 26, 2015 (“Americans for Financial Reform Letter”), at 1. See also Letter from Robert E. Rutkowski, dated October 27, 2015 (“Rutkowski Letter”). The Rutkowski Letter requested only that the Commission seriously consider the recommendations set forth in the Americans for Financial Reform Letter.

¹⁹ Letter from Bartlett Naylor, Public Citizen, dated October 26, 2015 (“Public Citizen Letter”), at 1-2.

to permit any person associated with the SBS Entity who is subject to a statutory disqualification to effect or be involved in effecting security-based swaps on behalf of the SBS Entity, if the SBS Entity knew, or in the exercise or reasonable care should have known, of the statutory disqualification.²⁰ Thus, while Exchange Act Section 15F(b)(6) makes it unlawful for an SBS Entity to permit an associated person who is subject to a statutory disqualification to effect or be involved in effecting security-based swaps on behalf of the SBS Entity, it also gives the Commission the discretion to determine (by rule, regulation, or order) that a statutorily disqualified associated person may effect or be involved in effecting security-based swaps on behalf of an SBS Entity.²¹ The Commission has determined to exercise its statutory authority under Exchange Act Section 15F(b)(6) to assess on a case-by-case basis whether to grant relief from the statutory prohibition because there may be instances where it is consistent with the public interest to permit an associated person who is subject to a statutory disqualification to effect or be involved in effecting security-based swaps on behalf of the SBS Entity.

Additionally, the commenter's approach²² would deviate from the Commission's current practice in other contexts, which permits associated persons to apply to reenter the securities industry notwithstanding the existence of a statutory disqualification.²³ In that respect, adopting the commenter's approach could lead to the anomalous result where an applicant may be permitted to engage in securities transactions with members of the retail public—for example, as an associated person of a broker-dealer or investment adviser—but prohibited from effecting or

²⁰ See Note 3, *supra*.

²¹ 15 U.S.C. 78o-10(b)(6).

²² See Public Citizen Letter, at 1-2.

²³ See, e.g., 17 CFR 240.19h-1; 17 CFR 201.193. See also Section I and Notes 8, 9, *supra*.

being involved in effecting security-based swap transactions with significantly more sophisticated institutional clients as an associated person of an SBS Entity.²⁴ Although we acknowledge that security-based swaps may also be more complex and opaque than equities or bonds, thus increasing information asymmetries between SBS Entities and their clients, we believe that institutional clients may be more informed and may process disclosures more efficiently than retail investors in parallel settings.

The Commission also believes that a process for granting relief with respect to a statutory disqualification should be formalized, as suggested by one commenter.²⁵ Exchange Act Section 15F(b)(6) provides the Commission with discretion to determine whether a statutorily disqualified associated person may effect or be involved in effecting security-based swaps on behalf of an SBS Entity. However, it does not specify what information should be provided to the Commission when an SBS Entity seeks relief, nor does it set forth the standard under which the Commission would evaluate requests for relief. Rule of Practice 194 specifies the information and documents that SBS Entities should provide to the Commission, as well as the applicable procedures and standard of review, for seeking relief from the statutory prohibition in Exchange Act Section 15F(b)(6). By articulating the materials to be submitted, the items to be considered, and the standard of review, Rule of Practice 194 provides a clear process for SBS

²⁴ See Proposing Release, 80 FR at 51698.

²⁵ See Americans for Financial Reform Letter, at 1. The commenter noted that without proposed Rule of Practice 194, SBS Entities would still be able to apply to the Commission for relief from the prohibition in Exchange Act Section 15F(b)(6); however, the commenter supported the Commission's efforts to formalize a process for seeking relief from the statutory prohibition of Exchange Act Section 15F(b)(6) to increase accountability and transparency into the application process.

Entities.²⁶ Therefore, the Commission is adopting paragraph (a) of Rule of Practice 194, which defines the scope of the rule, as proposed.

B. Rule of Practice 194(b) – Required Showing

Proposed Rule of Practice 194 provided that the applicant would be required to show that it would be consistent with the public interest to permit the associated person of the SBS Entity who is subject to a statutory disqualification to effect or be involved in effecting security-based swaps on behalf of the SBS Entity.²⁷

The Commission received one comment concerning the required showing set forth in the proposal. The commenter stated that, in assessing whether it is in the public interest to permit an associated person who is subject to a statutory disqualification to effect or be involved in effecting security-based swaps on behalf of an SBS Entity, the Commission should also consider whether the deterrent effect of disqualification would be diluted.²⁸ Specifically, the commenter stated that, to be granted relief, the SBS Entity should be required to show that granting relief “would actually enhance the deterrent effect.”²⁹

In assessing whether it is consistent with the public interest to permit an associated person that is a natural person who is subject to a statutory disqualification to effect or be involved in effecting security-based swaps on behalf of an SBS Entity, the Commission may

²⁶ See Proposing Release, 80 FR at 51712.

²⁷ See *id.* at 51689, 51719; proposed Rule of Practice 194(b). See Exchange Act Section 3(a)(39)(A) through (F), 15 U.S.C. 78c(a)(39)(A) through (F), for a description of statutorily disqualifying events. See also Note 2, *supra*.

²⁸ Public Citizen Letter, at 1, 4.

²⁹ *Id.* at 4. The commenter additionally stated that the entity requesting the waiver should be required to prove that “the implicit deterrence impact of disqualification is not diluted” by receiving a waiver from penalties resulting from criminal misbehavior. *Id.* at 1.

consider deterrence, among other factors.³⁰ However, the Commission does not agree with the commenter that the “applicant should be required to show that an exemption would actually enhance the deterrent effect”³¹ or that any petitioner for an exemption from disqualification should have to prove that the implicit deterrence impact of disqualification is not diluted by receiving a waiver from penalties from criminal misbehavior.³² Either standard could preclude the Commission from granting relief even where the public interest otherwise warrants doing so—*i.e.*, raising deterrence above all other public interest considerations. Moreover, it is not clear that any applicant could meet either standard proposed by the commenter. The Commission does believe, however, consistent with the proposal,³³ that the applicant should bear the burden of showing that permitting the associated person to effect or be involved in effecting security-based swaps on behalf of the SBS Entity is consistent with the public interest.

The Commission believes that the public interest standard is appropriate and consistent with Section 15F(b)(6) of the Exchange Act³⁴ and is adopting the standard as proposed. Exchange Act Section 15F(b)(6) is designed to limit the potential that associated persons who have engaged in certain types of “bad acts” will be able to negatively affect the security-based swap market and the participants in that market by prohibiting an SBS Entity from allowing a

³⁰ In this regard, the Commission noted in the Proposing Release that statutory disqualification and an inability to continue associating with SBS Entities may create a disincentive against underlying misconduct for associated persons. See Proposing Release, 80 FR at 51689, 51716-17.

³¹ Public Citizen Letter, at 4.

³² See *id.* at 1. Non-criminal conduct also may result in a statutory disqualification. See 15 U.S.C. 78c(a)(39).

³³ See Proposing Release, 80 FR at 51689.

³⁴ A public interest standard also is consistent with the standard in Rule of Practice 193. See 17 CFR 201.193(c).

statutorily disqualified associated person to effect or be involved in effecting security-based swap transactions, absent Commission relief. However, Section 15F(b)(6) also specifically provides that the Commission can allow SBS Entities to permit such statutorily disqualified associated persons to effect or be involved in effecting security-based swap transactions. The public interest standard is intended to capture those situations where the risk of the associated person engaging in security-based swap activity that may harm the market or the participants in the market is mitigated. Thus, as stated in the proposal, the Commission believes that it may grant relief in cases where the terms or conditions of association and the procedures proposed for supervision of the statutorily disqualified associated person are reasonably designed to mitigate the potential harm to the market or participants in the market.³⁵

The Commission also notes that the items set forth in the proposal³⁶ and adopted in final Rule of Practice 194(e), such as other misconduct in which the associated person may have engaged, the nature of the conduct that resulted in the statutory disqualification and disciplinary history of the associated person and SBS Entity requesting such relief, and the supervision to be accorded the associated person, would be relevant to the Commission's consideration of whether the risks of permitting such associated persons that are natural persons to effect or be involved in effecting security-based swaps on behalf of the SBS Entity are sufficiently mitigated. Therefore, the Commission is adopting paragraph (b) of Rule of Practice 194 as proposed.³⁷

³⁵ See Proposing Release, 80 FR at 51689.

³⁶ See *id.* at 51691-93, 51719-20; proposed Rule of Practice 194(d).

³⁷ Where the Commission determines that it would be consistent with the public interest to permit the associated person that is a natural person of the SBS Entity to effect or be involved in effecting security-based swaps on behalf of the SBS Entity, the Commission will issue an order granting relief. Where the Commission does not or cannot make the determination that it is in the public interest to permit the associated person that is a

C. Rule of Practice 194(c) – Exclusion for Other Persons

The Commission is adopting Rule of Practice 194(c), which provides an exclusion for an SBS Entity from the prohibition in Exchange Act Section 15F(b)(6) with respect to associated person entities.

Proposed Rule of Practice 194(i) would have provided temporary relief, subject to certain conditions,³⁸ from the statutory prohibition in Exchange Act Section 15F(b)(6) with respect to associated person entities that are subject to a statutory disqualification.³⁹ The Commission proposed paragraph (i) of Rule of Practice 194 to address the situation where an operating SBS Entity becomes subject to the statutory prohibition in Exchange Act Section 15F(b)(6) with respect to an associated person that is not a natural person—either as a result of an associated person that effects or is involved in effecting security-based swaps on behalf of the SBS Entity becoming subject to a statutory disqualification, or as a result of a person who is subject to a

natural person of the SBS Entity to effect or be involved in effecting security-based swaps on behalf of the SBS Entity, the Commission will issue an order denying the application. See Proposing Release, 80 FR at 51694.

³⁸ The Commission proposed two general limitations on the applicability of the temporary exclusion, namely that the temporary exclusion would not be available where: (1) the Commission has otherwise ordered—for example, where the Commission, by order, has censured, placed limitations on the activities or functions of the associated person, or suspended or barred such person from being associated with an SBS Entity; and (2) where the Commission, CFTC, an SRO or a registered futures association has previously denied membership, association, registration or listing as a principal with respect to the associated person that is the subject of the pending application. See *id.* at 51697. As discussed below, since the Commission is adopting the alternative that was set forth in the proposal, these limitations are no longer included in the rule. However, as discussed below, the Commission maintains its existing statutory authority to institute proceedings or bring an action against any associated person entities, and nothing in this provision affects the ability of the Commission, the CFTC, an SRO or the NFA to deny membership, association, registration or listing as a principal with respect to any associated person entity.

³⁹ See Proposing Release, 80 FR at 51694-98, 51721; proposed Rule of Practice 194(i).

statutory disqualification becoming an associated person effecting or involved in effecting security-based swaps on behalf of the SBS Entity.⁴⁰

The Commission also solicited comment on two alternative approaches with respect to the temporary exclusion, as proposed, including one alternative that would provide relief from the general prohibition in Exchange Act Section 15F(b)(6) with respect to all associated person entities.⁴¹ More specifically, the Commission requested comment on whether the Commission should instead provide an exclusion to permit an SBS Entity to allow associated person entities subject to a statutory disqualification to effect or be involved in effecting security-based swaps on behalf of SBS Entities.⁴² The Commission received two comments on this alternative, both of which stated that the Commission should not provide an exclusion to permit associated person entities that are subject to a statutory disqualification to effect or be involved in effecting security-based swaps on behalf of SBS Entities.⁴³

One commenter stated that adopting a temporary exclusion, as proposed, would be inconsistent with the language and Congressional intent of Exchange Act Section 15F(b)(6).⁴⁴ The commenter believes that the temporary exclusion provision addresses “industry-focused concerns” and would expose investors and markets to disruptive effects from unscrupulous

⁴⁰ See, e.g., Proposing Release, 80 FR at 51694.

⁴¹ See *id.* at 51697–98. The other alternative proposed by the Commission related to the ultimate disposition of an application to the extent the Commission does not act within a specified time period. See *id.* at 51697.

⁴² See *id.* at 51697–98, 51716. In addition, the Commission also provided an economic analysis on this proposed alternative. See *id.* at 51716.

⁴³ See Letter from Dennis M. Kelleher & Stephen W. Hall, Better Markets, Inc., dated October 26, 2015 (“Better Markets Letter”), at 5; Americans for Financial Reform Letter, at 3.

⁴⁴ See Better Markets Letter, at 5.

conduct by associated person entities subject to a statutory disqualification.⁴⁵ The commenter also believes that in the event that an associated person entity is prohibited from effecting or being involved in effecting security-based swaps on behalf of an SBS Entity, other market participants may fill the void with minimal disruption, or the SBS Entity may adopt measures to mitigate any negative impacts as a result of the statutory prohibition.⁴⁶

A second commenter provided similar objections to the temporary exclusion.⁴⁷ The commenter stated that disruption to an SBS Entity's business is not a sufficient justification for providing a temporary exclusion with respect to an associated person entity who is subject to a statutory disqualification. The commenter further stated that any statutory disqualification that may require an SBS Entity to move services (such as advisory, booking, cash or collateral management services) to another entity is not a "market-moving event," and would not justify the adoption of a temporary exclusion with respect to associated person entities. The commenter, however, acknowledged that there may be limited cases where an immediate change in a service provider would cause significant disruptions. But, rather than provide an automatic temporary exclusion, as proposed, the commenter suggested, as an alternative, that the Commission could in those limited cases grant a temporary exclusion of up to 30 days where doing so is appropriate and necessary.⁴⁸

The Commission received a related comment in response to a request for comment in connection with the proposed requirements for an SBS Entity to register with the Commission,

⁴⁵ *Id.*

⁴⁶ *See id.*

⁴⁷ *See* Americans for Financial Reform Letter, at 3.

⁴⁸ *See id.*

which solicited comment on whether the Commission should consider excepting associated person entities from the statutory prohibition in Exchange Act Section 15F(b)(6).⁴⁹ The commenter stated that, based on the Commission’s definition of the phrase “involved in effecting,” SBS Entities could have hundreds, if not thousands, of associated natural persons who will effect or will be involved in effecting security-based swaps.⁵⁰ Moreover, the commenter stated that the definition of “associated person” could be read to extend not just to natural persons, but also to non-natural persons (*e.g.*, entities) that are affiliates of SBS Entities.⁵¹ As a result, the commenter stated, prohibiting statutorily disqualified entities from effecting or being involved in effecting security-based swaps could result in “considerable” business disruptions and other ramifications.⁵² To address these concerns, the commenter stated that the Commission should narrow the scope of the associated persons considered to be effecting or involved in

⁴⁹ In connection with proposing requirements for an SBS Entity to register with the Commission, the Commission solicited comment on potentially developing an alternative process, in accordance with Exchange Act Section 15F(b)(6), to establish exceptions to the statutory prohibition in Exchange Act Section 15F(b)(6). See Registration Proposing Release, 76 FR at 65797 (Question 90).

⁵⁰ See Letter from Kenneth E. Bentsen, Jr., Securities Industry and Financial Markets Association, dated December 16, 2011 (“12/16/2011 SIFMA Letter”), at 8, *available at* <https://www.sec.gov/comments/s7-40-11/s74011-4.pdf>. The Commission has stated that the term “involved in effecting security-based swaps” generally means engaged in functions necessary to facilitate the SBS Entity’s security-based swap business, including, but not limited to the following activities: (1) drafting and negotiating master agreements and confirmations; (2) recommending security-based swap transactions to counterparties; (3) being involved in executing security-based swap transactions on a trading desk; (4) pricing security-based swap positions; (5) managing collateral for the SBS Entity; and (6) directly supervising persons engaged in the activities described in items (1) through (5) above. See Proposing Release, 80 FR at 51686, n.19 (citing the Registration Adopting Release, at Section II.B.1.ii.).

⁵¹ See 12/16/2011 SIFMA Letter.

⁵² See *id.* The commenter did not provide supporting data to quantify the number of associated persons or the magnitude of any potential business disruptions.

effecting security-based swaps, or, alternatively, exercise its statutory authority to grant exceptions to the general ban on an SBS Entity from associating with a person subject to a statutory disqualification.⁵³

The Commission believes that adopting a rule providing for an exclusion for associated person entities is consistent with Exchange Act Section 15F(b)(6), which explicitly permits the Commission to establish exceptions to that statutory prohibition by “rule, regulation, or order.”⁵⁴ In discussing the exclusion alternative, the Commission noted that it would take into consideration the extent to which this alternative approach would minimize potential disruptions to the business of SBS Entities that could lead to possible market disruption and how this approach would impact counterparty and investor protection.⁵⁵ We discuss each of those considerations below.

The Commission believes that granting an automatic exclusion for associated person entities could reduce potential disruptions to the business of SBS Entities that could lead to market disruption. The scope of the prohibition in Section 15F(b)(6) of the Exchange Act covers a wide range of actions, given the definitions of statutory disqualification and associated person, and the meaning of “involved in effecting” a security-based swap transaction.⁵⁶ Absent an exclusion, the statutory prohibition in Exchange Act Section 15F(b)(6) would apply immediately

⁵³ See *id.*

⁵⁴ 15 U.S.C. 78o-10(b)(6). In addition, Exchange Act Section 15F(b)(4) provides the Commission with authority (other than certain inapplicable exceptions specified in Exchange Act Section 15F(b)(4)(d) and (e)) to “prescribe rules applicable to security-based swap dealers and major security-based swap participants.” 15 U.S.C. 78o-10(b)(4).

⁵⁵ See Proposing Release, 80 FR at 51698.

⁵⁶ See Proposing Release, 80 FR at 51694. See also Registration Adopting Release, at Section III.B.1.i.

upon an associated person entity becoming subject to a statutory disqualification. Contrary to one commenter's general view that moving services to another entity is not a "market-moving event,"⁵⁷ the Commission continues to be concerned about the potential disruption to the security-based swap markets, including potential adverse effects to counterparties and other market participants, if SBS Entities engaged in the business must either cease operations, even temporarily, due to not being able to utilize the services of their associated person entities,⁵⁸ or move services to another entity that may not be as well-equipped to handle them pending a determination by the Commission on their application for relief under the proposed temporary exclusion or pending a determination by another regulator for similar relief.⁵⁹ For example, and as the Commission stated in the proposal, moving the cash and collateral management services from one entity to another would have a much more significant impact on the ability of the SBS Entity to operate—which, as noted above, could lead to possible market disruption—than assigning a different natural person to negotiate and execute security-based swap transactions.⁶⁰

⁵⁷ Americans for Financial Reform Letter, at 3. The commenter also acknowledged when discussing the proposed temporary exclusion for associated person entities that there may be some limited cases where an immediate change in a service provider would cause significant disruptions.

⁵⁸ See Proposing Release, 80 FR at 51695-96.

⁵⁹ Final Rule of Practice 194(h) provides that, subject to certain conditions, an SBS Entity may permit an associated person who is subject to a statutory disqualification to effect or be involved in effecting security-based swaps on its behalf, without making an application pursuant to the proposed rule, where the Commission, CFTC, an SRO or a registered futures association has granted a prior application or otherwise granted relief from a statutory disqualification with respect to that associated person. See Rule of Practice 194(h) and Section III.H, *infra*.

⁶⁰ See Proposing Release, 80 FR at 51696, n.88 (citing the Registration Adopting Release, 80 FR at 48975, where the Commission noted that it was particularly concerned that SBS Entities "may need to either cease operations, even temporarily, due to not being able to utilize these services of their associated person entities, or move these services to another

One commenter noted that other SBS Entities could potentially provide services to the market in the event that an associated person entity becomes subject to a statutory disqualification.⁶¹ However, irrespective of whether other SBS Entities may be able to provide such services over time (which may not necessarily occur), there is nonetheless a potential for short-term disruptions where an associated person entity becomes immediately barred as a result of being subject to a statutory disqualification. In particular, absent relief, an SBS Entity that is associated with a statutorily disqualified entity would be required either to restructure immediately or to cease dealing activity temporarily, which could result in various costs, such as costs associated with replacing the statutorily disqualified associated person entity or a legal reorganization.⁶² Such short-term disruptions could therefore adversely affect not just SBS Entities, but also counterparties or other market participants in the form of execution delays, potentially reduced liquidity or higher transaction costs.⁶³ In that respect, the exclusion is not limited to addressing “industry-focused concerns”⁶⁴ or concerns about disruptions to the SBS Entity’s business alone.⁶⁵

Although one commenter asserted that any short-term market disruptions could potentially be mitigated by the SBS Entity whose associated person entity becomes subject to a statutory disqualification, the commenter did not specify what measures could be taken by the

entity that may not be as well positioned to handle them, which could have an impact on the security-based swap market”).

⁶¹ See Better Markets Letter, at 5.

⁶² See also Section V.C.1.c, *infra*.

⁶³ See *id*.

⁶⁴ See Better Markets Letter, at 5.

⁶⁵ See Americans for Financial Reform Letter, at 3.

SBS Entity to mitigate potential market dislocations.⁶⁶ It is not clear that any measures that an SBS Entity could potentially take to mitigate potential market disruptions—*e.g.*, the SBS Entity restructuring its business to use the services of another associated person entity that is not subject to a statutory disqualification—would in all instances be effective, feasible, or cost-effective. For example, there may be instances where a change in a service provider could cause significant disruptions in the security-based swap market.⁶⁷ These disruptions are augmented by the fact that, as discussed below, the Commission estimates that dealing activity in the security-based swap market is highly concentrated among a small number of dealers, with the top five dealer accounts intermediating approximately 55 percent of all SBS Entity transactions.⁶⁸

In comparison to the proposed temporary exclusion approach, SBS Entities would be less constrained by the general statutory prohibition and would be able to associate with any and all statutorily disqualified associated person entities in any capacity without applying for relief under Exchange Act Section 15F(b)(6) or under Rule of Practice 194. This approach gives SBS Entities more certainty about their ability to permit statutorily disqualified associated person entities to effect or be involved in effecting security-based swaps, whereas the proposed temporary exclusion would have expired after 180 days, and SBS Entities would have 60 days to conform to the general statutory prohibition if the Commission, the CFTC, an SRO or a registered futures association does not render a decision on the application within that timeframe. Furthermore, SBS Entities associating with disqualified persons would not have to undergo

⁶⁶ See Better Markets Letter, at 5.

⁶⁷ See Americans for Financial Reform Letter, at 3 (acknowledging the potential for disruption in the event of an immediate change).

⁶⁸ See Section V.A, *infra*, for further discussion.

business restructuring or apply for relief, thereby mitigating the risk of disruptions and avoiding the costs associated with such restructuring or application for relief, which may flow through to counterparties under the rule being adopted.

As the Commission noted in the proposal, the overall effects on security-based swap markets of adopting the alternative approach are unclear. The proposal, in connection with estimating anticipated costs, noted that the alternative approach, which we are now adopting, could hinder the Commission's ability to make an individualized determination about whether permitting an associated person entity who is subject to a statutory disqualification to effect or be involved in effecting security-based swaps on behalf of an SBS Entity is consistent with the public interest, and that statutory disqualification and an inability to continue associating with SBS Entities creates disincentives against underlying misconduct for associated persons.⁶⁹ The Commission has also considered the potential impact on investors and the security-based swap markets from permitting associated person entities subject to a statutory disqualification to effect or be involved in effecting security-based swaps on behalf of SBS Entities. The Commission acknowledges, as it did in the proposal, that the counterparty and compliance risks under the entity exclusion approach may be somewhat greater than those under the proposed approach.⁷⁰ Nevertheless, the Commission recognizes, as it did in the proposal, that these risks and concerns are mitigated by the Commission's ability, in the appropriate case, to institute proceedings under Exchange Act Section 15F(l)(3) to determine whether the Commission should censure, place limitations on the activities or functions of such person, or suspend for a period not exceeding 12

⁶⁹ The Commission received comments supporting the potential deterrence effect of disqualification. *See, e.g.*, Public Citizen Letter; Better Markets Letter.

⁷⁰ *See, e.g.*, Better Markets Letter.

months, or bar such person from being associated with an SBS Entity.⁷¹ Therefore, the exclusion in final Rule of Practice 194(c) will neither limit nor otherwise affect the Commission's existing statutory authority to institute proceedings or bring an action against any associated person entities as outlined above.⁷² In addition, the exclusion in final Rule of Practice 194(c) will also neither limit nor otherwise affect the ability of the Commission, the CFTC, an SRO or the NFA to deny membership, association, registration or listing as a principal with respect to any associated person entity.⁷³

As also noted in the proposal,⁷⁴ this alternative approach would result in consistency with the CFTC's approach with respect to the statutory prohibition for Swap Entities as set forth in CEA Section 4s(b)(6).⁷⁵ The CFTC, with respect to statutorily disqualified associated persons of Swap Entities, limits the definition of associated persons of Swap Entities to natural persons.⁷⁶

⁷¹ See Proposing Release, 80 FR at 51698, n.98, 51716, n.194 (citing 15 U.S.C. 78o-10(l)(3)).

⁷² See Proposing Release, 80 FR at 51698, n.98, 51716, n.194 (citing 15 U.S.C. 78o-10(l)(3)). See, e.g., 15 U.S.C. 78u-3 (authorizing cease-and-desist proceedings).

⁷³ For example, under Exchange Act Section 15A(g)(2), 15 U.S.C. 78o-3(g)(2), where it is necessary or appropriate in the public interest or for the protection of investors, the Commission may, by order, direct the SRO to deny membership to any registered broker or dealer, and bar from becoming associated with a member any person, who is subject to a statutory disqualification. Section 17(h) of the CEA provides for the CFTC to review certain NFA decisions, including the NFA's disciplinary actions and member responsibility actions, as do the CFTC's Part 171 Rules, 17 CFR §§ 171.1-171.50.

⁷⁴ See Proposing Release, 80 FR at 51698.

⁷⁵ 7 U.S.C. 6s(b)(6).

⁷⁶ See 17 CFR 1.3(aa). Specifically, the CFTC amended CEA Regulation 1.3(aa), 17 CFR 1.3(aa), which generally defines the term "associated person" for purposes of entities registered with it, to cover Swap Entities. Consequently, with respect to Swap Entities, the definition reads, "(aa) Associated Person. This term means any natural person who is associated in any of the following capacities with: . . . (6) A swap dealer or major swap participant as a partner, officer, employee, agent (or any natural person occupying a similar status or performing similar functions), in any capacity that involves: (i) The

As a result, the prohibition in CEA Section 4s(b)(6) applies to natural persons (not entities) associated with a Swap Entity.⁷⁷ Indeed, under the alternative approach, which we are now adopting, SBS Entities cross-registered as Swap Entities with the CFTC would experience potential economies of scope in associating with persons that are statutorily disqualified entities.

One commenter noted that the temporary exclusion provision may expose investors and markets to disruptive effects from unscrupulous conduct by associated person entities subject to a statutory disqualification.⁷⁸ As noted in the Proposing Release, however, the Commission continues to believe that this approach appropriately considers the potentially competing objectives of minimizing the likelihood for market disruption while remaining consistent with the public interest and maintaining investor protections.⁷⁹

Given the adoption of the exclusion alternative for Rule of Practice 194(c), the Commission is not adopting a commenter's proposed alternative that the Commission could, on a case-by-case basis, provide a temporary exclusion of up to 30 days where doing so is necessary and appropriate. Under this alternative, pending approval by the Commission for such a temporary exclusion, an SBS Entity would be required to either (1) disassociate with the statutorily disqualified associated person entity immediately after the associated person entity

solicitation or acceptance of swaps (other than in a clerical or ministerial capacity); or (ii) The supervision of any person or persons so engaged.”).

⁷⁷ See 7 U.S.C. 6s(b)(6), which states, “Except to the extent otherwise specifically provided by rule, regulation, or order, it shall be unlawful for a swap dealer or a major swap participant to permit any person associated with a swap dealer or a major swap participant who is subject to a statutory disqualification to effect or be involved in effecting swaps on behalf of the swap dealer or major swap participant, if the swap dealer or major swap participant knew, or in the exercise of reasonable care should have known, of the statutory disqualification.”

⁷⁸ See Better Markets Letter, at 5.

⁷⁹ See *id.*

became subject to a statutory disqualification, or (2) immediately have that associated person cease effecting or being involved in effecting security-based swaps on behalf of the SBS Entity. This result would defeat the intent and purpose of the temporary exclusion and could result in a risk of market disruption immediately after the associated person entity becomes subject to a statutory disqualification, but prior to the entry of any order granting a temporary exclusion.

For the reasons discussed above, the Commission is adopting paragraph (c) of Rule of Practice 194, which provides an exclusion for an SBS Entity from the prohibition in Exchange Act Section 15F(b)(6) with respect to associated person entities.

D. Rule of Practice 194(d) – Form of Application

Proposed Rule of Practice 194 would have specified the form of the application to be submitted under the rule for natural persons.⁸⁰ In particular, the Commission proposed that each application would be required to be supported by a written statement, signed by a knowledgeable person authorized by the SBS Entity, which addresses other items in proposed Rule of Practice 194.⁸¹ The proposal would have required an applicant to provide certain exhibits to the written statement. For associated persons that are natural persons,⁸² the Commission proposed that an

⁸⁰ See *id.* at 51689-91, 51719; proposed Rule of Practice 194(c). The proposal also specified the form of application to be submitted under the rule for associated person entities. See proposed Rule of Practice 194(e). Rule of Practice 194(c), as adopted, provides an exclusion for an SBS Entity from the prohibition in Exchange Act Section 15F(b)(6) with respect to associated persons entities. Accordingly, the corresponding provision, proposed Rule of Practice 194(e), which would have specified the form of such applications for entities, is not needed and is not being adopted.

⁸¹ See Section III.E, *infra*, for a discussion of proposed Rule of Practice 194(d).

⁸² The Commission is making one technical change to the text of Rule of Practice 194(d) such that the phrase a “person *that* is subject to a statutory disqualification” (emphasis added) is being changed to read a “person *who* is subject to a statutory disqualification” (emphasis added). This technical change is intended to make the text of Rule of Practice 194 more closely track the language used in Exchange Act Section 15F(b)(6), which

SBS Entity provide: (1) a copy of the order or other applicable document that resulted in the associated person being subject to a statutory disqualification;⁸³ (2) an undertaking by the applicant to notify the Commission promptly in writing if any information submitted in support of the application becomes materially false or misleading while the application is pending;⁸⁴ (3) a copy of the questionnaire or application for employment specified in Exchange Act Rule 15Fb6-2(b);⁸⁵ and (4) a copy of any decision, order, or document issued with respect to any proceeding⁸⁶ resulting in the imposition of disciplinary sanctions or pending proceeding against the associated person by the Commission, CFTC, any federal or state or law enforcement regulatory agency, registered futures association, foreign financial regulatory authority, registered national securities association, or any other SRO, or commodities exchange, or any court, that occurred during the five years preceding the filing of the application pursuant to Rule of Practice 194.⁸⁷ The Commission also proposed that an application under Rule of Practice 194 would be filed

reads, in pertinent part, “*who* is subject to a statutory disqualification” (emphasis added). This technical change is also being made to Rule of Practice 194 (h)(1) and (h)(2).

⁸³ See proposed Rule of Practice 194(c)(1).

⁸⁴ See *id.* (c)(2).

⁸⁵ 17 CFR 240.15Fb6-2(b); see proposed Rule of Practice 194(c)(3).

⁸⁶ In connection with final Rule of Practice 194, applicants should look to the definition of “proceeding” in Form SBSE, which states that a “proceeding” includes “a formal administrative or civil action initiated by a governmental agency, self-regulatory organization or a foreign financial regulatory authority; a felony criminal indictment or information (or equivalent formal charge); or a misdemeanor criminal information (or equivalent formal charge). Does not include other civil litigation, investigations, or arrests or similar charges effected in the absence of a formal criminal indictment or information (or equivalent formal charge).” See Registration Adopting Release, at Section III.G.1, and Form SBSE.

⁸⁷ See proposed Rule of Practice 194(c)(4).

pursuant to Rules of Practice 151, 152 and 153.⁸⁸

The Commission did not receive any specific comments on the form of application and written statement in proposed Rule of Practice 194. However, one commenter stated that the Commission should require applicants to address disciplinary events going back ten years, not five years.⁸⁹ In support of a longer time period, the commenter stated that a ten-year time period would provide greater protections in accordance with the purpose of Exchange Act Section 15F(b)(6), and would be more consistent with other provisions of the securities laws dealing with statutory disqualification.⁹⁰

The Commission is adopting renamed paragraph (d) of Rule of Practice 194 as proposed, including the five-year time period in the proposal, for the reasons discussed in the Proposing Release.⁹¹ In determining to adopt the proposed five-year time period, the Commission carefully considered the burden that may be imposed by requiring SBS Entities to provide older materials and documents that may not be as readily available, as well as our need to evaluate the context

⁸⁸ 17 CFR 201.151, 201.152, 201.153. Rule of Practice 151, 17 CFR 201.151, concerns the procedure for filing of papers with the Commission; Rule of Practice 152, 17 CFR 201.152, concerns the form of filing papers with the Commission; Rule of Practice 153, 17 CFR 201.153, concerns the signature requirement and effect of filing papers.

⁸⁹ See Better Markets Letter, at 6. Although the commenter did not specify a particular provision, the Commission did propose a five-year time period in proposed paragraph (c)(4). Proposed paragraph (c)(4) would require a copy of any decision, order, or document issued with respect to any proceedings resulting in the imposition of disciplinary sanctions or pending proceeding against the associated person by the Commission, CFTC, any federal or state or law enforcement regulatory agency, registered futures association, foreign financial regulatory authority, registered national securities association, or any other SRO, or commodities exchange, or any court, that occurred during the five years preceding the filing of the application pursuant to Rule of Practice 194. Proposed paragraphs (d)(6) and (d)(10) also contain similar requests for certain information for a five-year time period. See Section III.E, *infra*.

⁹⁰ See Better Markets Letter, at 6.

⁹¹ Proposing Release, 80 FR at 51689-91, 51719; proposed Rule of Practice 194(c).

and circumstances underlying the application.⁹² Furthermore, we note that paragraph (d)(1) of the Rule as adopted requires that the application include a copy of the order or other applicable document that resulted in the associated person being subject to a statutory disqualification. Therefore, the orders or other applicable documents provided with the application may go back longer than five years.⁹³

In addition, the Commission does not agree with the commenter that a ten-year time period would be more consistent with the current practice in similar contexts. Paragraph (d)(4) of the final rule requires a copy of any decision, order, or document issued with respect to any proceeding resulting in the imposition of disciplinary sanctions or pending proceeding against the associated person by the Commission, CFTC, any federal or state or law enforcement regulatory agency, registered futures association, foreign financial regulatory authority, registered national securities association, or any other SRO, or commodities exchange, or any court, that occurred during the five years preceding the filing of the application pursuant to Rule of Practice 194. FINRA's membership continuance applications require analogous disciplinary information for a five-year time period—not a ten-year time period.⁹⁴ For example, like

⁹² We note that the Appendix paragraph (c) to Rule of Practice 194 states that, in addition to the information required by the rule, Commission staff may request supplementary information from the applicant to assist in the Commission's review. *See also* Proposing Release, 80 FR at 51689, n.54, 51722 (proposing the same requirement).

⁹³ For example, statutory disqualification may result where an associated person has committed "any other felony within ten years." 15 U.S.C. 78c(a)(39)(F). *See also, e.g.*, 15 U.S.C. 80a-9(a) (ineligibility under Section 9(a) of the Investment Company Act of 1940 ("Investment Company Act") may result where a person (or an affiliated person) within ten years has been convicted of any felony or misdemeanor involving the purchase or sale of any security or arising out of such person's conduct as an underwriter, broker, dealer, investment adviser, or in other specified categories).

⁹⁴ *See* FINRA Form MC-400, Section 4, Items 9a, 11; FINRA Form MC-400A, Section 2, Items 4, 5.

paragraph (d)(4), FINRA Form MC-400, Section 4, Items 9 and FINRA Form MC-400A, Section 2, Item 4 request information within the past five years concerning “any proceeding which has resulted in the imposition of disciplinary sanctions by FINRA, the U.S. Securities and Exchange Commission, the Commodity Futures Trading Commission, any federal or regulatory agency, foreign financial regulatory authority, any self-regulatory organization or commodities exchange, or any court or state agency.”⁹⁵ Additionally, the Commission’s Rule of Practice 193 only requires compliance and disciplinary history during the two years preceding the filing of a Rule 193 application.⁹⁶

As with the proposed rule, under the terms of the final rule, the SBS Entity (rather than the associated person) will be required to submit the application, including the signed written statement under paragraph (d). Further, as specified below, the Commission is requiring certain information (*e.g.*, concerning the supervision by the SBS Entity over the associated person) to be submitted with the application that is within the possession of the SBS Entity itself. An application under Rule of Practice 194, as proposed and adopted, will be filed pursuant to Rules of Practice 151, 152 and 153.⁹⁷ The Commission believes that filing pursuant to these rules will provide the Commission with the information that it needs to assess an application under Rule of Practice 194.

⁹⁵ FINRA Form MC-400, Section 4, Item 9a; FINRA Form MC-400A, Section 2, Item 4.

⁹⁶ See 17 CFR 201.193(b)(4)(iii). However, and as noted above, although paragraph (d)(4) (and other provisions relating to information that an applicant must provide regarding an individual’s disciplinary history) provide for a five-year time period, applicants will be required under paragraph (d)(1) of the final rule to provide the Commission with a copy of an order or other applicable document which subjects the individual to, a statutory disqualification irrespective of when the misconduct that gives rise to the statutory disqualification occurred (*e.g.*, even if outside the five-year time period).

⁹⁷ 17 CFR 201.151, 201.152, 201.153. See also Note 88, *supra*.

E. Rule of Practice 194(e) – Written Statement

Proposed Rule of Practice 194 would have set forth the items to be addressed for applications for natural persons.⁹⁸ In particular, the Commission proposed to require an applicant to address certain information in the written statement. For associated persons that are natural persons, an SBS Entity would be required to address: (i) the associated person's compliance with any order resulting in the statutory disqualification;⁹⁹ (ii) the associated person's employment during the period subsequent to the event giving rise to the statutory disqualification;¹⁰⁰ (iii) the capacity or position in which the associated person subject to a statutory disqualification proposes to be associated with the SBS Entity;¹⁰¹ (iv) the terms and conditions of employment and supervision to be exercised over the associated person and, where applicable, by such associated person;¹⁰² (v) the qualifications, experience, and disciplinary history¹⁰³ of the proposed supervisor(s) of the associated person;¹⁰⁴ (vi) the compliance and

⁹⁸ See Proposing Release, 80 FR at 51691-93, 51719-20; proposed Rule of Practice 194(d). The proposal also set forth the items to be addressed for applications for associated person entities. See proposed Rule of Practice 194(f). Rule of Practice 194(c), as adopted, provides an exclusion for an SBS Entity from the prohibition in Exchange Act Section 15F(b)(6) with respect to associated persons entities; therefore, the corresponding provision with respect to associate person entities, proposed Rule of Practice 194(f), is not needed and is not being adopted.

⁹⁹ See proposed Rule of Practice 194(d)(1).

¹⁰⁰ See *id.* (d)(2).

¹⁰¹ See *id.* (d)(3).

¹⁰² See *id.* (d)(4).

¹⁰³ Disciplinary history would include, for example, the items contained in Exchange Act Rule 17a-3(a)(12)(i)(D) through (G), 17 CFR 240.17a-3(a)(12)(i)(D) through (G), which items are required to be collected by broker-dealers with respect to their associated persons and are required to be provided on Form U-4. Such items include, among other things, a record of any disciplinary action taken, or sanction imposed, upon the associated person by any federal or state agency, or national securities exchange or national securities association, a record of any permanent or temporary injunction entered against

disciplinary history, during the five years preceding the filing of the application, of the SBS Entity;¹⁰⁵ (vii) the names of any other statutorily disqualified associated persons at the SBS Entity, and whether they are to be supervised by the associated person;¹⁰⁶ (viii) whether the associated person has taken any relevant courses, seminars, examinations or other actions subsequent to becoming subject to a statutory disqualification to prepare for his or her participation in the security-based swap business;¹⁰⁷ (ix) why the associated person should be permitted to effect or be involved in effecting security-based swaps on behalf of the SBS Entity;¹⁰⁸ (x) whether, during the five years preceding the filing of the application, the associated person has been involved in any litigation concerning investment or investment-related activities or whether there are there any unsatisfied judgments outstanding against the associated person concerning investment or investment-related activities;¹⁰⁹ and (xi) any other information that the

the associated person, or a record of any arrest or indictment for any felony or certain specified types of misdemeanors. *See also* 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, 25205, 25308-09 (May 2, 2014).

¹⁰⁴ See proposed Rule of Practice 194(d)(5).

¹⁰⁵ See *id.* (d)(6).

¹⁰⁶ See *id.* (d)(7).

¹⁰⁷ See *id.* (d)(8).

¹⁰⁸ See *id.* (d)(9).

¹⁰⁹ See *id.* (d)(10). Applicants should look to the definition of “investment or investment-related” in Form SBSE, which states that “investment or investment-related” includes “pertaining to securities, commodities, banking, savings association activities, credit union activities, insurance, or real estate (including, but not limited to, acting as or being associated with a broker-dealer, municipal securities dealer, government securities broker or dealer, issuer, investment company, investment adviser, futures sponsor, bank, security-based swap dealer, major security-based swap participant, savings association, credit union, insurance company, or insurance agency).” See Registration Adopting Release, Form SBSE.

applicant believes to be material to the application.¹¹⁰

The Commission did not receive any specific comments on the items to be addressed set forth in the proposal. However, as discussed in Section III.D above, the Commission received one general comment stating that the Commission should require applicants to address disciplinary events going back ten years, not five years.¹¹¹ For the same reasons set forth above in Section III.D, the Commission is adopting the five-year time period as proposed, and for the reasons discussed in the proposal,¹¹² the Commission is adopting renamed paragraph (e) of Rule of Practice 194, as proposed, with four minor technical changes.¹¹³

F. Rule of Practice 194(f) – Prior Applications or Processes

Proposed Rule of Practice 194 would have required an applicant to provide as part of the application any order, notice or other applicable document reflecting the grant, denial or other disposition (including any dispositions on appeal) of any prior application concerning the associated person under Rule of Practice 194 and other similar processes.¹¹⁴ More specifically, the proposal would have required an applicant to provide any order, notice or other applicable

¹¹⁰ See proposed Rule of Practice 194(d)(11).

¹¹¹ See Better Markets Letter, at 6. The commenter did not specify a particular provision of the proposal.

¹¹² See Proposing Release, 80 FR at 51691-93, 51719-20; proposed Rule of Practice 194(d).

¹¹³ The technical changes are (1) updating an internal cross reference to subsection (c) in the proposal to reflect subsection (d) in final Rule of Practice 194; (2) moving the phrase “notwithstanding the event resulting in statutory disqualification” from an introductory phrase to later in the text of subparagraph (9) to clarify any possible ambiguity in subparagraph (9) without changing the scope of that provision; (3) updating the technical wording in subparagraph (e)(9) to more closely conform to the other provisions in subsection (e) by removing the phrase “the applicant should provide;” and (4) changing the term “impact upon” to “affect” to clarify any possible ambiguity in subparagraph (9) without changing the scope of the provision.

¹¹⁴ See Proposing Release, 80 FR at 51693-94, 51720-21; proposed Rule of Practice 194(g).

document where an application has previously been made for the associated person: (1) pursuant to Rule of Practice 194;¹¹⁵ (2) pursuant to Rule of Practice 193;¹¹⁶ (3) pursuant to Section 9(c) of the Investment Company Act;¹¹⁷ (4) pursuant to Exchange Act Section 19(d),¹¹⁸ Exchange Act Rule 19h-1¹¹⁹ or a proceeding by an SRO for a person to become or remain a member, or an associated person of a member, notwithstanding the existence of a statutory disqualification; and (5) by the CFTC or a registered futures association for registration, including as a principal, notwithstanding the existence of a statutory disqualification.¹²⁰ Proposed Rule of Practice 194 also addressed: (i) the exception in CFTC Regulation 23.22(b)¹²¹ by requiring an SBS Entity to provide any order or other applicable document providing that the associated person may be listed as a principal, registered as an associated person of another CFTC registrant, or registered as a floor broker or floor trader, notwithstanding the statutory disqualification and (ii) the CFTC's and NFA's current process for granting relief from CEA Section 4s(b)(6),¹²² the

¹¹⁵ See proposed Rule of Practice 194(g)(1).

¹¹⁶ 17 CFR 201.193; see proposed Rule of Practice 194(g)(2).

¹¹⁷ 15 U.S.C. 80a-9(c); see proposed Rule of Practice 194(g)(3).

¹¹⁸ 15 U.S.C. 78s(d); see proposed Rule of Practice 194(g)(4).

¹¹⁹ 17 CFR 240.19h-1.

¹²⁰ See proposed Rule of Practice 194(g)(5).

¹²¹ 17 CFR 23.22(b); see proposed Rule of Practice 194(g)(5)(i). Under that provision, the CFTC allows association with a Swap Entity with respect to a person who is already listed as a principal, registered as an associated person of another CFTC registrant, or registered as a floor broker or floor trader, notwithstanding that the person is subject to a statutory disqualification under section 8a(2) or 8a(3) (7 U.S.C. 12a(2), (3)) of the CEA. See Note 11, *supra*.

¹²² 7 U.S.C. 6s(b)(6); see proposed Rule of Practice 194(g)(5)(ii). This provision requires the SBS Entity to submit any determination by NFA (the sole registered futures association, see CFTC Registration Release, 77 FR at 2624) with respect to that grant of no-action relief. The Commission is adopting the language in paragraph (f)(5)(ii) largely as proposed but with a minor technical modification to more accurately reflect the

provision that is parallel to Exchange Act Section 15F(b)(6), with respect to persons that are not exempt from that provision pursuant to CFTC Regulation 23.22(b).¹²³

Although the Commission did not receive any comments specifically addressing this provision of the proposal, one commenter stated that the Commission should take into account the views of other regulatory bodies that may have adjudicated similar issues with respect to the associated persons subject to a statutory disqualification.¹²⁴ Renamed paragraph (f) of Rule of Practice 194, as adopted, will facilitate the Commission's ability to take such views into account.

Paragraph (f) to Rule of Practice 194 is designed to inform the Commission when a similar application made with respect to the associated person has been granted or denied (or been subject to some other disposition).¹²⁵ Information concerning the grant or denial (or other disposition) of a prior application or other request for relief, and the reasons for the grant or denial, may inform the Commission's assessment as to whether it would be consistent with the public interest for the person to effect or be involved in effecting security-based swaps on behalf of an SBS Entity.

For example, in the event that a prior application has been granted, but the terms and conditions of the association with the other registrant are materially different than the proposed terms and conditions of the statutorily disqualified person's association with the SBS Entity, the

CFTC's and NFA's approach to statutory disqualification.

¹²³ 17 CFR 23.22(b).

¹²⁴ Letter from Elijah E. Cummings, Ranking Member, Committee on Oversight and Government Reform, U.S. House of Representatives, dated November 13, 2015 ("Cummings Letter"), at 2.

¹²⁵ As discussed in the Proposing Release, in cases where a statutorily disqualified person was formerly associated with another SBS Entity, an applicant should use reasonable efforts to obtain relevant documentation from the other SBS Entity.

Commission could consider whether the terms and conditions at the SBS Entity that are different may result in any greater risk of future misconduct.¹²⁶

Accordingly, for reasons discussed in the proposal,¹²⁷ the Commission is adopting renamed Rule of Practice 194(f), as proposed, with one minor technical change to more accurately reflect the CFTC's and NFA's approach to statutory disqualification.

The proposal would have required an applicant to provide any order, notice or other applicable document reflecting the grant, denial or other disposition (including any dispositions on appeal) of any prior application or process concerning the associated person by the CFTC and NFA through their process for granting relief from CEA Section 4s(b)(6)¹²⁸ with respect to persons that are not exempt from that provision pursuant to CFTC Regulation 23.22(b).¹²⁹ Under the CEA and CFTC regulations, the consequences of an individual's statutory disqualification differ depending upon whether the individual is an associated person of a CFTC registrant or a

¹²⁶ Notably, in circumstances where the prior application has been denied or where the terms and conditions of employment are not the same, an SBS Entity cannot avail itself of paragraph (h) of Rule of Practice 194, see Section III.H, *infra*, and therefore will be required to file an application under Rule of Practice 194 in order to permit an associated person subject to a statutory disqualification to be able to effect or be involved in effecting security-based swaps on behalf of an SBS Entity.

¹²⁷ See Rule of Practice 194 Proposing Release, 80 FR at 51693-94, 51720-21.

¹²⁸ 7 U.S.C. 6s(b)(6).

¹²⁹ 17 CFR 23.22(b). See Proposing Release, 80 FR at 51693-51694, 51721; proposed Rule of Practice 194(g)(5)(ii). Under the CFTC and NFA's process, available through no-action relief granted by CFTC staff, a Swap Entity may make an application to NFA to permit an associated person of a Swap Entity subject to a statutory disqualification to effect or be involved in effecting swaps on behalf of the Swap Entity. NFA will provide notice to a Swap Entity whether or not NFA would have granted the person registration as an associated person. As noted in the Proposing Release, and as adopted here as well, the rule requires the SBS Entity to submit any determination by NFA (the sole registered futures association) with respect to that grant of no-action relief. See CFTC Letter No. 12-15, at 5-8 (Oct. 11, 2012), available at <http://www.cftc.gov/ucm/groups/public/@lrllettergeneral/documents/letter/12-15.pdf>.

principal of a CFTC registrant. An associated person of a CFTC registrant is required to register separately with the CFTC by filing his or her own application for registration. Therefore, if the associated person of a CFTC registrant has a statutory disqualification, the application for registration will be denied unless the associated person goes through the process established by NFA to be registered notwithstanding the statutory disqualification. However, a principal of a CFTC registrant does not apply, either for registration or to be listed as a principal. Rather, the entity of which the person is a principal is required to list that principal on the entity's application for registration with the CFTC. As a result, if the principal has a statutory disqualification, the entity's application for registration with the CFTC will be denied unless the entity goes through the process with NFA to be registered, notwithstanding having to list a statutorily disqualified principal.¹³⁰

G. Rule of Practice 194(g) – Notification to Applicant and Written Statement

Proposed Rule of Practice 194 would have set forth the procedure where there is an adverse recommendation proposed by the Commission staff with respect to an application under proposed Rule of Practice 194.¹³¹ Consistent with Rule of Practice 193(e),¹³² the Commission proposed that where there would be an adverse recommendation, the applicant would be so advised and provided with a written statement by the Commission staff of the reasons for such

¹³⁰ Accordingly, the Commission has adopted the following language with the new language underlined for subpart (ii): “Any determination by a registered futures association (as provided in 7 U.S.C. 21) that had the associated person applied for registration as an associated person of a swap dealer or a major swap participant, or had a swap dealer or major swap participant listed the associated person as a principal in the swap dealer’s or major swap participant’s application for registration, notwithstanding statutory disqualification, the application of the associated person or of the swap dealer or major swap participant, as the case may be, would have been granted or denied.”

¹³¹ See Proposing Release, 80 FR at 51694, 51721; proposed Rule of Practice 194(h).

¹³² 17 CFR 201.193(e).

recommendation, and the applicant would then have 30 days to submit to the Commission a written statement in response.¹³³

The Commission did not receive comments concerning this provision of the proposal and, for the reasons discussed in the proposal, is adopting renamed paragraph (g) of Rule of Practice 194 as proposed.¹³⁴

H. Rule of Practice 194(h) – Notice in Lieu of an Application

Proposed Rule of Practice 194 would have limited the applicability of the statutory prohibition in Exchange Act Section 15F(b)(6) by prescribing the conditions under which an SBS Entity could permit a person associated with it who is subject to a statutory disqualification to effect or be involved in effecting security-based swaps on its behalf without being required to file an application under Rule of Practice 194.¹³⁵ The Commission proposed to permit, subject to all of the conditions specified in proposed paragraph (j)(2) being met,¹³⁶ an associated person who is subject to a statutory disqualification to effect or be involved in effecting security-based swaps on behalf of SBS Entities where the Commission or other regulatory authority previously reviewed the matter and permitted the person subject to a statutory disqualification to be a member, associated with a member, registered or listed as a principal of a regulated entity notwithstanding the statutory disqualification.¹³⁷ The Commission also proposed that where an

¹³³ See Proposing Release, 80 FR at 51694, 51721; proposed Rule of Practice 194(h).

¹³⁴ See *id.*

¹³⁵ Proposing Release, 80 FR at 51698-700, 51721-22; proposed Rule of Practice 194(j).

¹³⁶ As explained in the proposal, “[a]n SBS Entity seeking to rely on proposed Rule of Practice (j)(1) would have to meet all of the conditions specified in proposed paragraph (j)(2).” *Id.* at 51699. The same is true for adopted Rule of Practice 194(h).

¹³⁷ See *id.* at 51698-99 (discussing proposed paragraph (j)(1)(i) through (iv)). These same provisions are being adopted in Rule of Practice 194(h)(1)(i) through (iv). We note that

SBS Entity meets certain requirements the SBS Entity would be permitted to file notice with the Commission (in lieu of an application).¹³⁸

The Commission received comments objecting generally to the proposal.¹³⁹ One commenter stated that the provision should not be adopted as proposed because FINRA's statutory disqualification process is "typically designed for individuals" and Exchange Act Section 15F(b)(4) creates a "new statutory disqualification." As outlined above, FINRA member firms that are themselves subject to a statutory disqualification and wish to obtain relief from the eligibility requirements are required to seek approval from FINRA.¹⁴⁰ Furthermore, Exchange Act Section 15F(b)(4)¹⁴¹ does not reference "statutory disqualification" or otherwise establish a category of conduct that would disqualify an associated person from effecting or being involved in effecting security-based swaps.¹⁴²

Rule of Practice 194(h) would not be applicable in instances where the Commission itself has made an affirmative determination to bar or suspend the associated person. *See id.* at 51698 (explaining that, other than in cases where the person is subject to a Commission bar, the Commission did not believe it would be necessary to re-examine an event for which relief has already been granted by the CFTC, an SRO or a registered futures association).

¹³⁸ See Proposing Release, 80 FR at 51699-700; proposed Rule of Practice 194(j)(2)(iii), (iv).

¹³⁹ Americans for Financial Reform Letter, at 2; Better Markets Letter, at 3-4; Public Citizen Letter, at 4-5; Cummings Letter, at 2-3.

¹⁴⁰ See Note 9, *supra* (discussing FINRA Form MC-400A, Membership Continuance Application: Member Firm Disqualification Application, <http://www.finra.org/web/groups/industry/@ip/@enf/@adj/documents/industry/p013339.pdf>).

¹⁴¹ As noted above, *see* Note 54, *supra*, Exchange Act Section 15F(b)(4) provides the Commission with authority (other than certain inapplicable exceptions specified in Exchange Act Section 15F(b)(4)(d) and (e)) to "prescribe rules applicable to security-based swap dealers and major security-based swap participants." 15 U.S.C. 78o-10(b)(4).

¹⁴² Rather, Exchange Act Section 15F(b)(6) references "statutory disqualification," and the Commission has previously stated that a "statutory disqualification" for purposes of

The Commission also received comments arguing that allowing deference to SROs is inconsistent with current practice.¹⁴³ However, the Commission observes that Rule of Practice 194(h) is generally consistent with the current practice with respect to SROs and their members. For example, the information provided by the notice under adopted paragraph (h)(2)(iii) is consistent with the information that is currently required for a notification under Exchange Act Rule 19h-1(a)(4).¹⁴⁴ In the event that the views of the Commission were to diverge from the CFTC, an SRO or a registered futures association with respect to an associated person subject to a statutory disqualification under the statutory scheme of the Exchange Act, under Exchange Act Section 15F(l)(3), the Commission retains the authority to, by order, censure, place limitations on the activities or functions of the associated person, or suspend or bar such person from being associated with an SBS Entity.¹⁴⁵ As a result, even in cases where the CFTC, an SRO or a registered futures association has previously granted relief and an SBS Entity files a notice in lieu of an application under Rule of Practice 194(h), the Commission may, in the appropriate case, institute proceedings under Exchange Act Section 15F(l)(3) to determine whether the Commission should censure, place limitations on the activities or functions of such person, or

Exchange Act Section 15F(b)(6) is not a new defined term (with additional categories), but rather is described (consistent with other contexts) in Exchange Act Sections 3(a)(39)(A) through (F). 15 U.S.C. 78c(a)(39)(A) through (F); *see also* Registration Adopting Release, 80 FR at 48972; 17 CFR 240.15Fb2-1(e); 17 CFR 240.15Fb6-1; 17 CFR 240.15Fb6-2.

¹⁴³ See Americans for Financial Reform Letter, at 2. *See also* Cummings Letter, at 2-3 (arguing that the Commission should not delegate its authority to interpret the Exchange Act to the CFTC, FINRA or a registered futures association, in part, because “[n]one of the entities to which the proposed rule would grant the authority to issue a waiver has been granted that responsibility by statute.”).

¹⁴⁴ 17 CFR 240.19h-1(a)(4); proposed Rule of Practice 194(j)(2)(iii), (iv).

¹⁴⁵ 15 U.S.C. 78o-10(l)(3). *See also* Proposing Release, 80 FR at 51698 n.98.

suspend for a period not exceeding 12 months, or bar such person from being associated with an SBS Entity.¹⁴⁶ The Commission also believes that where the conditions set forth in paragraph (h) are met, it would not be necessary for the Commission (other than in cases where the person is subject to a Commission bar) to re-examine by means of a full application under Rule of Practice 194 an event for which relief has already been granted. Rather, the Commission believes that the better approach is to require an applicant to provide a notice under Rule of Practice 194(h) in lieu of a full application under Rule of Practice 194, which would alert the Commission to issues that could lead to the institution of proceedings pursuant to Exchange Act Section 15F(l)(3)¹⁴⁷ where doing so is appropriate.

Another commenter argued that the Commission should not “delegate” its authority to determine whether an exclusion from Exchange Act Section 15F(b)(6) is appropriate because regulators administer different statutory schemes and have different priorities.¹⁴⁸ This same commenter argued that this proposed subsection should not be adopted because, among other things, the Commission should exercise its own judgment in each case to ensure that the policies underlying the securities laws are fulfilled.¹⁴⁹

The Commission acknowledges that other regulators administer different statutory

¹⁴⁶ See 15 U.S.C. 78o-10(l)(3). *See also, e.g.*, 15 U.S.C. 15(b)(6).

¹⁴⁷ 15 U.S.C. 78o-10(l)(3).

¹⁴⁸ See Better Markets Letter, at 3-4.

¹⁴⁹ See Better Markets Letter, at 3-4 (arguing that this proposed subsection should not be adopted because the Commission should exercise its judgment in each case to ensure that the policies underlying the securities laws are fulfilled and because the proposal would not ensure that applications for an exemption from disqualification will be subject to strong, consistent, and relevant considerations under the securities laws).

schemes,¹⁵⁰ but it does not believe that the applicable standards that regulators identified in paragraph (h) use in their respective statutory disqualification processes are sufficiently different to warrant requiring SBS Entities to file a full application under Rule of Practice 194, as opposed to a notice in lieu of an application. In particular, the CFTC and NFA assess whether registration would not pose a substantial risk to the public despite the existence of the statutory disqualification.¹⁵¹ Likewise, and as noted above, consistent with Exchange Act Section 15A(g)(2),¹⁵² under Article 3, Section 3(d) of the FINRA By-Laws,¹⁵³ the FINRA Board may, in its discretion, approve the continuance in membership, and may also approve the association or continuance of association of any person, if the FINRA Board determines that such approval is consistent with the public interest and the protection of investors.¹⁵⁴ Although the CFTC or a registered futures association may not review “considerations under the securities laws,”¹⁵⁵ and may have “different statutory schemes and . . . different priorities,”¹⁵⁶ those regulators, and SROs, will generally assess whether it is consistent with the public interest to permit a person who is subject to statutory disqualification to be associated with (or a principal of) a registered entity. As a result, a review by the regulators provided for in paragraph (h) would substantially overlap with any review that the Commission would undertake in assessing whether an applicant

¹⁵⁰ See Better Markets Letter, at 3-4; Cummings Letter, at 2-3.

¹⁵¹ See CEA Regulation 3.60(e)(1), (2), 17 CFR 3.60(e)(1)(2), NFA Registration 507(a)(1), (2).

¹⁵² 15 U.S.C. 78o-3(g)(2).

¹⁵³ See FINRA By-Laws, Article III, Section 3(d), http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4606. See also Registration Proposing Release, 80 FR at 51687.

¹⁵⁴ See also FINRA Rules 9522(e), 9524(b)(1).

¹⁵⁵ See Better Markets Letter, at 3-4.

¹⁵⁶ *Id.*

has made a showing under Rule of Practice 194(b) that it would be consistent with the public interest to grant relief with respect to a statutorily disqualified associated person. And, as stated, the Commission will retain authority under Exchange Act Section 15F(l)(3)¹⁵⁷ to determine whether potential considerations under the securities law would warrant diverging from a decision of another regulator in a particular matter.

Similarly, the Commission received comments arguing that SROs are conflicted or do not otherwise have the impartiality necessary to make decisions regarding the best interests of the public.¹⁵⁸ While the Commission has carefully considered the concerns raised by these commenters, the Commission believes that the statutory and regulatory framework under which SROs operate (including the Commission's oversight function of SROs¹⁵⁹ and the CFTC's oversight of the NFA¹⁶⁰), and the Commission's independent authority to, where appropriate,

¹⁵⁷ 15 U.S.C. 78o-10(l)(3).

¹⁵⁸ See Public Citizen Letter, at 4-5; Better Markets Letter, at 3-4; Cummings Letter, at 2; Americans for Financial Reform Letter, at 2.

¹⁵⁹ As stated in Note 9, *supra*, an SRO may be required to send a notice or notification to the Commission of its proposal to admit or continue the membership of a person or association with a member notwithstanding statutory disqualification in accordance with Exchange Act Rule 19h-1. See 17 CFR 240.19h-1. Under Exchange Act Section 15A(g)(2), 15 U.S.C. 78o-3(g)(2), where it is necessary or appropriate in the public interest or for the protection of investors, the Commission may, by order, direct the SRO to deny membership to any registered broker or dealer, and bar from becoming associated with a member any person, who is subject to a statutory disqualification. See also 15 U.S.C. 78f(c)(2) (national securities exchange); 15 U.S.C. 78q-1(b)(4)(A) (registered clearing agency).

¹⁶⁰ The NFA is a registered futures association under section 17 of the CEA, 7 U.S.C. 21, and is the SRO for swap transactions. Section 17(h) of the CEA provides for CFTC review of certain NFA decisions, including the NFA's disciplinary actions and member responsibility actions, as do the CFTC's Part 171 Rules, 17 CFR §§ 171.1-171.50. In addition, the CFTC may institute review of disciplinary actions taken by the NFA on its own motion. See 17 U.S.C. 21(h)(3). See also CFTC, Division of Clearing and Intermediary Oversight, *Review of the Disciplinary Program of National Futures*

institute proceedings with respect to the statutorily disqualified associated person under Exchange Act Section 15F(l)(3), serves to mitigate commenters' concerns.¹⁶¹ SROs are entrusted with quasi-governmental authority, and, subject to Commission oversight.¹⁶² SROs must also be organized and have the capacity to carry out the purposes of the Exchange Act and to comply and enforce compliance by its members and persons associated with its members with the Exchange Act, the rules and regulations thereunder and the rules of the SRO.¹⁶³ The Exchange Act reflects a recognition of self-regulation as a fundamental component of the oversight and supervision of U.S. securities markets and their members.

The Commission likewise disagrees with a commenter's view that "[n]one of the entities to which the proposed rule would grant the authority to issue a waiver has been granted that responsibility by statute."¹⁶⁴ To the extent that the commenter may be concerned that the Commission does not have the statutory authority to rely on prior determinations made by those regulators, as set forth in Rule of Practice 194(h), Exchange Act Section 15F(b)(6) expressly provides broadly and without limitation that the Commission can establish exceptions to that statutory prohibition by "rule, regulation, or order."¹⁶⁵ Granting relief from the statutory prohibition to SBS Entities where the conditions set forth in Rule of Practice 194(h) are met, including the filing of a notice in lieu of an application, is within the scope of the statutory

Association, July 2002,
<https://www.cftc.gov/sites/default/files/files/tm/tmnfarer071102.pdf>.

¹⁶¹ See 15 U.S.C. 78o-10(l)(3); Proposing Release, 80 FR at 51698 n.98.

¹⁶² See, e.g., 15 U.S.C. 78o-3 (registered securities associations); 15 U.S.C. 78s (registration, responsibilities, and oversight of SROs).

¹⁶³ See, e.g., 15 U.S.C. 78o-3(b)(2).

¹⁶⁴ See Cummings Letter, at 2.

¹⁶⁵ 15 U.S.C. 78o-10(b)(6).

authority provided to the Commission under Exchange Act Section 15F(b)(6).¹⁶⁶ Moreover, the regulators identified in paragraph (j) are currently granted the authority under their own statutory and regulatory frameworks to provide relief from a statutory disqualification.¹⁶⁷ Paragraph (h) does not “delegate [the Commission’s] authority to interpret the Exchange Act”¹⁶⁸ because such regulators only interpret their own statutory and regulatory frameworks with respect to persons subject to a statutory disqualification. The Commission believes that where the conditions set forth in paragraph (h) are met, it would not be necessary for the Commission (other than in cases where the person is subject to a Commission bar) to re-examine by means of a full application under Rule of Practice 194 an event for which relief has already been granted. Rather, the Commission believes that the better approach is to require an applicant to provide a notice under Rule of Practice 194(h) in lieu of a full application under Rule of Practice 194, which would alert the Commission to issues that could lead to the institution of proceedings pursuant to Exchange Act Section 15F(l)(3)¹⁶⁹ where doing so is appropriate.

Another commenter objected to the proposal on the grounds that the Commission should itself make a determination, rather than the CFTC, an SRO or a registered futures association, in part, because the proposal would “render[] the [Commission] unaccountable to Congress.”¹⁷⁰ The Commission also received a comment objecting to the proposal on the grounds that the Commission retains sole authority and responsibility to interpret and adjudicate the entire body of securities law in the public interest and any waiver decision should be reviewed by the

¹⁶⁶ See 5 U.S.C. 78o-10(b)(4). See also Note 54, *supra*.

¹⁶⁷ See Registration Adopting Release, 80 FR at 51687-89.

¹⁶⁸ See Cummings Letter, at 2.

¹⁶⁹ 15 U.S.C. 78o-10(l)(3).

¹⁷⁰ Public Citizen Letter, at 4-5.

Commission.¹⁷¹ In all cases where paragraph (h) applies, although the Commission would not receive an application under Rule of Practice 194, the Commission would be able to review the facts of cases.¹⁷² Nor is it the case that paragraph (h) of Rule of Practice 194 would “render[] the [Commission] unaccountable to Congress”¹⁷³ or divest the Commission of its “sole authority and responsibility to interpret and adjudicate the entire body of securities law in the public interest,”¹⁷⁴ because, as noted above, the Commission retains its statutory authority to bring an action under Exchange Act Section 15F(l)(3).

After careful consideration of the comments received, and for the reasons discussed in the proposal,¹⁷⁵ the Commission is adopting renamed paragraph (h) to Rule of Practice 194 as proposed, with five technical modifications. First, because Rule of Practice 194, as adopted, provides an exclusion for an SBS Entity from the prohibition in Exchange Act Section 15F(b)(6) with respect to associated persons entities, references in the proposed rule text to “is a natural person”¹⁷⁶ and one proposed subsection, which pertained to associated person entities only,¹⁷⁷ are no longer needed, and are not being adopted. Second, certain internal cross references to other provisions within this subsection are being revised to reflect renamed Rule of Practice 194(h).¹⁷⁸ Third, the phrase “or otherwise by the Commission” is being added to paragraph (h)(1)(ii) to

¹⁷¹ Cummings Letter, at 2-3.

¹⁷² *Contra* Americans for Financial Reform Letter, at 2.

¹⁷³ Public Citizen Letter, at 5.

¹⁷⁴ Cummings Letter, at 2.

¹⁷⁵ See Proposing Release, 80 FR at 51698-700, 51721-22.

¹⁷⁶ See proposed Rule of Practice 194(j)(1)(ii), (j)(2)(iii).

¹⁷⁷ See *id.* (j)(2)(iv).

¹⁷⁸ Internal cross references to subsection (j) in the proposal are being updated to reflect subsection (h) in final Rule of Practice 194. See *id.* (j)(1), (j)(2)(ii).

address situations where the Commission has granted a natural person consent to associate or change the terms and conditions of association with a regulated entity even if that consent was not granted pursuant to Rule of Practice 193.¹⁷⁹ Fourth, the Commission is changing the phrase a “person *that* is subject to a statutory disqualification” (emphasis added) in paragraphs (h)(1) and (h)(2) to read a “person *who* is subject to a statutory disqualification” (emphasis added) to more closely track the language used in Exchange Act Section 15F(b)(6).¹⁸⁰ Finally, a reference to the Commission’s Rules of Practice 151, 152 and 153 is being added to provide guidance on how the notice in Rule of Practice 194 (h)(2)(iii) should be filed with the Commission.¹⁸¹

I. Note to Rule of Practice 194

The Commission proposed adopting an accompanying Note to Rule of Practice 194, similar to the Preliminary Note to Rule of Practice 193.¹⁸² The Commission received no comments concerning the Note to proposed Rule of Practice 194 and is adopting, for the reasons discussed in the proposal, the Note substantially as proposed.¹⁸³

As adopted, the Note to Rule of Practice 194 provides that:

- An application made pursuant to the rule must show that it would be consistent with the

¹⁷⁹ This modification to paragraph (h)(1)(ii) is intended to address a regulatory gap with respect to Commission orders granting natural persons consent to associate with regulated entities that are not currently listed in Rule of Practice 193, such as, for example, natural persons associated with municipal advisors. Although Rule of Practice 193 does not currently mention municipal advisors, Rule 15Bc4-1 states that the Commission may “consent” to a person being associated with a municipal advisor. As a result, this modification will include Commission orders granting such consent within the scope of Rule 194.

¹⁸⁰ See Note 82, *supra* (discussing the same technical change to Rule of Practice 194(d)).

¹⁸¹ See Note 88, *supra* (discussing the Commission’s Rules of Practice 151, 152 and 153).

¹⁸² See Proposing Release, 80 FR at 51700-01; proposed Rule of Practice 194, Appendix. See also 17 CFR 201.193, Preliminary Note.

¹⁸³ See Proposing Release, 80 FR at 51700-01.

public interest to permit the associated person of the SBS Entity to effect or be involved in effecting security-based swaps on behalf of the SBS Entity.¹⁸⁴

- The nature of the supervision that an associated person will receive or exercise as an associated person with a registered entity is an important matter bearing upon the public interest.
- In meeting the burden of showing that permitting the associated person to effect or be involved in effecting security-based swaps on behalf of the SBS Entity is consistent with the public interest, the application and supporting documentation must demonstrate that the terms or conditions of association, procedures, or proposed supervision (if the associated person is a natural person), are reasonably designed to ensure that the statutory disqualification does not negatively affect the ability of the associated person to effect or be involved in effecting security-based swaps on behalf of the SBS Entity in compliance with the applicable statutory and regulatory framework. The Commission made one technical amendment in the Note to Rule of Practice 194 to change the term “impact upon” to “affect” in order to clarify any possible ambiguity without changing the scope of the provision.
- Normally, the applicant’s burden of demonstrating that permitting the associated person to effect or be involved in effecting security-based swaps on behalf of the SBS Entity is consistent with the public interest will be difficult to meet where the associated person is to be supervised by, or is to supervise, another statutorily disqualified individual.
- The associated person may be limited to association in a specified capacity with a

¹⁸⁴ See Section III.B, *supra*.

particular registered entity and may also be subject to specific terms and conditions.

Notably, the Commission proposed that where the associated person wishes to become the sole proprietor of a registered entity and thus is seeking that the Commission issue an order permitting the associated person who is subject to a statutory disqualification to effect or be involved in effecting security-based swaps on behalf of an SBS Entity notwithstanding an absence of supervision, the applicant's burden will be difficult to meet.¹⁸⁵ The Commission has modified this sentence because the Commission does not anticipate that a registered SBS Entity will be formed as a sole proprietorship in light of the *de minimis* exception to the definition of "security-based swap dealer"¹⁸⁶ and the thresholds applicable to the definition of "major security-based swap participant."¹⁸⁷ As modified, paragraph (i)(5) to the Note to Rule of Practice 194 provides that where there is an absence of supervision over the associated person who is subject to a statutory disqualification, the applicant's burden will be difficult to meet. The Commission is including this statement because, as stated, the Commission believes that there is a greater risk of harm where the associated person subject to a statutory disqualification is not subject to adequate supervision.

Finally, the Note discusses various procedural aspects of Rule of Practice 194, including the following:

- In addition to the information specifically required by the rule, applications with respect to natural persons should be supplemented, where appropriate, by written statements of

¹⁸⁵ See, e.g., Final Rule of Practice 194(e)(3). See also Proposing Release, 80 FR at 51700, 51722. Accord 17 CFR 201.193, Preliminary Note.

¹⁸⁶ See 17 CFR 240.3a71-2.

¹⁸⁷ See, e.g., 17 CFR 240.3a67-1(a)(2), 240.3a67-3, 240.3a67-5, 3a67-9.

individuals who are competent to attest to the associated person's character, employment performance, and other relevant information.

- In addition to the information required by the rule, the Commission staff may request additional information to assist in the Commission's review.
- Intentional misstatements or omissions of fact may constitute criminal violations of 18 U.S.C. 1001, *et seq.* and other provisions of law.
- The Commission will not consider any application that attempts to reargue or collaterally attack the findings that resulted in the statutory disqualification.

J. Confidentiality of Materials

In the proposal, the Commission stated that orders issued in accordance with Rule of Practice 194 would be made publicly available, but applications and supporting materials would be kept confidential subject to applicable law.¹⁸⁸ The Commission received three comments stating that the Commission should require all applications and supporting materials to be made public.¹⁸⁹ Specifically, one commenter stated that requiring all applications and supporting materials to be made public would: (i) promote transparency; (ii) ensure that the public understands that the Commission's handling of such applications, thereby improving the public's confidence in the Commission's oversight of market participants more generally; and (iii) influence the application process under Rule of Practice 194 if it appears to be too lenient in favor of allowing disqualified persons to serve in the security-based swap markets.¹⁹⁰ Another

¹⁸⁸ See Proposing Release, 80 FR at 51694.

¹⁸⁹ Better Markets Letter, at 6; American for Financial Reform, at 3-4; Cummings Letter, at 3.

¹⁹⁰ Better Markets Letter, at 6.

commenter stated that that: (1) applications and any supporting materials should be made public as soon as they are received to ensure public transparency in the application and accountability; and (2) should the Commission adopt the temporary exclusion in paragraph (i), the notice required to be sent to the Commission should be made public.¹⁹¹ Another commenter noted that, although the Commission should make applications under Rule of Practice 194 public, the Commission should be able to make a good cause determination that such applicants remain under seal.¹⁹²

The Commission has carefully considered the comments and has determined not to automatically make applications and supporting materials under Rule of Practice 194 public (*e.g.*, on the Commission's website). For the reasons set forth below and consistent with the Commission's current practice in other contexts (*e.g.*, applications and supporting materials under Rule of Practice 193), the Commission believes that, as proposed, it is appropriate to keep applications and supporting materials confidential, subject to the existing statutory and regulatory framework with respect to the public availability of such materials, including the Freedom of Information Act ("FOIA"),¹⁹³ the Exchange Act,¹⁹⁴ and applicable Commission rules.¹⁹⁵

First, applications and supporting materials may contain information that is proprietary or otherwise confidential and not generally subject to disclosure under applicable law.¹⁹⁶ As one

¹⁹¹ Americans for Financial Reform Letter, at 3-4.

¹⁹² Cummings Letter, at 3.

¹⁹³ 5 U.S.C. 552, *et seq.*

¹⁹⁴ See 15 U.S.C. 78x.

¹⁹⁵ See, *e.g.*, 17 CFR 200.80; 17 CFR 201.190; 17 CFR 240.24b-2.

¹⁹⁶ See 5 U.S.C. 552; 17 CFR 200.80(b)

commenter acknowledged, good cause may exist not to disclose certain information contained in application materials.¹⁹⁷ The existing statutory and regulatory framework sets forth a detailed process for the Commission to make available application materials¹⁹⁸ to members of the public, upon request, but to keep certain information contained in those materials confidential, where appropriate.¹⁹⁹ FOIA, for example, contains express categories of statutory exemptions where public disclosure is not required²⁰⁰—*e.g.*, information that would invade an individual’s personal privacy, or trade secrets or commercial or financial information that is confidential or privileged.²⁰¹ In addition to protecting the privacy interests of applicants and their associated persons, there is also a public interest in preserving the confidentiality of such materials to promote candor in applications so that the Commission may assess, based on all material facts, whether granting an application is consistent with the public interest.

The Commission believes that this existing statutory and regulatory framework, which provides for the public availability of certain materials, appropriately takes into consideration the applicants’ interests in confidentiality with the concerns identified by commenters concerning accountability, transparency, appropriateness of decision-making, and public confidence in the Rule of Practice 194 application process (and the Commission’s oversight of market participants more generally). Moreover, the Commission believes that relying on the existing statutory and regulatory framework with respect to application materials is preferable to a “good cause”

¹⁹⁷ See Cummings Letter, at 3.

¹⁹⁸ 15 U.S.C. 78x(a) (for purposes of 5 U.S.C. 552, “the term ‘records’ includes all applications . . . notices, and other documents filed with or otherwise obtained by the Commission pursuant to the [Exchange Act] or otherwise”).

¹⁹⁹ See, *e.g.*, 17 CFR 200.80(a)(4), (b).

²⁰⁰ See 5 U.S.C. 552(b). See also 17 CFR 200.80(b).

²⁰¹ See 5 U.S.C. 552(b)(4), (6). See also 17 CFR 200.80(b)(4), (b)(6).

standard of public disclosure, as suggested by one commenter,²⁰² for the same reasons noted above, as well as because the current statutory and regulatory framework is generally well-established and is routinely administered by Commission staff.

Second, in light of the information that the Commission intends to make publicly available, the Commission believes that there is minimal additional benefit in requiring all applications and supporting materials automatically to be made public—particularly given that the existing statutory and regulatory framework provides a process for members of the public to request application materials to be made available, consistent with the protections of the existing framework. Further, statutorily disqualified associated persons that are natural persons will not be permitted to effect or be involved in effecting security-based swaps on behalf of SBS Entities until an order is issued granting relief under Rule of Practice 194. Such orders will be made publicly available on the Commission’s website, consistent with current practice,²⁰³ and will provide notice to the public and identify for the benefit of counterparties and other market participants instances where a statutorily disqualified associated person that is a natural person has been permitted to effect or be involved in effecting security-based swaps on behalf of an SBS Entity.

K. Deleting Rule 15Fb6-1 and Schedule C to Forms SBSE, SBSE-A and SBSE-BD

Concurrent with the issuance of the Rule of Practice 194 proposal, the Commission adopted registration requirements for SBS Entities, including certain rules relating to the

²⁰² Cummings Letter, at 3.

²⁰³ See 17 CFR 200.80(a)(2)(i), (3).

statutory prohibition in Exchange Act Section 15F(b)(6).²⁰⁴ The Registration Adopting Release provided, among other things, that an SBS Entity, when it files an application to register with the Commission, may permit an associated person that is not a natural person who is subject to a statutory disqualification to effect or be involved in effecting security-based swaps on the SBS Entity's behalf, provided that the statutory disqualification(s) occurred prior to the compliance date set forth in the Registration Adopting Release and that the SBS Entity identifies each such associated person on its registration form, namely Schedule C to Forms SBSE, SBSE-A and SBSE-BD.

Because Rule of Practice 194, as adopted, provides an exclusion for an SBS Entity from the prohibition in Exchange Act Section 15F(b)(6) with respect to associated persons entities, Rule 15Fb6-1 and its related Schedule C are no longer necessary. Accordingly, given the associated person entity exclusion that the Commission is adopting in final Rule of Practice 194(c), the Commission is making technical amendments to: (1) delete Exchange Act Rule 15Fb6-1; (2) remove Schedule C to Forms SBSE, SBSE-A and SBSE-BD; and (3) remove all references to Schedule C in the instructions in the above-mentioned forms.

L. Compliance Date

As noted above, the effective date of Rule of Practice 194, as adopted, is [insert date that is 60 days after publication in the Federal Register]. We note, however, that the compliance date for the SBS Entity registration rules set forth in the Registration Adopting Release is the later of: six months after the date of publication in the Federal Register of a final rule release adopting rules establishing capital, margin and segregation requirements for SBS Entities; the compliance

²⁰⁴ See Registration Adopting Release, 80 FR at 48964. See also, e.g., 17 CFR 240.15Fb6-1.

date of final rules establishing recordkeeping and reporting requirements for SBS Entities; the compliance date of final rules establishing business conduct requirements under Exchange Act Sections 15F(h) and 15F(k); or the compliance date for final rules establishing a process for a registered SBS Entity to make an application to the Commission to allow an associated person who is subject to a statutory disqualification to effect or be involved in effecting security-based swaps on the SBS Entity's behalf.²⁰⁵

IV. PAPERWORK REDUCTION ACT

Rule of Practice 194 contains "collection of information requirements" within the meaning of the Paperwork Reduction Act of 1995 ("PRA"). 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. The Commission has submitted the information to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507 and 5 CFR 1320.11. The title of this collection is "Rule of Practice 194." The collection of information was assigned OMB Control No. 3235-0733. The responses to the collection of information are required to obtain a benefit.

In the proposal, the Commission solicited comment on the collection of information requirements associated with proposed Rule of Practice 194.²⁰⁶ In particular, pursuant to 44 U.S.C. 3505(c)(2)(B), the Commission asked commenters to evaluate whether the proposed

²⁰⁵ See Registration Adopting Release, at 1. The Commission recently requested comment on, among things, whether a longer compliance period, such as 18 months after the date of publication of the last of four releases noted above in the Federal Register, would be more appropriate. See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Exchange Act Release No. 34-84409 (Oct. 11, 2018), 83 FR 53007, 53019 (Oct. 19, 2018).

²⁰⁶ See Proposing Release, 80 FR at 51708.

collection is necessary for the proper performance of our functions, including whether the information shall have practical utility; to evaluate the accuracy of our estimate of the burden of the proposed collection of information; to determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and to evaluate whether there are ways to minimize the burden of collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology. The Commission did not receive any comments on the collection of information requirements.

A. Summary of Collection of Information

Rule of Practice 194 provides a process by which an SBS Entity may apply to the Commission for an order permitting an associated person to effect or be involved in effecting security-based swaps on behalf of the SBS Entity notwithstanding a statutory disqualification. To make an application under Rule of Practice 194, the SBS Entity filing an application with respect to an associated person that is a natural person would provide to the Commission:

- Exhibits required by paragraph (d) to Rule of Practice 194, including a copy of the order or other applicable document that resulted in the associated person being subject to a statutory disqualification; an undertaking by the applicant to notify promptly the Commission in writing if any information submitted in support of the application becomes materially false or misleading while the application is pending; a copy of the questionnaire or application for employment specified in Rule 15Fb6-2(b),²⁰⁷ with respect to the associated person; in cases where the associated person has been subject of any proceeding resulting in the imposition of disciplinary sanctions during the five years

²⁰⁷ 17 CFR 240.15Fb6-2(b).

preceding the filing of the application or is the subject of a pending proceeding by the Commission, CFTC, any federal or state regulatory or law enforcement agency, registered futures association, foreign financial regulatory authority, registered national securities association, or any other SRO, or commodities exchange or any court, a copy of the related order, decision, or document issued by the court, agency or SRO.

- A written statement that includes the information specified in paragraphs (e) and (f) to Rule of Practice 194, including, but not limited to: the associated person's compliance with any order resulting in statutory disqualification; the capacity or position in which the person subject to a statutory disqualification proposes to be associated with the SBS Entity; the terms and conditions of employment and supervision to be exercised over such associated person and, where applicable, by such associated person; the compliance and disciplinary history, during the five years preceding the filing of the application, of the SBS Entity; information concerning prior applications or processes.

Under paragraph (g) to Rule of Practice 194, an applicant could submit a written statement in response to any adverse recommendation proposed by Commission staff with respect to an application under Rule of Practice 194.

An SBS Entity would not be required to file an application under Rule of Practice 194 with respect to certain associated persons that are subject to a statutory disqualification, as provided for in paragraph (h) of proposed Rule of Practice 194. To meet those requirements, however, the SBS Entity would be required to file a notice with the Commission. For associated persons that are natural persons, the notice in paragraph (h)(2)(iii) would set forth: (1) the name of the SBS Entity; (2) the name of the associated person subject to a statutory disqualification; (3) the name of the associated person's prospective supervisor(s) at the SBS Entity; (4) the place

of employment for the associated person subject to a statutory disqualification; and

(5) identification of any SRO or agency that has indicated its agreement with the terms and conditions of the proposed association, registration or listing as a principal.

The information sought in connection with Rule of Practice 194 would assist the Commission in determining whether allowing associated persons to effect or be involved in effecting security-based swaps on behalf of a SBS Entity, notwithstanding statutory disqualification, is consistent with the public interest.

The Commission has sought to minimize the burdens and costs associated with Rule of Practice 194. First, the Commission is not requiring an application under Rule of Practice 194 with respect to certain associated persons subject to a statutory disqualification previously granted relief (*i.e.*, by the Commission, the CFTC, an SRO, or a registered futures association). Rather, in such instances, SBS Entities would only be required to provide a notice to the Commission under Rule of Practice 194(h)(2)(iii). Second, Rule of Practice 194 generally requires information that is already required by Rule of Practice 193²⁰⁸ and FINRA Form MC400.²⁰⁹ Because the requirements in Rule of Practice 194 are generally similar to pre-existing requirements in Rule of Practice 193 and FINRA Form MC-400 (and largely use the same terminology), Rule of Practice 194 should provide a familiar process for respondents.²¹⁰ Third, where appropriate, the Commission has limited the scope of certain requirements, including by limiting the time period for requested information (for example, paragraphs (d)(4),

²⁰⁸ 17 CFR 201.193; *see* Note 8, *supra*.

²⁰⁹ *See* FINRA Form MC-400; *see* Note 9, *supra*.

²¹⁰ The Commission estimates that approximately 16 registered SBS Entities will be broker-dealers, and thus registered with FINRA. *See* Section V.B.

(e)(6), and (e)(10) to Rule of Practice 194) or the scope of information sought (for example, paragraph (e)(10) and to proposed Rule of Practice 194). Finally, the documents that are requested to be provided with the written statement in paragraph (d) of Rule of Practice 194 (e.g., a copy of the order or other applicable document that resulted in statutory disqualification) should be readily available or accessible to the SBS Entity or to the associated person.

B. Proposed Use of Information

Information collected in connection with an application under Rule of Practice 194 will assist the Commission in determining whether an associated person of an SBS Entity should be permitted to effect or be involved in effecting security-based swaps on behalf of the SBS Entity, notwithstanding that the associated person is subject to a statutory disqualification. Although, absent the rule, an SBS Entity could nonetheless submit an application for an exemptive order directly under Exchange Act Section 15F(b)(6),²¹¹ Rule of Practice 194 specifies the information the Commission needs to evaluate such an application, and under what standard the Commission will consider whether to grant such relief.

Information collected in connection with the notice provided by Rule of Practice 194(h)(2)(iii) will assist the Commission for examination purposes by identifying associated persons that are subject to a statutory disqualification (and other basic information).

C. Respondents

The Commission has previously stated that it believes that, based on data obtained from the Depository Trust & Clearing Corporation and conversations with market participants, approximately fifty entities may fit within the definition of security-based swap dealer and up to five entities may fit within the definition of major security-based swap participant—55 SBS

²¹¹ 15 U.S.C. 78o-10(b)(6).

Entities in total.²¹²

With respect to associated persons that are natural persons, as discussed in Section V.B.2 below, the Commission has estimated that there will be 420 total associated persons that are natural persons at each SBS dealer and 62 total associated persons that are natural persons at each major participant, or 21,310 total associated persons that are natural persons. The Commission anticipates that, on an average annual basis, only a small fraction of the natural persons would be subject to a statutory disqualification. Between 2011 and June of 2018 FINRA received an average of 33 MC-400 applications with respect to individuals subject to a statutory disqualification seeking relief under the FINRA Rule 9520 Series.²¹³ Given that the Commission estimates that there will be far fewer associated persons of SBS Entities that are natural persons (21,310 total associated persons that are natural persons) than the approximately 267,000 registered representatives,²¹⁴ the Commission anticipates that SBS Entities will file for relief under Rule of Practice 194 with respect to substantially fewer associated persons that are natural persons.

In addition, to estimate the number of such persons, the Commission staff has conferred with NFA to assess how many associated persons of the 102 provisionally registered Swap

²¹² See Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, Exchange Act Release No. 77617, (April 14, 2016) 81 FR 30089 (May 13, 2016) (“Business Conduct Adopting Release”).

²¹³ See Section V.B, *infra*.

²¹⁴ Based on an analysis of regulatory filings, as of December 31, 2017, there are 3,523 broker-dealers that employed full-time registered representatives and were doing a public business; these broker-dealers each employed on average 75.8 registered representatives, or 267,043 in total. See Section V.B, *infra*.

Entities²¹⁵ have applied for relief from CEA 4s(b)(6)²¹⁶ (the analogous provision to Exchange Act Section 15F(b)(6)²¹⁷ for SBS Entities) for determination by NFA that, had the associated person applied for registration as an associated person of a Swap Entity, notwithstanding statutory disqualification, the application would have been granted.²¹⁸ NFA has informed Commission staff that, from October 11, 2012 to June 30, 2018, NFA determined that in 13 out of 15 requests NFA would have granted registration with respect to the associated person subject to a statutory disqualification.²¹⁹

Accordingly, based on that available data, the Commission estimates that, on an average annual basis, SBS Entities will seek relief in accordance with Rule of Practice 194 for up to five natural persons subject to a statutory disqualification, and SBS Entities would provide notices pursuant to Rule of Practice 194(h)(2)(iii) for up to five natural persons.

Therefore, the Commission anticipates that, on an average annual basis, SBS Entities would file up to five applications under Rule of Practice 194 with respect to associated persons that are natural persons and five notices for natural persons under Rule of Practice 194(h)(2)(iii).

D. Total Burden Estimates Relating to Rule of Practice 194

It is likely that the time necessary to complete an application under Rule of Practice 194

²¹⁵ See CFTC Provisionally Registered Swap Dealers as of October 11, 2018, <https://www.cftc.gov/LawRegulation/DoddFrankAct/registerwapdealer.html>, last accessed November 6, 2018.

²¹⁶ 7 U.S.C. 6s(b)(6).

²¹⁷ 15 U.S.C. 78o-10(b)(6); *see* Note 11, *supra*.

²¹⁸ See EasyFile AP Statutory Disqualification Form Submission, NFA, <https://www.nfa.futures.org/NFA-electronic-filings/easyFile-statutory-disqualification.HTML>.

²¹⁹ Of the 15 requests, for one, an application for registration was filed and subsequently withdrawn and for the other, the individual was no longer employed by the firm.

will vary depending on the number of exhibits required to be submitted in accordance with Rule of Practice 194(d), and the amount of information that would need to be discussed in the written statement, as specified in Rule of Practice 194(e).

Based on the Commission staff's estimates and experience,²²⁰ the Commission estimates that for associated persons that are natural persons it would take SBS Entities approximately 30 hours to research the questions, and complete and file an application under Rule of Practice 194. In addition, the Commission believes that the average time necessary for an SBS Entity to research the questions, complete and file a notice under Rule of Practice 194(h)(2)(iii) would be less than for a full application under Rule of Practice 194 and the Commission estimates that it would take approximately 6 hours.²²¹

Given that the Commission estimates that, on an average annual basis, there will be up to five applications under Rule of Practice 194 with respect to associated persons that are natural persons, and up to five notices under Rule of Practice 194(h)(2)(iii), the Commission estimates

²²⁰ For example, based on the experience relative to Form BD, the Commission has estimated the average time necessary for an SBS Entity to research the questions and complete and file a Form SBSE for an entity, including the accompanying schedules and disclosure reporting pages—which solicit information regarding statutory disqualification—to be approximately one work week, or 40 hours. However, the Commission has estimated that it would take an SBS Entity three-quarters of the time to make a similar application on behalf of a natural person, or in this case, 30 hours per natural person. See *Proposing Release*, 80 FR at 51707. Additionally, as noted above, Rule of Practice 194, as adopted, makes Schedule C to Forms SBSE, SBSE-A, and SBSE-BD unnecessary. The elimination of Schedule C with respect to those Forms is expected to separately reduce the time burden on SBS Entities unrelated to the time burdens otherwise associated with Rule of Practice 194.

²²¹ Although the Commission did not receive any comments on the time burden for completing a notice under Rule of Practice 194, we have decided to increase the estimate of 3 hours per notice to 6 hours per notice to reflect that it may take an SBS Entity, especially one doing this for the first time, longer to research the questions, complete and file a notice than the proposed 3 hours per notice.

the total burden associated with filing such applications and notices on average to be 180 hours on an annual basis.²²²

E. Confidentiality

As stated above, under both the proposed and adopted approach, orders and notices under Rule of Practice 194 will be made publicly available on the Commission's website, whereas applications and supporting materials will be kept confidential, subject to the existing statutory and regulatory framework with respect to the public availability of such materials, including the FOIA,²²³ the Exchange Act,²²⁴ and applicable Commission rules.²²⁵

V. ECONOMIC ANALYSIS

A. Broad Economic Considerations

On August 5, 2015, the Commission adopted final rules and forms establishing the registration process for SBS Entities.²²⁶ Those rules reference the events in the existing definition of "statutory disqualification" in Exchange Act Section 3(a)(39)(A) through (F)²²⁷ and apply them to Exchange Act Section 15F(b)(6). This definition disqualifies associated persons from effecting or being involved in effecting security-based swaps for violations of the securities laws, but also for all felonies and certain misdemeanors, including felonies and misdemeanors

²²² This estimate is based on the following: $(((30 \text{ hours}) \times (\text{up to } 5 \text{ SBS Entities applying with respect to associated persons that are natural persons})) + (6 \text{ hours}) \times (\text{up to } 5 \text{ SBS Entities filing notices under Rule of Practice 194(h)(2)(iii))) = 180 \text{ hours total}.$

²²³ See 5 U.S.C. 552, *et seq.*

²²⁴ See 15 U.S.C. 78x.

²²⁵ See, e.g., 17 CFR 200.80; 17 CFR 201.190; 17 CFR 240.24b-2.

²²⁶ See Registration Adopting Release.

²²⁷ See 15 U.S.C. 78o-10(b)(6)(A) through (F).

not related to the securities laws and/or financial markets.²²⁸ Once compliance with the registration process is required, registered SBS Entities will be unable, absent Commission action, to utilize any associated person, including entities and natural persons with potentially valuable capabilities, skills or expertise, to effect or be involved in effecting security-based swaps if the person has been disqualified for any reason, including for non-investment-related conduct that may not pose a risk to security-based swap market participants.²²⁹

Exchange Act Section 15F(b)(6) gives the Commission flexibility to address situations involving statutorily disqualified associated persons. Specifically, under this section, the prohibition with respect to statutorily disqualified persons applies “[e]xcept to the extent otherwise specifically provided by rule, regulation, or order of the Commission.”²³⁰ This statutory provision gives the Commission discretion to determine that a statutorily disqualified person may effect or be involved in effecting security-based swaps on behalf of an SBS Entity. Exchange Act Section 15F(b)(6), however, does not specify what information must be provided to the Commission when an SBS Entity seeks relief, nor does it set forth the standard under which the Commission would evaluate requests for relief. Rule of Practice 194 is intended to establish a framework for SBS Entities seeking such relief from the statutory prohibition in Exchange Act Section 15F(b)(6).

We are mindful of the economic effects, including the costs and benefits, of our rule.

²²⁸ 15 U.S.C. 78c(a)(39)(A) through (F).

²²⁹ The final SBS Entity registration rules also require the Chief Compliance Officer of an SBS Entity, or his or her designee, to certify on its registration form that none of its associated persons that effect or are involved in effecting security-based swaps on its behalf are subject to a statutory disqualification. *See* Registration Adopting Release, at Section II.B.3.

²³⁰ *See* 15 U.S.C. 78o-10(b)(6).

Section 3(f) of the Exchange Act provides that whenever the Commission is engaged 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, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.²³¹ In addition, Section 23(a)(2) of the Exchange Act requires the Commission, when making rules under the Exchange Act, to consider the impact such rules would have on competition.²³² Exchange Act 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.

In the Proposing Release, the Commission solicited comment on all aspects of the costs and benefits associated with the rule, including any effect the rule may have on efficiency, competition, and capital formation. The Commission has considered these comments, as discussed in greater detail in the sections that follow. The analysis below addresses the likely economic effects of the final Rule of Practice 194, including the benefits and costs of the final rule, and their potential impact on efficiency, competition, and capital formation.

In the Proposing Release, the Commission noted that the inability of a statutorily disqualified associated person to effect or be involved in effecting security-based swaps on behalf of an SBS Entity creates a disincentive against underlying misconduct by an associated person.²³³ We continue to believe that limiting the involvement of statutorily disqualified associated persons in security-based swap markets on behalf of SBS Entities may lower

²³¹ See 15 U.S.C. 78c(f).

²³² See 15 U.S.C. 78w(a)(2).

²³³ See Proposing Release, 80 FR at 51716.

compliance and counterparty risks arising from disqualification, facilitate competition among higher quality SBS Entities, and enhance counterparty protections, supervision and integrity of security-based swap markets.²³⁴ However, we continue to recognize that limits on statutorily disqualified associated persons may require SBS Entities to undergo business restructuring in the event of disqualification or to apply with the Commission for relief, resulting in costs for SBS Entities, such as costs of searching for and initiating relationships with new associated persons or legal reorganization.

We also recognize that the above costs of SBS Entities may be passed on to counterparties in the form of higher transaction costs or reduced liquidity. Market participants may value bilateral relationships with SBS Entities and searching for and initiating bilateral relationships with new SBS Entities may involve additional direct costs for counterparties. For example, security-based swaps are long-term contracts that are often renegotiated and, in the absence of Rule of Practice 194, counterparties could price the potential future inability to modify a contract, widening spreads. The Commission continues to recognize that where SBS Entities must cease dealing activity with counterparties as a result of disqualification (pending reorganization or resolution of application under Rule of Practice 194), other SBS Entities may step in to intermediate transaction activity in security-based swap markets. The resulting effects on competition will depend on whether SBS Entities that capture the newly available market share are smaller participants, which could increase competition, or those that already enjoy a degree of market power and are able to consolidate their position while the disqualified SBS Entity is undergoing restructuring or awaiting a relief determination, which may decrease competition, at least temporarily.

²³⁴ See, e.g., Public Citizen Letter; Better Markets Letter.

Moreover, our economic analysis recognizes that information about the conduct that gave rise to statutory disqualification in the United States (*e.g.*, by SEC orders, FINRA actions etc.) is generally public. In addition, under the final SBS Entity registration rules, SBS Entities are required to provide disciplinary history (criminal, regulatory action, civil judicial and financial disclosures) information for SBS Entity control affiliates.²³⁵

While there is a dearth of evidence on misconduct in swap and security-based swap markets, our economic analysis recognizes research that shows, in some settings:²³⁶ (i) past misconduct may predict future misconduct risk, and some public disclosures may be informative of future misconduct risk; (ii) capital markets may penalize some disclosed misconduct, and market participants engaging in misconduct generally suffer reputational costs; (iii) entities may disassociate from employees engaging in misconduct, but there may be a significant amount of heterogeneity in the incidence of misconduct by natural persons across employer firms, and the match between natural associated person and SBS Entities tends to be endogenous; and (iv) the reduction in misconduct in a particular market can reduce the number of service providers, but high prevalence of misconduct can reduce capital market participation.²³⁷

²³⁵ In conjunction with adopting Rule of Practice 194(c), the Commission is also removing Schedule C from Forms SBSE, SBSE-A and SBSE-BD. Importantly, this change does not eliminate questions 14A and 14B and corresponding disclosure reporting pages and related obligations, and such information will continue to be available to market participants. Under the final SBS Entity registration rules, SBS Entity applications on Forms SBSE, SBSE-A, and SBSE-BD (including the Schedules and disclosure reporting pages) filed with the Commission as required by Rule 15Fb2-1, will be made public. All amendments to SBS Entity applications, required by Rule 15Fb2-3, will be made public. SBS Entities' Form SBSE-C certifications, required by Rules 15Fb2-1 and 15Fb6-2 and filed as part of their applications, will be made public. See 80 FR at 48995.

²³⁶ See Sections V.B and V.C.2, *infra*.

²³⁷ We also recognize that there is a body of behavioral finance research, commonly focused on retail investor behavior, and a law and economics literature on compensatory and

While we seek to identify the closest parallel regulatory and market settings, we are cautious in interpreting these results. We recognize that the unique characteristics of security-based swap markets may reduce or strengthen these effects. For example, as shown in the economic baseline, security-based swap markets are dealer markets, with the overwhelming bulk of activity taking place among dealers and between dealers and non-dealer financial entities. The Commission estimates that dealing activity in security-based swap markets is highly concentrated among a small number of dealers, with the top five dealer accounts intermediating approximately 55 percent of all SBS Entity transactions,²³⁸ and reaching hundreds and even thousands of counterparties. At the same time, a median non-dealer counterparty transacts in security-based swaps with two security-based swap dealers (“SBS Dealers”) in over-the-counter security-based swaps (and an average with three SBS Dealers), outside of registered exchanges or swap execution facilities. If several SBS Dealers with a large market share facing thousands of counterparties are disqualified at the same time and must immediately cease dealing activity, a

punitive damages, deterrence, moral heuristics, and related issues. For example, we have received comment citing Schkade et al. (1999), which presented evidence from two experiments designed to test whether individuals believe in optimal deterrence. They concluded that individuals may not spontaneously think in terms of optimal deterrence and their proposed punishments do not differ depending on the probability of deterrence. See Better Markets Letter at 2. See also David Schkade, Cass R. Sunstein, & Daniel Kahneman, *Do People Want Optimal Deterrence?* (John M. Olin Program in Law and Economics, Working Paper No. 77, 1999), available at http://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=1173&context=law_and_economics, last accessed Sept. 28, 2018. We believe the applicability of this body of literature to statutory disqualification in security-based swap markets is likely limited due to the unique features of these markets (such as dealer concentration increasing the role of dealer reputation, public nature of most misconduct, and institutional nature of the investor clientele).

²³⁸ The Commission staff analysis of DTCC Derivatives Repository Limited Trade Information Warehouse transaction records indicates that approximately 99 percent of single-name CDS price-forming transactions in 2017 involved an ISDA-recognized dealer.

risk of market-wide disruption may exist. However, the concentrated nature of security-based swap dealing activity limits the ability of customers to choose SBS Entity counterparties that do not rely on disqualified persons and corresponding reputational incentives. Moreover, security-based swaps may also be more complex and opaque than equity or bonds, increasing information asymmetries between SBS Entities and their clients. Nevertheless, institutional clients may be more informed and may process disclosures more efficiently than retail investors in parallel settings, reducing the impact of these asymmetries.

The Commission recognizes that the final rules may directly and indirectly impact SBS Entities, as well as counterparties of SBS Entities and other market participants. We have considered these economic effects as they pertain to individual provisions and rule alternatives. As we have noted above, Exchange Act Section 15F(b)(6) gives the Commission authority to provide relief from the statutory prohibition against associating with disqualified persons by rule, regulation, or order, and the Commission is not bound by any particular approach in exercising its discretion to provide relief. In particular, in the absence of a disqualification review process, SBS Entities would still be able to apply for relief from Exchange Act Section 15F(b)(6), and the Commission would be able to issue an order either granting or denying relief.

The Commission continues to believe that when determining whether to make an application for relief, SBS Entities will weigh the scarcity and value of the particular skills of an associated person against any application and reputational costs from associating with disqualified persons and their beliefs as to the likelihood of an approval or denial decision by the Commission. To the extent that the final Rule of Practice 194 (compared with the availability of and process for obtaining relief without the Rule) alters an SBS Entity's assessment of either application and reputational costs, its beliefs about likely outcomes, or its decision to apply with

the Commission, economic costs and benefits may accrue to SBS Entities, their associated persons, and counterparties to SBS Entities.

The Commission believes that the primary benefits of the final approach include:

(i) providing SBS Entities clarity regarding the items to be addressed, the information and supporting documentation to be submitted, and the standard of review (affecting application costs and beliefs about likely outcomes); (ii) ensuring that the Commission has sufficient information to make a meaningful determination that allowing an SBS Entity to permit statutorily disqualified associated persons to effect or be involved in effecting security-based swaps is consistent with the public interest; (iii) streamlining the treatment of statutorily disqualified associated person entities across integrated swap and security-based swap markets; and (iv) mitigating the risk of business disruptions to SBS Entities and their counterparties from disqualification of associated person entities. We note that, regardless of the regulatory approach chosen, SBS Entities may find it less costly to disassociate with, or reassign, disqualified persons than to apply for relief, as discussed in greater detail in the Economic Baseline.

B. Economic Baseline

To assess the economic impact of Rule of Practice 194, the Commission is using as a baseline the regulation of SBS Entities as it exists at the time of this release, including applicable rules we have adopted, but excluding rules we have 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, rules adopted in the Intermediary Definitions Adopting Release, the Cross-Border Adopting Release, and the SDR Rules and Core Principles Adopting Release. Additionally, our baseline includes rules that have been adopted but for which

compliance is not yet required, including the Registration Adopting Release,²³⁹ and the Business Conduct Adopting Release,²⁴⁰ as these final rules—even if compliance is not yet required—are part of the existing regulatory landscape that market participants expect to govern their security-based swap activity.

There are currently no registered entities that are required to comply with either the statutory disqualification certifications in the final SBS Entity registration rules or the statutory prohibition in Exchange Act Section 15F(b)(6). However, to perform a meaningful assessment of the final Rule of Practice 194, our economic baseline presumes that compliance with the final SBS Entity registration rules is required as set forth in Exchange Act Rules 15Fb1-1 through 15Fb6-2,²⁴¹ the general prohibition in Exchange Act Section 15F(b)(6)²⁴² is in effect, and the Commission may use its authority under Exchange Act Section 15F(b)(6) to issue an order providing relief.

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.²⁴³ Since these data do not cover the entire market, the Commission has analyzed market activity using a

²³⁹ See Registration Adopting Release, 80 FR at 48997-9003.

²⁴⁰ See Business Conduct Adopting Release, 81 FR at 29960.

²⁴¹ Notably, the final SBS Entity registration rules included Exchange Act Rule 15Fb6-1, 17 CFR 240.15Fb6-1. See Note 5, *supra*, for background on Exchange Act Rule 15Fb6-1.

²⁴² See 15 U.S.C. 78o-10(b)(6).

²⁴³ The Commission also relies on qualitative information regarding market structure and evolving market practices provided by commenters and knowledge and expertise of Commission staff.

sample of transactions that includes only certain segments of the market. The Commission believes, however, that the data underlying this analysis provides reasonably comprehensive information regarding single-name credit default swap (“CDS”) transactions and the composition of the participants in the single-name CDS market.

Specifically, the analysis of the current state of the security-based swap market is based on data obtained from the DTCC Derivatives Repository Limited Trade Information Warehouse (“TIW”), especially data regarding the activity of market participants in the single-name CDS market during the period from 2006 to 2017.²⁴⁴ Although the definition of security-based swaps is not limited to single-name CDS,²⁴⁵ single-name CDS contracts make up a majority of security-based swaps, and we believe that the single-name CDS data are 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,²⁴⁶ in multi-name index CDS was approximately \$4.4 trillion, and in multi-name, non-index CDS was approximately \$343

²⁴⁴ 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.

²⁴⁵ 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.

²⁴⁶ 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.

billion.²⁴⁷ The total gross market value outstanding in single-name CDS was approximately \$130 billion, and in multi-name CDS instruments was approximately \$174 billion.²⁴⁸ The global notional amount outstanding in equity forwards and swaps as of December 2017 was \$3.21 trillion, with total gross market value of \$197 billion.²⁴⁹

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;²⁵⁰ and (ii) are based on

²⁴⁷ See BIS, Semi-annual OTC derivatives statistics at December 2017, Table 10.1, https://www.bis.org/statistics/d10_1.pdf, last accessed May 18, 2018.

²⁴⁸ See *id.*

²⁴⁹ 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, <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.

²⁵⁰ 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).

non-U.S. reference entities. Notwithstanding this limitation, the TIW single-name CDS data should provide sufficient information to permit the Commission to identify the types of market participants active in the security-based swap market and the general pattern of dealing within that market.²⁵¹

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,²⁵² 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 intermediated transactions with a gross notional amount of approximately \$2.9 trillion, with approximately 55 percent of the gross notional intermediated by the top five dealer

²⁵¹ 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 – Reporting and Dissemination of Security-Based Swap Information; Final Rule Amendments, Exchange Act Release No. 78321 (July 14, 2016), 81 FR 53545 (Aug. 12, 2016).

²⁵² See, e.g., Registration Adopting Release, 80 FR at 49000.

accounts.²⁵³

These dealers transact with hundreds or thousands of counterparties. Approximately 21 percent 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 2017.²⁵⁴ Another 25 percent of these accounts transacted with 500 to 1,000 unique counterparty accounts; 29 percent transacted with 100 to 500 unique accounts; and 25 percent 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

²⁵³ The Commission staff analysis of TIW transaction records indicates that approximately 99% of single-name CDS price-forming transactions in 2017 involved an ISDA-recognized dealer.

²⁵⁴ 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.

engaged directly in trading between November 2006 and December 2017.²⁵⁵

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 percent (about 30 percent of all transacting agents) were registered as investment advisers under the Advisers Act.²⁵⁶ Although investment advisers are the vast majority of transacting agents, the transactions they executed account for only 12.8 percent 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 percent) measured by number of transaction-sides were executed by ISDA-recognized dealers.

²⁵⁵ These 2,110 entities, which are presented in more detail in Table 1, below, include all DTCC-defined “firms” shown in TIW as transaction counterparties that report at least one transaction to TIW as of December 2017. The staff in the Division of Economic and Risk Analysis classified these firms, which are shown as transaction counterparties, by machine matching names to known third-party databases and by manual classification. *See, e.g.*, 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.

²⁵⁶ *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 ¹	17	0.8%	83.3%
Other	125	5.9%	0.2%
Total	2,110	100.0%	100%

¹ 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>.

Principal holders of CDS risk exposure are represented by “accounts” in the TIW.²⁵⁷ 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.²⁵⁸ For instance, banks in Table 1 allocated transactions across 349 accounts, of which 20 were represented by investment advisers. In the remaining instances, banks traded for their own accounts. Meanwhile, ISDA-recognized dealers in Table 1 allocated

²⁵⁷ “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.

²⁵⁸ 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.

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.²⁵⁹

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 ²	
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%

² This column reflects the number of participants who are also trading for their own accounts.

²⁵⁹ 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.

2. Natural Persons and Entity Persons Associated with SBS Entities

We now estimate the number of natural persons associated with entities likely to register with the SEC as SBS Entities. Based on an analysis of broker-dealer FOCUS reports, as of December 31, 2017, there were 3,523 broker-dealers that employed full-time registered representatives and were doing a public business; these broker-dealers each employed on average 75.8 registered representatives, or approximately 267,043 in total. However, based on our review of the entities we believe may register as SBS Dealers and their activities, the Commission believes the subset of clearing broker-dealers provides a better estimate given their size, complexity of operations, and role in clearing and trade execution. As of December 31, 2017, there were 438 clearing broker-dealers which had, on average, each employed 420 persons who were registered representatives; we use this average as the basis for our estimate of 21,000 natural persons associated with dealers ($420 \times 50 = 21,000$). Note, however, that SBS Entities will be limited to sales of security-based swaps, whereas broker-dealers are generally engaged in the sale of a broader range of financial instruments, as well as other business lines such as prime brokerage services. Thus, it is possible that fewer people would be needed to facilitate this business.

Since registration requirements for major security-based swap participants are triggered by position thresholds, as opposed to activity thresholds for dealer registration, we anticipate that entities seeking to register with the Commission as major security-based swap participants may more closely resemble hedge funds and investment advisers. Accordingly, to estimate the number of natural persons associated with major security-based swap participants, we use Form ADV filings by registered investment advisers. Based on this analysis, as of June 30, 2018 there were 13,010 registered investment advisers; these investment advisers had an average of 62

employees each. We use this average as the basis for our estimate of 310 natural persons associated with major security-based swap participants ($62 \times 5 = 310$).

The estimated 21,000 natural persons associating with security-based swap dealers and estimated 310 natural persons associating with major security-based swap participants together provide our estimate of 21,310 natural persons associating with entities that are likely to register with the Commission as SBS Entities.

We now turn to the estimate of the number of entities associated with SBS Entities. Based on an analysis of historical Form BD filings, broker-dealers with control affiliates had an average of 8 control affiliates that started to associate between 2000 and 2017, and have not ended the association by December 31, 2017. Similar to the approach in the Proposing Release, it may be appropriate to scale the figure by a factor of two to account for complexity in business structures and for the fact that security-based swap dealers are likely to resemble some of the larger broker dealers, which results in an estimate of up to 800 ($8 \times 50 \times 2 = 800$) entities associated with security-based swap dealers. We continue to recognize that some SBS Entities, especially those SBS Entities not cross-registered as broker-dealers, may be engaged in sales of a more limited range of financial instruments than broker-dealers.

Using information on entity control persons in Schedules A, B and D in historical Form ADV filings for investment advisers as of June 30, 2018, investment advisers with control persons had an average of approximately 38.4 control persons listed as firms or organizations that started to associate between 2000 and June 2018 and have not ended the association by June 2018. We continue to believe that it may be appropriate to scale the figure by a factor of two to account for complexity in business structures and for the fact that major swap participants are likely to be similar to some of the larger investment advisers, which results in an estimate of up

to approximately 384 ($38.4 \times 5 \times 2 = 384$) entities associated with major security-based swap participants.

The estimated 800 entity persons associating with security-based swap dealers and estimated 384 entity persons associating with major security-based swap participants together provide our estimate of 1,184 entity persons associating with SBS entities that will register.

Overall, we estimate that as many as 420 natural persons may associate with each dealer and as many as 62 natural persons may associate with each major participant, amounting to as many as 21,310 associated natural persons in total. In addition, we estimate that 1,184 entity persons may be associating with all SBS Entities.

We note that SBS Entities currently intermediating security-based swaps are frequently part of complex organizational structures, which may include thousands of natural persons and hundreds of entities. Further, we believe that SBS Entities may adjust their organizational structures and activities in response to the associated person and other requirements of the final SBS Entity registration rules and the pending substantive Title VII rules. We anticipate that there may be a high degree of heterogeneity in business structures and organizational complexity among SBS Entities. Ultimately, the Commission lacks data on SBS Entity associations with disqualified persons effecting or involved in effecting security-based swaps on their behalf, and commenters have not provided information or data that would allow such quantification. It is, therefore, difficult to estimate with a high degree of certainty the number of associated persons currently intermediating security-based swaps on behalf of SBS Entities that may be affected by the final rules.

3. Other Markets and Existing Regulatory Frameworks

The numerous financial markets are integrated, often attracting the same market

participants that trade across corporate bond, swap, and security-based swap markets, among others.²⁶⁰ For example, persons who will register as SBS Dealers and major security-based swap participants are likely also to be engaged in swap activity. In part, this overlap reflects the relationship between single-name CDS contracts, which are security-based swaps, and index CDS contracts, which may be swaps or security-based swaps. A single-name CDS contract covers default events for a single reference entity or reference security. Index CDS contracts and related products make payouts that are contingent on the default of index components and allow participants in these instruments to gain exposure to the credit risk of the basket of reference entities that comprise the index, which is a function of the credit risk of the index components. A default event for a reference entity that is an index component will result in payoffs on both single-name CDS written on the reference entity and index CDS written on indices that contain the reference entity. Because of this relationship between the payoffs of single-name CDS and index CDS products, prices of these products depend upon one another,²⁶¹ creating hedging opportunities across these markets.

These hedging opportunities mean that participants that are active in one market are likely to be active in the other. Commission staff analysis of approximately 4,358 TIW accounts that participated in the market for single-name CDS in 2017 revealed that approximately 2,936 of those accounts, or 67 percent, also participated in the market for index CDS. Of the accounts that participated in both markets, data regarding transactions in 2017 suggest that, conditional on

²⁶⁰ See Proposing Release, 80 FR at 51711.

²⁶¹ “Correlation” typically refers to linear relationships between variables; “dependence” captures a broader set of relationships that may be more appropriate for certain swaps and security-based swaps. See, e.g., George Casella & Roger L. Berger, *Statistical Inference* 171 (2nd ed. 2002).

an account transacting in notional volume of index CDS in the top third of accounts, the probability of the same account landing in the top third of accounts in terms of single-name CDS notional volume is approximately 38 percent; by contrast, the probability of the same account landing in the bottom third of accounts in terms of single-name CDS notional volume is only 5.4 percent. As a result of cross-market participation, informational efficiency, pricing and liquidity may spill over across markets.²⁶²

Based on an analysis of 2017 TIW data, the Commission estimates that approximately 46 of the 50 entities expected to register as security-based swap dealers will be dually registered with the CFTC and therefore be subject to CFTC requirements for swap dealers. Additionally, based on an analysis of TIW data and filings with the Commission, the Commission continues to estimate that 16 market participants that will register as SBS Dealers have already registered with the Commission as broker-dealers and are thus subject to Exchange Act and FINRA requirements applicable to such entities. Therefore, we expect SBS Entities to associate with persons effecting or involved in effecting transactions across the various markets overseen by the Commission, CFTC, FINRA, and NFA.

The Commission, CFTC, FINRA, and NFA have already established processes that enable various persons subject to a statutory disqualification or other bars to be permitted to associate with regulated entities transacting in equity, bond, commodity, swap, and other markets. In light of these considerations, our analysis below considers the costs and benefits, as

²⁶² See Business Conduct Adopting Release, 81 FR at 30108; Christopher Culp, Andria van der Merwe, & Bettina J. Starkle, *Single-name Credit Default Swaps: A review of the Empirical Academic Literature* 71-85 (International Swaps and Derivatives Association Study, 2016), available at <https://www.isda.org/a/KSiDE/single-name-cds-literature-review-culp-van-der-merwe-staerkle-isda.pdf>; Patrick Augustin, Marti G. Subrahmanyam, Dragon Y. Tang, & Sarah Q. Wang, *Credit Default Swaps: Past, Present, and Future*, 8 Ann. Rev. Fin. Econ. 175 (2016).

well as the effects on efficiency, competition and capital formation of the disqualification review process under final Rule of Practice 194 in context of existing review processes established by the Commission, CFTC, FINRA, and NFA.

4. Data on Parallel Review Processes and Statutory Disqualification

While the Commission lacks data on the incidence of statutory disqualifications in the security-based swap market, and therefore the likely number of applications for relief, we look to the securities market and the experience of broker-dealers as a guide. In the Proposing Release, we presented data on closely parallel statutory disqualification review processes. In this section, we provide updated information and data on applications, dispositions, investor losses, and re-offenses from parallel review processes by FINRA, the CFTC, the Commission's review under Rule of Practice 193, and recent research. From the outset, we recognize that one of the limitations of the data provided below is the time period for which the data are available (post-crisis period). We recognize that incidences of misconduct and fraud may be more prevalent and more difficult to detect in economic booms. As such, the figures below may underestimate the prevalence of certain types of misconduct in other markets.

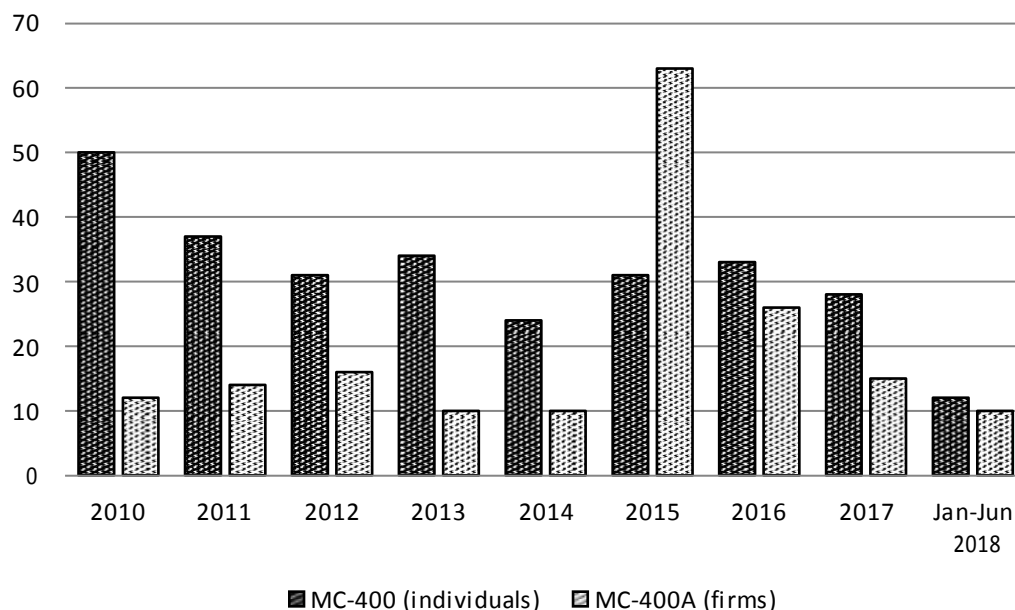
a. FINRA's Review Process

The Commission continues to believe that the incidence of statutory disqualification among broker-dealers serves as a reasonable basis to estimate the incidence of disqualification among SBS Entities, because both broker-dealers and SBS Entities are engaged in the business of intermediating trades in financial instruments.

Based on information provided by FINRA to the Commission, in 8.5 years between 2010 and June 2018, FINRA has received 280 MC-400 applications (an average of approximately 33 per year), and 176 MC-400A applications (an average of approximately 21 per year). The

number of applications by type on an annual basis is reported in Figure 1.

Figure 1. MC-400 and MC-400A applications received in 2010 - June 2018.²⁶³



Of all MC-400 applications for individuals received during 2010 – June of 2018, approximately 26 percent of applications were related to statutory disqualification for solely non-investment related conduct; the other 74 percent were for investment-related conduct. Of all MC-400 applications received during 2010 – June 30, 2018, 24 percent of those applications were related to SEC orders, 20 percent of those applications were related to FINRA actions, 16 percent of those applications were related to SOX violations, and 3 percent of those applications were related to injunctions. The remaining approximately 11 percent of those MC-400 applications were due to other investment-related or multiple types of conduct (including investment related conduct). Of all MC-400A applications received during 2010 – June of 2018,

²⁶³ The overwhelming majority of MC-400A applications submitted in 2015 resulted from the Commission’s Municipalities Continuing Disclosure Cooperation (“MCDC”) initiative. The relatively high number of MC-400A Applications processed in 2015 is atypical of the amount of MC-400A applications that FINRA typically disposes of in a calendar year.

1 application was related to statutory disqualification for solely non-investment related conduct; the remaining 175 were for investment-related conduct. Figure 2 and Figure 3 present information about the nature of underlying conduct related to applications MC-400 and MC-400A applications in the full sample.

With respect to application dispositions, between 2010 and June of 2018, FINRA made 299 MC-400 dispositions for individuals subject to a statutory disqualification seeking relief under its FINRA Rule 9520 Series. Of these dispositions, 89 (or 30 percent) were approvals (including 23 approvals for non-investment-related disqualifications and 66 for investment-related disqualifications); 157 (or 53 percent) were denials; 29 were instances where the individuals were no longer required to file an application; and 24 were determined not to be statutorily disqualified. Figure 4 shows time trends in MC-400 dispositions.

Further, between 2010 and June of 2018, FINRA made dispositions pertaining to 173 MC-400A applications for statutorily disqualified member firms under its Rule 9520 Series. Of the MC-400A dispositions, 102 (or 59 percent) were approvals; 1 was a denial; in 53 (or 31 percent) applications the firm filed Form BDW, was canceled by FINRA or the application was no longer required; and in 17 applications (10 percent) the firm was determined not to be disqualified. Figure 5 shows time trends in MC-400A dispositions.

Figure 2. MC-400 Applications received in 2010 - June 2018, by nature of underlying conduct.

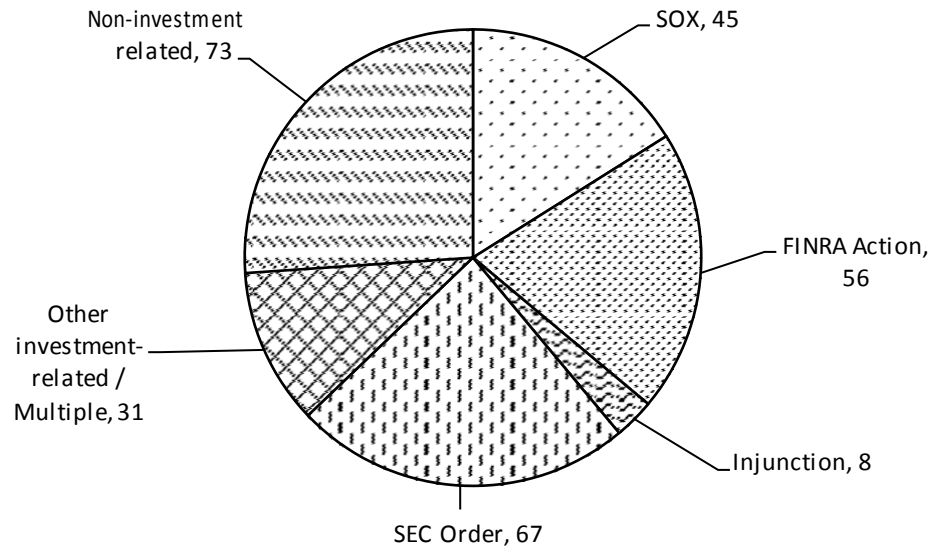


Figure 3. MC-400A Applications received in 2010 - June 2018, by nature of underlying conduct.

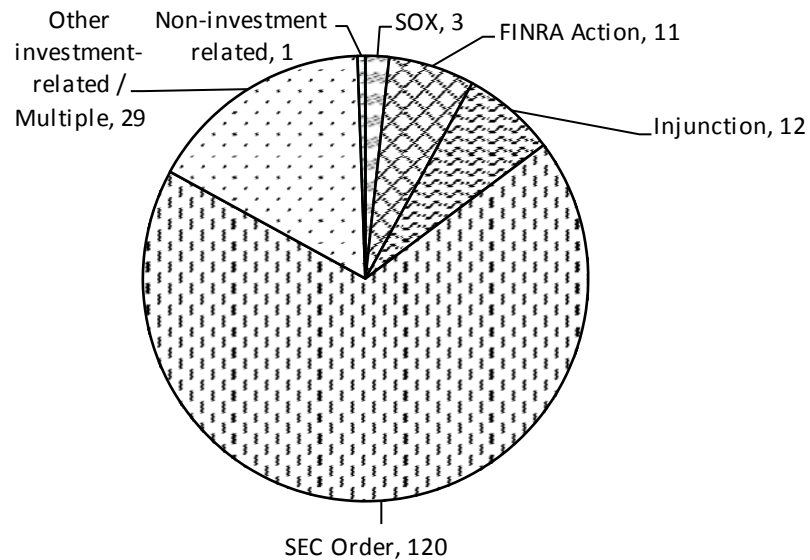


Figure 4. Application dispositions by year of disposition (regardless of when the applications were received): MC-400 applications for natural persons.

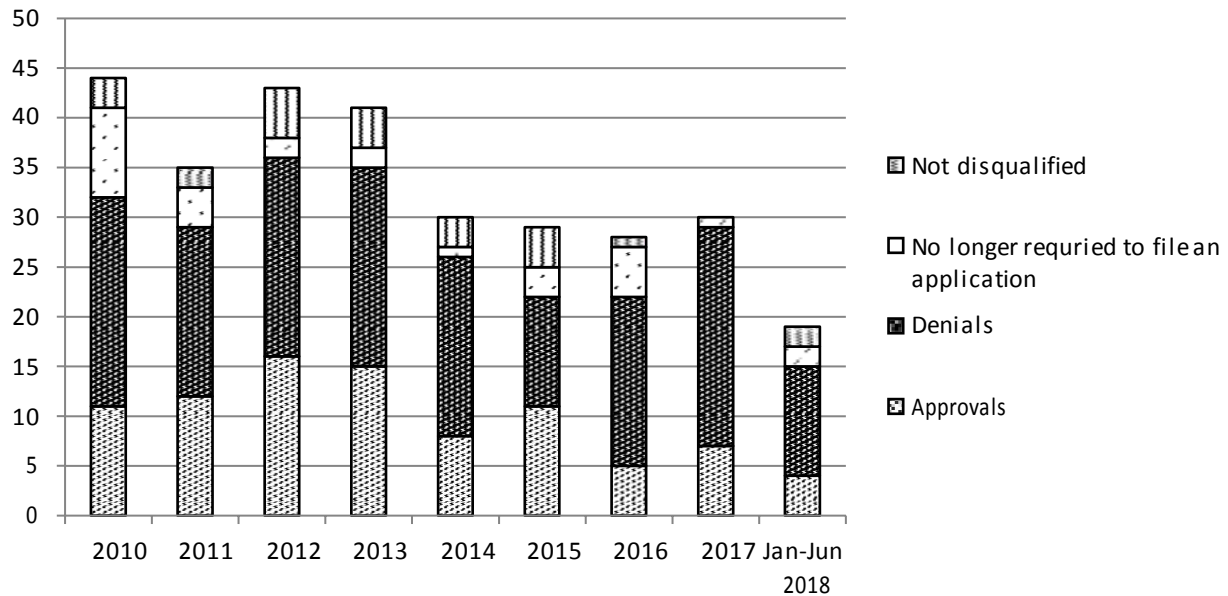
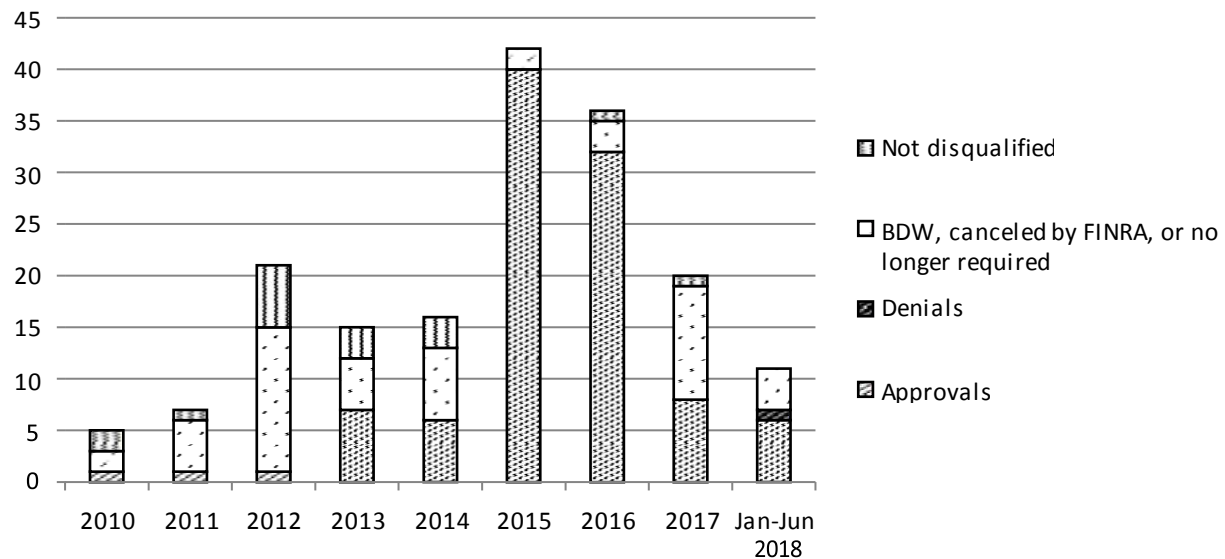


Figure 5. Application dispositions by year of disposition (regardless of when the applications were received): MC-400A applications for entities.²⁶⁴



Regarding reoffenses,²⁶⁵ out of 89 MC-400 applications approved between 2010 and June

²⁶⁴ See Note 263.

²⁶⁵ For MC-400 Applications: Reoffender is defined as a disqualified individual who was

of 2018, there were 10 reoffenses. Of the 10 MC-400 reoffenses, 2 offenders were originally disqualified for non-investment related offenses, and the repeat offense for both offenders was also non-investment related; and 2 offenders were originally disqualified for non-investment related misconduct and the repeat offense was investment related.²⁶⁶ For entities, out of 102 MC-400A application approvals between 2010 and June of 2018, there were 29 reoffenses (all were investment-related). A portion of these occurred in 2015, which saw an increase in MC-400A applications as a result of the Commission's MCDC Initiative.

b. CFTC/NFA Review Process

We have also requested and received data from NFA. According to NFA staff, between October 11, 2012, and June 30, 2018, 7 different Swap Dealers filed 15 applications to the NFA for NFA to provide notice to the Swap Dealer that, had the person applied for registration as an associated person, NFA would have granted such registration. As noted above, the Commission has estimated that up to 55 SBS Entities may seek registration, while the CFTC has provisionally registered 102 Swap Entities.²⁶⁷ Using the data from NFA concerning 15 applications over approximately 5.75 years, we estimate the filing of approximately 2 applications per year on

previously approved to associate pursuant to Rule 19h-1 and who then became subject to a subsequent final regulatory action or was convicted of a criminal offense within the relevant time period (January 1, 2010, through June 30, 2018), as reported on the individual's Uniform Registration Forms.

For MC-400A Applications: Reoffender is defined as a broker-dealer who was previously approved pursuant to Rule 19h-1 and who then became subject to statutory disqualification again within the relevant time period (January 1, 2010, through June 30, 2018), as reported on the broker-dealer's Uniform Registration Forms.

²⁶⁶ A total of 3 individuals account for 4 reoffenses (*i.e.*, one person reoffended twice).

²⁶⁷ See CFTC Provisionally Registered Swap Dealers, as of October 11, 2018, <https://www.cftc.gov/LawRegulation/DoddFrankAct/registerwapdealer.html>, last accessed November 6, 2018.

aggregate across all SBS Entities requesting that statutorily disqualified associates persons be permitted to effect or be involved in effecting security-based swaps on behalf of an SBS Entity.²⁶⁸

We note that the number of applications received by NFA may only present a partial picture of the potential impact of a disqualification because, *inter alia*, (1) the CFTC definition of “associated person” of a Swap Entity includes only natural persons, not entities (see 17 CFR 1.3(aa)(6)); (2) in CFTC Regulation 23.22(b), 17 CFR 23.22(b), the CFTC provided an exception from the prohibition set forth in CEA Section 4s(b)(6), 7 U.S.C. 6s(b)(6), for any person subject to a statutory disqualification who is already listed as a principal, registered as an associated person of another CFTC registrant, or registered as a floor broker or floor trader.

Most applications were made with respect to individuals disqualified for non-investment related conduct: of the 15 applications, 9 applications were filed by Swap Dealers for associated persons whose disqualifying misconduct was not investment-related (misdemeanors and felonies for non-investment related conduct). With respect to application dispositions, the NFA made a determination that it would have granted registration as an associated person of a Swap Dealer if that person had applied for registration as an associated person on 13 applications. In two other instances, an application for registration was filed and subsequently withdrawn (2012) and an individual was no longer employed by the firm (2013).

Regarding instances of repeated misconduct, since individuals who act as associated persons of Swap Dealers are not registered, NFA receives no information regarding re-offenses. However, to date, none of the swap dealers have filed additional statutory disqualification forms

²⁶⁸ This figure slightly overestimates the number of applications calculated as: (15 applications x 55 SBSEs /102 Swap entities) / approximately 5.75 years ≈1.4.

to request NFA determination with respect to a new statutory disqualification for any of the individuals. Information that would provide any estimates of investor losses in various disqualification instances was not available.

c. Other Data about Misconduct

In the Proposing Release, the Commission described available data on disqualification and misconduct in the securities market. In this section, we supplement the discussion with recent research on that topic. In addition to data on parallel review processes, research has examined data on misconduct of brokers, registered investment advisers, and money managers.²⁶⁹ These results are generally obtained from registered brokers and investment advisers, in a more competitive industry with a clientele that includes retail customers. This differs from security-based swap markets, which have unique features. For example, security-based swaps may be more opaque than equity or bonds, potentially increasing informational asymmetries among transacting counterparties.²⁷⁰ At the same time, security-based swap markets have a dealer-oriented market structure, where a relatively small group of dealers serves a predominantly institutional clientele.²⁷¹ This can strengthen repeated game reputational incentives, and the institutional nature of the clientele may suggest a greater degree of investor sophistication than in the retail context.

²⁶⁹ A significant limitation of this literature is the fact that only a fraction of misconduct may be detected. As a result, misconduct rates in the data reflect both the prevalence of the underlying misconduct and the probability of detection.

²⁷⁰ See Better Markets Letter, at 2 (stating that “derivatives are so complex and poorly understood by even sophisticated market participants.”).

²⁷¹ As can be seen from Tables 1 and 2 above, the overwhelming bulk of activity is conducted by dealers and institutions. See also Inaki Aldasoro & Torsten Ehlers, *The Credit Default Swap Market: What a Difference a Decade Makes*, BIS Quarterly Review, June 2018, at 1, 4 (Graph 2), available at https://www.bis.org/publ/qtrpdf/r_qt1806b.pdf, last accessed July 30, 2018.

Nevertheless, these data imply that, at least in their specific settings: (i) past disciplinary events and other disclosed matters may predict higher probability of future misconduct; (ii) employee characteristics are strong predictors of future employee misconduct; (iii) the ability to predict future misconduct with past misconduct may weaken over time; and (iv) misconduct may be relatively rare, employees with misconduct histories may be attracted to employers with higher prevalence of misconduct, and the misconduct of employees may increase the likelihood of misconduct of their colleagues.

Egan, Matvos, and Seru (2017)²⁷² examine BrokerCheck disclosures of the disciplinary history of FINRA registered representatives in 2005-2015. The paper defines misconduct broadly and includes in the definition customer disputes, disciplinary events, and financial matters reported by FINRA. On average, only 7 percent of employees in a given firm have misconduct records. However, rates of misconduct in several firms with the highest incidences of misconduct are as high as 15-20 percent. Hence, entities exhibit significant differences in misconduct risks in their labor force and, at least in some entities, the prevalence of misconduct by associated natural persons is significantly higher than industry average. In addition, firms tend to “match on misconduct,” with firms with higher rates of prior misconduct hiring employees with misconduct histories. Finally, prior misconduct strongly predicts repeated misconduct: approximately a third of employees with misconduct engage in repeated misconduct, and employees with prior misconduct are approximately five times as likely to

²⁷² See Mark Egan, Gregor Matvos, & Amit Seru, *The Market for Financial Adviser Misconduct*, J. Pol. Econ. (forthcoming, 2017), available at <https://ssrn.com/abstract=2739170>. Their measures of misconduct reflect customer disputes, disciplinary events, and financial matters reported by FINRA from advisers' disclosure statements during that period.

engage in new misconduct compared to the sample average. Similarly, Assadi (2018)²⁷³ finds that misconduct predicts future misconduct, and this relationship is weakened by time elapsed since the previous incidence of misconduct.

Dimmock, Gerken, and Graham (2018)²⁷⁴ examine customer complaints against FINRA-registered representatives in 1999 through 2011, and argue that misconduct of individuals influences the misconduct of their coworkers. The paper uses mergers of firms as a quasi-exogenous shock and examines changes in an adviser's misconduct around changes to an employee's coworkers due to a merger. The paper estimates that an employee is 37 percent more likely to commit misconduct if her new coworkers encountered in the merger have a history of misconduct. The paper contributes to broader evidence on peer effects, connectedness, and commonality of misconduct,²⁷⁵ and can help explain the distributional properties in the prevalence of misconduct across firms documented in Egan, Matvos, and Seru (2017).

Other papers have considered the role of disclosures for the predictability of misconduct and the distribution of investor losses related to misconduct. They seem to indicate that, in some contexts, existing disclosures accessible to the investing public allow investors to identify brokers, investment managers, and hedge funds that have significantly higher misconduct risk both in terms of probability of misconduct as well as dollar investor losses. While these results

²⁷³ See Pooria Assadi, *Empirical Investigation of the Causes and Effects of Misconduct in the U.S. Securities Industry* (Working Paper, 2018), available at http://summit.sfu.ca/system/files/iritems1/17890/etd10567_PAssadi.pdf.

²⁷⁴ See Stephen G. Dimmock, William C. Gerken, & Nathaniel Graham, *Is Fraud Contagious? Coworker Influence on Misconduct by Financial Advisors*, 73 J. Fin. 1417, (2018).

²⁷⁵ See, e.g., Christopher A. Parsons, Johan Sulaeman, & Sheridan Titman, *The Geography of Financial Misconduct*, 73 J. Fin. 2087 (2018), available at <https://onlinelibrary.wiley.com/doi/abs/10.1111/jofi.12704>.

are limited to their specific settings, we note that the security-based swap market is an institutional market. As such, the investor clientele consuming public disclosures of registered SBS Entities may be more sophisticated than that of retail brokerages or investment managers in the settings discussed below. In the broker-dealer setting, which may be most analogous to the security-based swap setting, Qureshi and Sokobin (2015)²⁷⁶ use BrokerCheck data for 2000 through 2013 to explore the distribution of events involving investor losses (measured as complaints that led to awards against brokers or voluntarily settled above a *de minimis* threshold). They also test whether public disciplinary records, financial and other disclosures, and employment history information can meaningfully predict future misconduct and investor losses. The paper's three main results are as follows. First, investor loss events are rare and predominantly one-time offenses. Between 98.7 percent and 99 percent of brokers are not associated with any investor loss events. Of the brokers with investor loss events, the overwhelming majority (approximately 82 percent) have only 1 event, with only about 12 percent having 2 events and about 6 percent of brokers having 3 events or more. Second, publicly observable data yield a high degree of predictability of future investor loss events. For example, 20 percent of brokers with the highest *ex-ante* predicted probability of investor losses (based on public disclosures) are associated with more than 55 percent of the investor loss events with approximately 56 percent of total dollar investor losses. In turn, 20 percent of brokers with the lowest *ex-ante* probability of investor loss events are associated with only 3.8 percent of investor loss events. The paper concludes that publicly available information allows investors to

²⁷⁶ See Hammad Qureshi & Jonathan S. Sokobin, *Do Investors Have Valuable Information about Brokers?* (FINRA Office of the Chief Economist Working Paper, August 2015), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2652535, last accessed July 30, 2018.

discriminate between brokers with a high propensity for investor loss from other brokers. Third, losses associated with the broker's coworkers meaningfully increase the overall power to predict investor loss events; however, undisclosed financial events, undisclosed disciplinary events, and exam performance do not.

5. Requests for Relief from Statutory Disqualification under Rule of Practice 194

In the Proposing Release, the Commission relied on disqualification review application data for 2014, and estimated that there may be as many as five applications per year with respect to associated natural persons and as many as two applications per year with respect to associated person entities.²⁷⁷ As described above, we estimate that up to 55 entities may register with the Commission as SBS Entities, and we now estimate 21,310 associated natural persons. We have also received additional data regarding the total number of MC-400 and MC-400A applications received by FINRA from 2010 through June of 2018. Assuming the ratio of applications for association with statutorily disqualified persons at SBS Entities is the same as at broker-dealers, the data indicate there may be approximately three applications for natural persons per year.²⁷⁸ Recognizing potential annual fluctuations in the incidence of disqualification review applications, we now conservatively estimate that SBS Entities may file up to five applications per year with respect to their associated natural persons.²⁷⁹

²⁷⁷ See Proposing Release, 80 FR at 51707.

²⁷⁸ For natural persons: $21,310 * (33/267,043) = 2.6$.

²⁷⁹ To the extent that SBS Entities are using the same personnel to transact in security-based swaps, swaps, and underlying securities, and if those personnel are the subject of a prior application or other form of relief from the Commission, CFTC, an SRO, or a registered futures association, the number of new applications the Commission receives may be lower than the calculated estimate.

We also note that registered SBS Entities retain the option of complying with statutory

C. Benefits, Costs, and Effects on Efficiency, Competition, and Capital Formation

Exchange Act Section 15F(b)(6) provides the Commission with the authority to provide relief from the prohibition against using associated natural persons subject to a statutory disqualification to effect or be involved in effecting security-based swaps.²⁸⁰ As discussed above, clarity provided by the final rule regarding the materials to be submitted, the items to be considered, and the standard of review, may alter an SBS Entity's assessment of (1) any application costs and reputational costs that come with choosing to associate with disqualified persons, and (2) its beliefs as to the likelihood of an approval or denial decision by the Commission. To the extent that any such alteration leads to greater or fewer applications for relief under Rule of Practice 194 relative to the baseline with no process rule in place, economic costs and benefits may accrue to SBS Entities, associated persons, and counterparties to SBS Entities.

As discussed above, we estimate that the Commission will receive five or fewer applications per year under the final Rule of Practice 194. Given the number of natural persons expected to associate with SBS Entities, and our understanding of the labor market in security-based swaps, reassigning or disassociating from a disqualified natural person for the purposes of effecting security-based swaps on behalf of SBS Entities may be relatively less costly than disassociating from disqualified person entities. We continue to believe that the overall

disqualification provisions by disassociating with or reassigning disqualified persons. As a result, many instances of disqualification may be resolved through disassociation or reassignment. Registered SBS Entities would likely take advantage of the provision only when the benefits of associating with a disqualified person outweigh the costs, including reputational costs, of making an application.

²⁸⁰

See 15 U.S.C. 78o-10(b)(6).

economic impact of the final rule will depend primarily on: (i) how many associated persons of SBS Entities become disqualified and their value to their associated SBS Entities, (ii) the relative market share of affected SBS Entities, (iii) the importance and structure of relationships between SBS Entities and their counterparties, and (iv) the response of unaffected SBS Entities and their counterparties. We are mindful of the economic tradeoffs inherent in our policy choices and their impact on the securities markets. We discuss these economic effects in more detail below.

The Commission lacks data on the complexity and variety of current SBS Entity business structures and activities, the degree of SBS Entity reliance on associated persons subject to statutory disqualification, the location and specificity of expertise of such persons, as well as any reputational costs of associating with disqualified persons in security-based swap markets.

Further, the economic effects of various provisions of the final Rule of Practice 194 hinge on a number of factors. Such factors include: (i) whether and how significantly SBS Entities may be affected by the statutory prohibition in Exchange Act Section 15F(b)(6); (ii) any reputational and direct costs and response of counterparties to SBS Entities seeking relief under Rule of Practice 194 relative to the baseline exemptive relief process; (iii) differences in counterparty risks and related losses under final Rule of Practice 194 relative to the baseline exemptive relief process; and (iv) how other SBS Entities may react to the newly opened market share should some SBS Entities temporarily cease effecting security-based swaps or exit the market due to the statutory prohibition in Exchange Act Section 15F(b)(6). To the best of our knowledge, no such data are publicly available, and commenters have not provided data, estimates or other information to enable quantification. We, therefore, cannot quantify many of the effects of the final Rule of Practice 194, including the tradeoff behind an SBS Entity's choice to pursue relief and face potential reputational losses versus disassociating with the statutorily disqualified associated

person. Where we cannot quantify, we discuss in qualitative terms the relevant economic effects, including the costs and benefits of the final rule and alternative approaches.

1. Costs and Benefits of Rule of Practice 194

a. Costs and Benefits of a Review Process

In evaluating the likely benefits to SBS Entities of the approach being adopted, we note that absent Rule of Practice 194, SBS Entities would still be able to apply to the Commission, and the Commission would still be able to exercise its authority to grant relief.²⁸¹ The final Rule of Practice 194 does, however, establish a structured process that provides SBS Entities clarity and guidelines on the form of application, the items to be considered, and the standard of review that the Commission will apply. Furthermore, the final rule helps to ensure that the Commission will have sufficient information to make a meaningful determination that providing relief for an associated person is consistent with the public interest.

Specifically, absent Rule of Practice 194 and without a formal review process, SBS Entities seeking to apply for relief from Section 15F(b)(6) are likely to apply to the Commission directly, looking to either Rule of Practice 193²⁸² or an analogous process as a guide. We believe that such applications would be more time-consuming and would be more prone to errors or more likely to be deemed to contain insufficient information to allow the Commission to make an informed determination.

Under the final Rule of Practice 194, SBS Entities will generally be aware of the information they are required to provide, as well as the standard of review. Clarity about the items that the Commission will consider in making a determination, will allow SBS Entities to

²⁸¹ See 15 U.S.C. 78o-10(b)(6). See also Section V.B, *supra*.

²⁸² See 17 CFR 201.193.

make more-informed assessments as to the likelihood that the Commission will either grant or deny relief, which may affect their decision whether to apply for relief. The final Rule of Practice 194 may thus conserve resources relative to a more time-consuming and error-prone application process absent the rule. Delays in the application process absent the rule may require SBS Entities to replace or reassign a statutorily disqualified associated person. To the extent that the application review process under Rule of Practice 194 is less error-prone and involves fewer delays, such costs may be reduced. In addition, the final Rule of Practice 194 may allow SBS Entities to make more-informed evaluations about the tradeoff between pursuing an application and either disassociating with or reassigning a person subject to a statutory disqualification.

To the extent that Rule of Practice 194 increases certainty and conserves resources for SBS Entities applying for relief from the statutory prohibition in Exchange Act Section 15F(b)(6), some SBS Entities may choose to apply to the Commission under Rule of Practice 194, where they would have otherwise disassociated from a disqualified person. This may benefit affected SBS Entities that would have incurred higher costs from disassociating compared with costs of applying for relief under Rule of Practice 194. As discussed in greater detail in Section V.C.2, under Rule of Practice 194, a greater number of SBS Entities may be able to effect security-based swaps without potentially costly business restructuring. As a result, the counterparties of SBS Entities may benefit from greater choice of SBS Entity counterparties and lower transaction costs. Finally, applications and supporting materials, including information concerning supervisory structure, terms of employment and other items, may inform Commission understanding of SBS Entity associations and ongoing oversight.

While Rule of Practice 194 is expected to result in benefits discussed above, it will also result in direct application costs for SBS Entities filing with the Commission under the final Rule

of Practice 194. In the Proposing Release, the Commission estimated that the average time necessary for an SBS Entity to research the questions, and complete and file an application under Rule of Practice 194 would be approximately 40 hours for applications regarding entities, and 30 hours for applications regarding natural persons.²⁸³ The Commission received no comments and continues to believe the estimate for applications regarding natural persons is reasonable and appropriate; the exclusion for entities under the final rule, however, means that SBS Entities will not make any applications regarding entities and thus will spend no time on such applications. Since the Commission now estimates that SBS Entities would make up to five applications on an average annual basis, the Commission estimates the economic costs to prepare, review, and submit applications under the final Rule of Practice 194 of up to \$73,620 per year.²⁸⁴

Notably, an SBS Entity would only submit an application where the SBS Entity believed that the economic value of retaining a particular person to effect security-based swaps outweighed the application costs associated with the final Rule of Practice 194. In other words, any application costs would be incurred by SBS Entities on a voluntary basis. As such, it is not clear how many SBS Entities will choose to apply for relief rather than simply disassociate from a statutorily disqualified associated person. Furthermore, the decision to incur application costs would also reflect an SBS Entity's assessment of the likelihood of the Commission granting relief under the public interest standard set forth in the final Rule of Practice 194. Lastly, under

²⁸³ See Proposing Release, 80 FR at 51713.

²⁸⁴ This estimate is based on the following. Total burden hours = [(30 hours) x (up to 5 SBS Entities applying with respect to associated persons that are natural persons) + (6 hours) x (up to 5 SBS Entities filing notices)] = 180. Attorney at \$409 per hour x 180 burden hours = \$73,620. The hourly cost figure is based upon data from SIFMA's *Management & Professional Earnings in the Securities Industry 2013* (modified by the Commission staff to adjust for inflation and to account for an 1,800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead).

the baseline and absent Rule of Practice 194, SBS Entities can apply to the Commission for exemptive relief from the statutory prohibition, which would also involve costs. Since compliance with SBS Entity registration is not yet required and, thus, no exemptive relief applications by SBS Entities have been filed, we are unable to estimate those costs. The net costs of the application process under Rule of Practice 194 must be assessed relative to the baseline process of requesting exemptive relief, and the above estimate of \$73,620 per year is likely to overestimate the additional costs of the application process.

Under the baseline, an SBS Entity would not be precluded under Exchange Act Section 15F(b)(6) from seeking Commission relief.²⁸⁵ However, as already discussed, SBS Entities would lack clarity about the application process and, though they may look to Rule of Practice 193 or similar processes as a guide, SBS Entities could potentially expend more resources than necessary due to process uncertainty. Thus, notwithstanding the cost estimates above, the final rule may mitigate application costs relative to the baseline due to the existence of a structured process. We expect that this cost mitigation would be most significant for SBS Entities that would be among the first to seek relief. SBS Entities seeking relief later would enjoy the benefits of learning by observing the process experienced by first-movers.

The Commission has received comment that the absence of penalties invites misconduct and that a ban on disqualified persons without exclusions would lead firms to understand that failure to oversee and disassociate from disqualified persons jeopardizes business.²⁸⁶ In evaluating this argument, the Commission has considered recent supplemental information relevant to this question. Specifically, in other contexts, some entities dismiss or disassociate

²⁸⁵ See Section *supra*.

²⁸⁶ See Public Citizen Letter, at 1-2.

from disqualified persons to limit reputational costs. For example, Egan, Matvos, and Seru (2017) show that approximately half of employees with a misconduct history lose their jobs. However, other firms frequently rehire such employees, and the rehiring firms tend to have higher rates of prior misconduct. Employees with prior misconduct records are more likely to be hired by firms with higher rates of misconduct that pay lower compensation, have retail customers, and operate in counties with lower education, elderly populations, and higher incomes. The paper hypothesizes that such firms “specialize” in misconduct and cater to unsophisticated customers, but the paper does not evaluate fees or performance of investor portfolios. However, in the residential mortgage-backed securities (“RMBS”) market, Griffin, Kruger, and Maturana (2018)²⁸⁷ do not find that RMBS employees had lower levels of job retention, promotion, or outside moves than non-RMBS employees, even when RMBS employees signed high-loss deals or deals implicated in lawsuits. While these results in the RMBS market appear somewhat inconsistent with evidence in the broker-dealer setting (Egan et al. (2017)), Amiram et al. (2018) suggest that instances of RMBS-related fraud in the sample may not have imposed on banks reputational costs large enough to result in significant labor market discipline of RMBS employees. In addition, some RMBS employees that signed deals implicated in lawsuits may have remained in continued employment of issuing banks to support litigation.

We continue to acknowledge that the results of the cited studies are not specific to the swap or security-based swap contexts. However, the studies suggest that, in some settings, even

²⁸⁷ See John M. Griffin, Samuel Kruger, & Gonzalo Maturana, *Do Labor Markets Discipline? Evidence from RMBS Bankers*, J. Fin. Econ. (accepted, 2018), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2977741, last accessed Aug. 19, 2018.

without a ban on disqualified persons, some employers may already understand that failure to oversee and disassociate from some disqualified persons may jeopardize the firms' business, and the labor market may provide some penalties against misconduct. To the degree that these findings may apply to institutional security-based swap markets, they indicate that market discipline may be a separate disincentive against misconduct and may partly mitigate the concern raised by the commenter²⁸⁸ that the absence of bans invites misconduct.

b. Costs and Benefits of the Commission, CFTC, SRO, Registered Futures Association Provision

Beyond establishing a process for submitting applications, Rule of Practice 194 allows an SBS Entity, subject to certain conditions, to permit an associated person who is subject to a statutory disqualification to effect or be involved in effecting security-based swaps on behalf of the SBS Entity without making an application to the Commission, if the associated person's membership, association, registration, or listing as a principal has been granted or otherwise approved by the Commission, CFTC, an SRO, or a registered futures association. In such cases where an SBS Entity meets the requirements of the final rule, these SBS Entities would be able to provide notice to the Commission in lieu of having to compile the same information and documentation for a repeated review, thereby eliminating redundancy and decreasing SBS Entity costs.

This provision of final Rule of Practice 194 provides SBS Entities with flexibility in hiring and assigning employees and associating with entities depending on business needs and required capabilities. To the extent that SBS Entities, Swap Entities, and broker-dealers use the same personnel or entities to effect security-based swaps, swaps, and securities transactions, SBS

²⁸⁸ See Public Citizen Letter, at 1-2.

Entities will not have to undergo and bear costs of duplicate review when decisions about relief from statutory disqualifications have already been made by the Commission or another regulatory authority. This provision would, therefore, primarily benefit SBS Entities transacting across markets through statutorily disqualified associated persons previously granted relief by the Commission, the CFTC, FINRA or NFA by enabling those SBS Entities to avoid costs of a separate application process under Rule of Practice 194 or business restructuring. We also recognize that this provision reduces costs incurred by SBS Entities associating with disqualified persons previously granted relief by the Commission, the CFTC, FINRA or NFA so it may benefit these disqualified persons by potentially improving their employment options and business outcomes.

Notwithstanding these benefits, this provision of the final Rule of Practice 194 may give rise to risks related to permitting otherwise statutorily disqualified associated persons to effect or be involved in effecting security-based swaps on behalf of SBS Entities without an individualized determination by the Commission that doing so is consistent with the public interest. Exchange Act Rule 19h-1 provides for Commission review of notices filed by SROs proposing to admit any person to, or continue any person in, membership or association with a member, notwithstanding statutory disqualification.²⁸⁹ The Commission does not, however, review or approve statutory disqualification decisions of NFA or CFTC. As a result, in circumstances where the SBS Entity has obtained relief from the NFA or CFTC, the Commission will not have the opportunity through the Rule of Practice 194 process to make an individualized determination or impose terms of reassociation specific to risks and activities in security-based swap markets. However, this relief is only available where an application related to a specific

²⁸⁹ See 17 CFR 240.19h-1.

disqualifying event has been reviewed and approved by the CFTC, FINRA, or the NFA, and the terms and conditions of association with the SBS Entity are the same in all material respects as those approved by the CFTC, FINRA, or the NFA. Since this provision would result in a potentially greater number of statutorily disqualified associated persons being permitted to effect or be involved in effecting security-based swaps on behalf of SBS Entities, it may increase compliance and counterparty risks, as discussed in section IV.D. However, we note that the Commission continues to have authority to bring a separate action under Exchange Act Section 15F(l)(3).²⁹⁰ As discussed above and in Section III, the Commission continues to believe that this provision may benefit SBS Entities relying on the same associated persons transacting across integrated markets, and, to the extent SBS Entity costs may be passed along to counterparties in the form of less attractive terms of available security-based swaps, it may also benefit counterparties.

c. Costs and Benefits of the Relief for Associated Entity Persons from Exchange Act Section 15F(b)(6)

As part of the final Rule of Practice 194, the Commission is adopting a blanket exclusion from the general prohibition in Exchange Act Section 15F(b)(6) with respect to all associated person entities. As a result of this provision, SBS Entities cross-registered as Swap Entities with the CFTC would experience economies of scope in associating with persons that are entities because the “associated person” definition of a Swap Entity is limited solely to natural persons and excludes person entities.²⁹¹ SBS Entities will be able to rely on the same associated person entities in transactions with the same counterparties across integrated swap and security-based

²⁹⁰ See 15 U.S.C. 78o-10(l)(3).

²⁹¹ See 17 CFR 1.3(aa)(6). See also CFTC Regulation 23.22(b), 17 CFR 23.22(b).

swap markets. As estimated in the economic baseline, approximately 46 out of 50 entities likely to register with the Commission as SBS Dealers are already registered with the CFTC as Swap Dealers and are currently able to associate with statutorily disqualified associated person entities in their swap activity.

In addition, as discussed above, approximately two thirds of accounts participating in the single-name CDS market also transact in index CDS subject to the CFTC's disqualification regime. This suggests that a majority of security-based swap counterparties are already currently transacting with the same entities likely to register as SBS Entities and that those SBS Entities may be associating with disqualified entities. The entity exclusion would enable the same SBS Entity – counterparty relationships to continue across swap and security-based swap markets, eliminating the need for a counterparty to establish new dealer relationships solely for the purpose of security-based swap transactions.

Further, SBS Entities will avoid all costs of business restructuring related to associated person entities that become statutorily disqualified, or in the event of new associations with statutorily disqualified associated person entities effecting or involved in effecting security-based swaps on the SBS Entity's behalf. This flexibility may benefit SBS Entities and enable them to provide counterparty services to security-based swap counterparties more effectively or efficiently. In addition, the exclusion eliminates the potential for disruption to security-based swap markets, including potential adverse effects to counterparties, that may occur if SBS Entities temporarily cease operations due to not being able to utilize the services of their associated person entities or if SBS Entities move services to associated person entities that may not be as well-equipped to handle them, pending a determination on their application for relief.

Relief for SBS Entities associating with statutorily disqualified person entities would

result in SBS Entities being less constrained by the general statutory prohibition. We continue to recognize that associating with statutory disqualified person entities effecting or involved in effecting security-based swaps on behalf of SBS Entities may give rise to counterparty and compliance risks and related losses.²⁹² We also continue to recognize that statutory disqualification and an inability to continue associating with SBS Entities creates disincentives against underlying misconduct for associated persons.²⁹³ Further, we recognize that, under the provision being adopted, the Commission would be unable to make an individualized determination about whether permitting a given associated person entity subject to a statutory disqualification to effect or be involved in effecting security-based swaps on behalf of an SBS Entity is consistent with the public interest.²⁹⁴

Some counterparties may respond to the exclusion by increasing the amount of due diligence they perform on their SBS Entity counterparties (such as accessing public Form SBSE disclosures, SEC orders, FINRA actions, and other public records) relative to the current baseline. We are unable to quantitatively estimate the number of counterparties that may respond in this way and related costs, as the extent of additional information acquisition and related costs will depend on: each counterparty's baseline due diligence and compliance practices; the size of the counterparty's security-based swap transaction activity and relative importance of such activity in the counterparty's business; the degree to which the counterparty

²⁹² See, e.g., Better Markets Letter. See also Proposing Release, 80 FR at 51713. Accord Egan, Matvos, & Seru (2017) (showing in another context that there is considerable clustering of employees engaging in misconduct in a handful of firms).

²⁹³ See, e.g., Public Citizen Letter; Better Markets Letter. See also Proposing Release, 80 FR at 51716.

²⁹⁴ However, the Commission could, by order, censure, place limitations on the activities or functions of the associated person, or suspend or bar such person from being associated with an SBS Entity. See 15 U.S.C. 78o-10(l)(3).

values statutory disqualification of associated persons as a signal of SBS Entity quality; and each counterparty's assessment of the tradeoff between potentially higher ongoing risks related to disqualification of SBS Entities' associated persons and the relative attractiveness of the price and non-price terms of security-based swaps that SBS Entities with disqualified associated persons may offer.

Several factors may limit the above economic effects of this final provision.

First, information about conduct giving rise to statutory disqualification (*e.g.*, SEC orders, injunctions, FINRA actions) in the U.S. is generally public.²⁹⁵ In addition, the final SBS Entity registration rules that form a part of our economic baseline require all SBS Entities to submit to the Commission information about their disciplinary histories, including those of control affiliates. Under the final SBS Entity registration rules that form a part of the economic baseline, this information will subsequently be made public by the Commission.²⁹⁶ We recognize that control affiliates are a subset of all associated person entities of an SBS Entity. However, to the extent that SBS market participants consider disciplinary history of control affiliates important in predicting future misconduct, assessing counterparty risks, or selecting security-based swap market counterparties, market participants will have access to such disclosures. Under the baseline, SBS market participants are, thus, able to choose whether and

²⁹⁵ As a general matter, Commission orders are publicly available, and FINRA disciplinary actions issued in 2005 or later are eligible for publication pursuant to Rule 8313 (Release of Disciplinary Complaints, Decisions and Other Information). Information about criminal convictions are generally publicly available in the United States (absent orders sealing those records), but are typically made available through federal, state, and local criminal dockets, which can be more costly to access. Statutorily disqualifying events in foreign jurisdictions may not be public depending on the rules and blocking/privacy statutes in various jurisdictions.

²⁹⁶ See Registration Adopting Release, 80 FR at 49004.

how to transact with SBS Entities that use control affiliates with a history of misconduct, enabling better informed counterparty selection and market discipline of misconduct.

Second, the security-based swap market is a dealer market, with the bulk of activity and exposure among dealers, or between dealers and non-dealer financial entities.²⁹⁷ To the degree that disciplinary history may predict future counterparty risks, and to the extent that institutional market participants are able to process the information in disclosures, disciplinary history disclosures regarding control affiliates are likely to reduce counterparty selection of SBS Entities that have been the subject of disciplinary actions, imposing market discipline.²⁹⁸ SBS Entities, knowing that disciplinary history of control affiliates must be disclosed, may have further incentives to avoid engaging in misconduct or may exit the market.

As discussed above, one commenter indicated that a ban on statutorily disqualified associated persons without any exclusions (including without an entity exclusion) would lead firms to understand that lax oversight and failure to disassociate from disqualified persons jeopardizes business.²⁹⁹ In addition, a commenter indicated that, absent an associated person entity prohibition, there would be no deterrent for entities or firms engaging in misconduct that gives rise to disqualification.³⁰⁰ In evaluating these arguments, the Commission has considered recent supplemental information. Specifically, existing evidence on reputational incentives surrounding misconduct is limited to other contexts (such as corporate restatements, SEC enforcement actions, securities class actions, mutual fund scandals, and broker disclosures, etc.).

²⁹⁷ See Tables 1 and 2 of the baseline. See also Aldasoro & Ehlers (2018) at 4 (Graph 2), available at https://www.bis.org/publ/qtrpdf/r_qt1806b.pdf.

²⁹⁸ See Registration Adopting Release, 80 FR at 49004.

²⁹⁹ See Public Citizen Letter, at 1-2.

³⁰⁰ See Americans for Financial Reform Letter, at 3.

However, most existing evidence on broker-dealers and mutual funds seems to suggest that markets may often respond to disclosures of financial misconduct and investors may vote with their feet, such that companies and mutual funds engaging in misconduct suffer direct and reputational costs around the revelation of misconduct.³⁰¹ We note that not all misconduct affects reputational capital, and some papers show that the market may be less likely to penalize non-financial, third-party, and some financial reporting misconduct.³⁰² However, to the degree that disclosures of disciplinary history information are informative of the probability of different types of future misconduct,³⁰³ customers may choose to closely monitor such disclosures and make informed counterparty selection decisions. Sophisticated institutional investors with large security-based swap exposures may have stronger incentives and better ability to monitor their SBS Entity counterparties, and their choice to shift business to another SBS Entity may result in

³⁰¹ For example, in the mutual fund advisor context, Wu (2018) shows that advisors with ADV disciplinary history disclosures are more likely to be replaced in the year following misconduct, which dampens the effect of misconduct on fund flows. See Kai Wu, *The Economic Consequences of Mutual Fund Advisory Misconduct* (Asian Finance Association 2018 Conference, Working Paper, 2018) available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3061419, last accessed Sept. 8, 2018. See also Dan Amiram, Serene Huang, & Shiva Rajgopal, *Does Financial Reporting Misconduct Pay Off Even When Discovered?* (Working Paper, October 1, 2018), available at <https://www0.gsb.columbia.edu/mygsb/faculty/research/pubfiles/25784/Does%20misconduct%20pay%20Oct%201%202018%20SR.pdf>.

³⁰² See, e.g., Jonathan M. Karpoff, D. Scott Lee, & Gerald S. Martin, *Foreign Bribery: Incentives and Enforcement* (Working Paper, April 7, 2017), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1573222, last accessed Aug. 19, 2018. See also Bruce Haslem, Irena Hutton, & Aimee Hoffman Smith, *How Much Do Corporate Defendants Really Lose? A New Verdict on the Reputation Loss Induced by Corporate Litigation* (Working Paper, November 21, 2016), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2290821, last accessed Aug. 19, 2018. See also Amiram, Huang, & Rajgopal (2018).

³⁰³ For example, in the parallel broker-dealer context, some existing research suggests that disclosures of past misconduct are strongly predictive of future misconduct risk. See, e.g., Qureshi & Sokobin (2015).

greater losses for their original SBS Entity counterparty. As a result, reputational incentive effects may be more important in markets with a concentrated institutional investor clientele. Thus, we recognize that reputational costs of misconduct may be another important disincentive against SBS Entity associations with disqualified persons, separate from a ban on statutorily disqualified associated persons, potentially mitigating the concern raised by commenters.³⁰⁴

At the same time, the concentrated nature of security-based swap dealing activity may reduce the ability of counterparties to choose to transact with SBS Entities that do not rely on disqualified associated persons. As estimated in the economic baseline, the top five dealer accounts engaged in over 55 percent of all SBS Entity transactions, and the median counterparty transacted with only 2 dealers in 2017. While reputational incentives may flow from a customer's willingness to deal with an SBS Entity, the fact that the customer may not have many dealers to choose from weakens those incentives. Importantly, we recognize that these estimates of market concentration are themselves reflecting market participants' current choice of counterparties. Institutional counterparties are likely to trade off the potentially higher counterparty risk of transacting with SBS Entities with disqualified person entities against the price and non-price terms of security-based swaps such SBS Entities may offer. If a number of active counterparties choose to move their business to SBS Entities without disqualified associated persons, even if they currently have low market share, activity may become further concentrated among SBS Entities without disqualified persons and / or market concentration itself may decrease.

³⁰⁴ See Public Citizen Letter, at 1-2; Americans for Financial Reform Letter, at 3.

Third, as discussed above,³⁰⁵ the exclusion in Rule of Practice 194(c) will neither limit nor otherwise affect the Commission's statutory authority to institute proceedings or bring an action against any associated person entities, including, in the appropriate case, to institute proceedings under Exchange Act Section 15F(l)(3) to determine whether the Commission should censure, place limitations on the activities or functions of such person, or suspend for a period not exceeding 12 months, or bar such person from being associated with an SBS Entity. As noted above, this exclusion will also neither limit nor otherwise affect the ability of the Commission, the CFTC, an SRO or the NFA to deny membership, association, registration or listing as a principal with respect to any associated person entity.

The overall effects of this exclusion on security-based swap markets reflect these economic tradeoffs and will likely be similar to those observed in swap markets, which involve largely the same group of dealers (46 out of 50 SBS Dealers expected to be cross-registered in swap markets) and most of the same counterparties (approximately two thirds of accounts are active across single name and index CDS markets).

d. Costs and Benefits of Public Availability of Orders and Notices

The publication of orders and notices gives rise to both costs and benefits for affected SBS Entities, their counterparties, and other market participants.

First, publicly available and publicly disseminated information regarding applications under Rule of Practice 194 would provide market participants with information they may find useful in assessing their counterparties. In particular, market participants may use knowledge about whether an SBS Entity has applied for relief and/or whether an SBS Entity currently

³⁰⁵ See Section III.C, *infra*, for a discussion of proposed Rule of Practice 194(c).

employs or associates with disqualified persons to effect or be involved in effecting security-based swaps when choosing counterparties. In general, such information may be valued by market participants when selecting counterparties, if they believe such knowledge is informative about the misconduct risk of a counterparty.

In addition, we note that this information may be useful to SBS Entities that have not applied for relief under the final Rule of Practice 194. In particular, publicly available information regarding the outcome of Rule of Practice 194 applications may inform other SBS Entities' assessments of the likelihood that the Commission would grant relief in particular circumstances. For example, SBS Entities could look to outcomes in applications where disqualifications were for similar reasons. Such information may be useful in determining whether it is cost effective to seek relief.

We note that some SBS Entities may prefer that orders approving or denying an application under the rule remain private if they believe that counterparties will use this information as a signal of low quality or high counterparty risks of transacting with SBS Entities. Therefore, potential reputational costs associated with going through the application process and potentially associating with statutorily disqualified associated persons may discourage some SBS Entities from applying for relief under the final rule. Such SBS Entities may instead choose to disassociate from disqualified persons or reassign them to responsibilities that do not involve effecting or being involved in effecting security-based swaps. In considering disassociation, an SBS Entity will weigh any reputational costs against any costs of disassociation. For disqualified natural persons, such costs include the cost to an SBS Entity of replacing an employee (or other associated person), and will depend on the scarcity and value of a particular person's skills.

As stated above, under the approach being adopted, orders and notices under Rule of Practice 194 will be made publicly available on the Commission's website, whereas applications and supporting materials will be kept confidential, subject to the existing statutory and regulatory framework with respect to the public availability of such materials, including the FOIA,³⁰⁶ the Exchange Act,³⁰⁷ and applicable Commission rules.³⁰⁸ To the extent that 1) the information provided by SBS Entities in applications and supporting materials may be informative about future compliance and counterparty risks, 2) this information will not be fully reported in orders and notices, and 3) market participants may face costs of obtaining this information under the FOIA and other applicable laws, the approach being adopted provides fewer benefits relative to the alternative of routine mandatory disclosure of applications and supporting materials by applicants or the Commission. These considerations are discussed in greater detail in Section IV.D.6.

2. Effects on Efficiency, Competition, and Capital Formation

The Commission has assessed the effects arising from the final Rule of Practice 194 on efficiency, competition, and capital formation. As noted above, limiting the ability of statutorily disqualified associated persons to effect or be involved in effecting security-based swaps on behalf of SBS Entities may mitigate compliance and counterparty risks and may facilitate competition among higher quality SBS Entities, thereby enhancing integrity of security-based swap markets. At the same time, limits on a statutorily disqualified associated person's participation in the security-based swap markets may result in costs of business restructuring or

³⁰⁶ See 5 U.S.C. 552, *et seq.*

³⁰⁷ See 15 U.S.C. 78x.

³⁰⁸ See, *e.g.*, 17 CFR 200.80; 17 CFR 201.190; 17 CFR 240.24b-2.

applying to the Commission for relief, which may disrupt existing counterparty relationships and increase transaction costs borne by counterparties. As with the other economic effects already discussed, the effects of final Rule of Practice 194 on efficiency, competition, and capital formation flow primarily from: (i) how the rule alters an SBS Entity's evaluation of the tradeoff between the value of an associated person's skill and expertise in effecting security-based swaps against the costs of applying for relief or restructuring, and its ultimate decision concerning whether to seek relief and (ii) the exclusion of statutorily disqualified associated person entities from the scope of the prohibition.

As noted above, by providing a structured process and clarity as to the standard of review, the final Rule of Practice 194 may conserve resources relative to the baseline for SBS Entities applying for relief under Section 15F(b)(6), and therefore create a more efficient process for SBS Entities that choose to apply. Clarity about the items that the Commission will consider in making determinations on applications for relief may allow SBS Entities to make more informed assessments about whether a particular application is likely to be approved or denied. Increased certainty about the process may, in turn, alter an SBS Entity's evaluation of its own cost-benefit tradeoff in determining whether to file an application for relief, enabling the entity to more efficiently expend resources. To the extent that the savings resulting from the final rule encourage more SBS Entities to apply for relief, a greater number of SBS Entities may be able to effect security-based swaps without disruptions related to reassignments of statutorily disqualified staff. This may facilitate competition among SBS Entities or improve terms of available security-based swaps, if some SBS Entities pass along their costs to counterparties in the form of higher priced security-based swaps.

In addition, should more SBS Entities apply for relief or seek to avail themselves of the

associated person entity exclusion, a greater number of statutorily disqualified persons may seek employment and business opportunities in security-based swap markets. On the one hand, this could increase the “lemons” problem and related costs of adverse selection,³⁰⁹ since market participants may demand a discount from counterparties if they expect a greater chance that counterparties have employed statutorily disqualified associated persons that are involved in arranging transactions. On the other hand, the conduct that gives rise to disqualification is generally public information and orders regarding the outcome of review applications under Rule of Practice 194 as well as notices submitted by SBS Entities will be made public by the Commission, which may significantly attenuate this effect.

Persons eligible to rely on the exclusion related to applications already reviewed by the Commission, the CFTC, an SRO, or a registered futures association may enjoy a competitive advantage over persons not eligible for the same treatment. Because SBS Entities would not need to expend resources filing an application and would not face uncertainty concerning the likelihood of approval of such applications, they may prefer associating with persons who can rely on such an exclusion over other disqualified persons. If SBS Entities exhibit a preference for such persons, it could create competitive disparities among statutorily disqualified associated persons.

The associated person entity exclusion may prevent the fragmentation of transaction activity across related markets due to differential regulatory treatment of statutory

³⁰⁹ See, e.g., George A. Akerlof, *The Market for “Lemons”: Quality Uncertainty and the Market Mechanism*, 84 Q. J. Econ. 488 (1970). Informational asymmetry about quality can negatively affect market participation and decrease the amount of trading—a problem commonly known as adverse selection. When information about counterparty quality is scarce, market participants may be less willing to enter into transactions and the overall level of trading may fall.

disqualification. The Commission continues to recognize extensive spillovers between the informational efficiency, pricing, and liquidity of swap and security-based swap markets, and their connection to activity in reference security markets. Given the high degree of concentration of dealing activity in single-name and index CDS markets, even a temporary inability of one or several SBS Entities to transact due to a statutorily disqualifying event of an associated person entity may result in liquidity fragmentation and mispricing of claims with otherwise identical payoffs and risks. As a result, the associated person entity exclusion may limit fragmentation of integrated markets.

In addition, under the associated person entity exclusion, SBS Entities would be able to continue their security-based swap market participation without incurring the costs of reassigning or disassociating from disqualified entities. As a result, SBS Entities associating with entities that become subject to a statutory disqualification can continue dealing in security-based swaps without incurring costs of business restructuring. SBS Entities that begin to associate with already statutorily disqualified entities would be eligible for the same relief. This may enhance competition among SBS Entities as both SBS Entities with and those without statutorily disqualified associated person entities will be able to compete for security-based swap business with counterparties. This competitive effect may be particularly important given the highly concentrated nature of the security-based swap dealer market.

The overall effects of the exclusion for associated person entities from the general statutory prohibition on efficiency, competition, and capital formation, depend on the balance of several competing effects. Broadly, the exclusion may lower costs to SBS Entities of beginning or continuing to associate with statutorily disqualified entities. It also may serve to mitigate potential disruptions—such as SBS Entities temporarily ceasing dealing activity pending

business restructuring—should associated person entities of a number of SBS Entities become disqualified. At the same time, the presence and magnitude of the potential market disruption is unclear, since other SBS Entities are likely to begin competing for the newly opened market share if, for example, the SBS Entity had to, at least temporarily, cease dealing activity. The overall effects of this provision on security-based swap market quality, competition, and capital formation depend primarily on: (i) whether and which SBS Entities would be able to win the newly opened market share in such cases; (ii) the degree to which statutory disqualification may indicate future misconduct risk by associated person entities; (iii) the reputation costs to SBS Entities from associating with statutorily disqualified associated person entities relative to costs of disassociating and establishing a relationship with a non-statutorily disqualified associated person entity, and (iv) the degree to which existing public information about conduct giving rise to statutory disqualification is informative of future misconduct risk and the extent to which counterparties pay attention to such public information.

The Commission has received comment in support of strong disqualification standards as a feature of the SBS Entity regulatory framework, the general need of the public to have confidence in regulatory oversight of market participants, and making applications and supporting materials public.³¹⁰ We note that some recent research in other contexts shows that greater prevalence of disclosed misconduct can reduce investor participation in capital markets. Some research suggests that retail investor participation in the stock market may decrease around the revelation of fraud or misconduct, and there may be negative spillovers for firms that were not engaged in misconduct. For example, Gurun, Stoffman, and Yonker (2018) find that

³¹⁰ See Americans for Financial Reform Letter, at 4; Better Markets Letter, at 2, 6; Cummings Letter, at 3.

residents of communities more exposed to fraud were more likely to shift from capital markets to bank deposits. This result is consistent with the theoretical result in Gennaioli, Shleifer, and Vishny (2015) that portfolio managers provide “hand-holding” to build investor trust. Giannetti and Wang (2016) show that household participation in the stock market in a given state decreases after the revelation of corporate fraud in that state. They find that even households that do not hold stocks in scandal firms decrease holdings in both fraudulent and non-fraudulent firms. They also find that households with more lifetime exposure to corporate fraud allocate a lower share of capital into equity.³¹¹ Importantly, this research pertains to retail investor behavior in markets with relatively low informational asymmetries. We continue to recognize that these effects may be muted in institutional swap or security-based swap markets, or amplified due to the greater opacity of swaps or security-based swaps.

In addition, strong disqualification standards suggested by commenters may adversely affect competition and consumer surplus. For example, Berk and van Binsbergen (2017) model the costs and benefits of both disclosure and standards regulation of “charlatans” (professionals who sell a service they do not deliver) in high skill professions. Both standards and disclosure regulations drive charlatans out of the market, but the resulting reduction in competition amongst producers actually reduces aggregate consumer surplus, benefiting producers.³¹²

³¹¹ See Umit G. Gurn, Noah Stoffman, & Scott E. Yonker, *Trust Busting: The Effect of Fraud on Investor Behavior*, 31 Rev. Fin. Stud. 1341 (2018); Nicola Gennaioli, Andrei Shleifer, & Robert Vishny, *Money Doctors*, 70 J. Fin. 91 (2015); Mariassunta Giannetti & Tracy Yue Wang, *Corporate Scandals and Household Stock Market Participation*, 71 J. Fin. 2591 (2016).

³¹² The model assumes that, among others, the producers have no dominating outside options (skilled producers do not exit the market when the equilibrium wage in the profession declines). The paper models a labor market in which skill is in high demand, but very short supply. As a result, price increases due to standards regulation lead to the entry of

Further, information about underlying misconduct is public, and other research discussed above suggests that there may be significant capital market and labor market penalties for misconduct in some settings.³¹³ This may suggest that SBS Entities may simply disassociate from or reassign a statutorily disqualified associated person where the reputational penalties are severe. In addition, instead of exiting the market, some counterparties of SBS Entities with statutorily disqualified associated persons may simply move transaction activity to SBS Entities without such statutorily disqualified associated persons. Thus, where counterparties may become less willing transact with SBS Entities relying on statutorily disqualified associated persons, other SBS Entities that do not rely on disqualified associate persons may win business. Finally, we continue to note that Exchange Act Section 15F(b)(6) does not preclude either SBS Entities from seeking relief or the Commission from granting relief in the absence of the final Rule of Practice 194 or another disqualification review process. This economic analysis assesses the impacts of Rule of Practice 194 relative to a statutory baseline under which SBS Entities can seek exemptive relief from the Commission.

charlatans, but, because supply of skill is constrained, that does not increase quality. By contrast, Leland (1979) and the literature that emerged from it does not model charlatans or focus on markets with a short supply of skill. In Leland (1979), the introduction of standards can benefit consumers since the resulting price increase leads to the entry of higher quality goods – something that cannot happen when the supply of high quality goods is constrained, as in Berk and van Binsbergen (2017). Moreover, in Leland (1979) the government is fully informed and the consumer has no information about the quality of the good, whereas Berk and van Binsbergen (2017) model a homogeneous good bought by heterogeneous consumers. See Jonathan Berk & Jules H. van Binsbergen, *Regulation of Charlatans in High-Skill Professions* (Stanford University Graduate School of Business, Research Paper No. 17-43, August 4, 2017), available at <https://ssrn.com/abstract=2979134>, last accessed Aug. 18, 2018. See also Hayne E. Leland, *Quacks, Lemons, and Licensing: A Theory of Minimum Quality Standards*, 87 J. Pol. Econ. 1328 (1979).

³¹³ See Section V.C.1.a, *supra*. See also Note 301, *supra*.

D. Rule Alternatives

In addition to Rule of Practice 194, the Commission has considered several primary alternative approaches, which are discussed below.

1. Temporary Exclusions

The Commission proposed a temporary exclusion, under which SBS Entities would not have to comply with the statutory prohibition in Exchange Act Section 15F(b)(6) with respect to associated person entities for the first 180 days that an application before the Commission, the CFTC, an SRO, or a registered futures association is pending. However, after 180 days, the SBS Entity would have 60 days to disassociate from the disqualified person entity pending disposition of the review application. The Commission is not adopting such an approach, but is, instead, adopting a broader exclusion that provides relief to all associated person entities and is not time limited.

The alternative would provide more limited relief to SBS Entities associating with statutorily disqualified associated person entities relative to the approach being adopted. Similar to the final exclusion for associated person entities, the alternative would lower business restructuring costs for SBS Entities that are associated with disqualified entities. As a result, like the rule being adopted, the alternative would limit the risk that SBS Entities may become, at least temporarily, unable to intermediate transactions and bear additional costs, which may be passed along to counterparties in the form of execution delays, potentially reduced liquidity or higher transaction costs. Further, similar to the final rule, the alternative would recognize that non-dealer counterparties may value bilateral relationships with SBS Entities, and searching for and initiating bilateral relationships with new SBS Entities may involve direct costs for counterparties. The alternative would also eliminate costs and delays related to SBS Entities

ceasing dealing activity, but only conditional on filing a review application and only for the first 180 days.

Unlike the approach being adopted, the alternative would introduce significant uncertainty about the eventual ability of an SBS Entity to associate with a statutorily disqualified associated person entity, even when the affiliate has disassociated from any natural persons who may have engaged in the underlying misconduct. Such an alternative and resulting uncertainty may be particularly costly for those SBS Entities that are cross-registered with the CFTC as Swap Entities, as Swap Entities are able to freely associate with statutorily disqualified associated person entities and, in swap markets, the statutory prohibition is applied to natural persons only. In addition, under the alternative, SBS Entities would bear direct costs of time and resources necessary to complete applications and collect necessary documentation to file for relief under Rule of Practice 194 – costs that may be passed on to counterparties in the form of more expensive security-based swaps. In addition, similar to the approach being adopted, and as discussed in Section V.C.1., some counterparties may choose to engage in greater due diligence and bear related costs, to the degree that they have a significant security-based swap business, interpret statutory disqualification as a meaningful signal of SBS Entities' quality, and do not already perform such due diligence.

The Commission continues to believe statutory disqualification may have incentive effects with respect to underlying misconduct. Relative to the approach being adopted, the temporary exclusion alternative could result in fewer statutorily disqualified associated person entities transacting in security-based swap markets on behalf of SBS Entities. While the alternative may involve lower compliance and counterparty risks relative to the approach being adopted, it would also impose new costs on SBS Entities and counterparties, and may involve

greater risks of disruptions to security-based markets. Moreover, as recognized in the Proposing Release, the temporary nature of the exclusion under the alternative would introduce uncertainty concerning the eventual need to restructure before the Commission, the CFTC, an SRO, or registered futures association has rendered a decision on the application.

The Commission could also have adopted a modified temporary exclusion, under which, the application would be considered granted if the Commission, the CFTC or an SRO does not render a decision within 180 days of the application. This alternative would effectively default to relief from the statutory prohibition for applications under review. SBS Entities would be able to permit statutorily disqualified associated person entities to effect or be involved in effecting security-based swaps on their behalf, unless the Commission made an individualized determination that it is not consistent with the public interest to permit the participation of such statutorily disqualified associated person entities within 180 days of the application being filed. Relative to the approach being adopted, this would involve greater application costs and uncertainty about the eventual need to restructure the business and disassociate from the statutorily disqualified associated person entity. However, it would allow the Commission, the CFTC or SRO to perform an individualized assessment of the facts of each case within the first 180 days of filing. This alternative may somewhat strengthen counterparty protections relative to the approach being adopted, but would increase uncertainty and costs of restructuring for affected SBS Entities and their counterparties.³¹⁴

The overall effects of the temporary stay alternatives relative to the approach being adopted, thus, depend on: (i) the degree to which disqualifying conduct by an associated person

³¹⁴ See, e.g., Americans for Financial Reform Letter; Better Markets Letter; Cummings Letter.

may predict future misconduct and related counterparty risks; (ii) the extent to which the largely institutional security-based swap market participants fail to observe and process public information regarding their counterparties' disqualifying conduct; (iii) the reputational costs of SBS Entities in associating with statutorily disqualified associated person entities relative to the uniqueness of their resources and abilities; and (iv) the degree to which uncertainty related to the temporary exclusion alternative would lead to preemptive disassociations from valuable statutorily disqualified associated person entities.

2. Relief for Non-Investment-Related Offenses

The Commission could also adopt the approach of automatically excepting from the Section 15F(b)(6) prohibition all SBS Entities that associate with statutorily disqualified persons if the matters that triggered the statutory disqualification were non-investment-related.³¹⁵ SBS Entities would still be required to apply for relief under Rule of Practice 194 for investment-related statutory disqualifications. Such an approach would eliminate restructuring or application costs for SBS Entities associating with statutorily disqualified persons when statutory disqualification arises out of non-investment related offenses. This may, in turn, attract new persons currently disqualified for non-investment-related offenses into the security-based swap market, and increase competition among SBS Entity associated persons. At the same time, other SBS Entities associating with persons statutorily disqualified for investment-related offenses would still have to bear costs of disassociating or applying for relief, and would have to compete with a greater number of SBS Entities that do not have to apply for relief.

As discussed above, statutory disqualification and the potential inability to deal in various

³¹⁵ Section V.B.4 presents data from 2010 through June 2018 about the incidence of statutory disqualification and reoffenses by investment-related and non-investment related nature of conduct in a somewhat analogous scenario for broker-dealers.

markets may present an incentive against misconduct, including non-investment-related misconduct. Relative to the approach being adopted, this alternative may weaken incentives against non-investment-related misconduct. The alternative would also lower the information benefits of reviewing applications and supporting materials, including information concerning supervisory structure, terms of employment and other items, which will inform Commission understanding of SBS Entity associations and ongoing oversight. Finally, some statutory disqualification triggers that may not fall in the “investment related offense” category may point to a higher risk of future misconduct, including violations of securities laws, federal rules, and regulations thereunder.³¹⁶ Uniformly excepting associated persons disqualified for non-investment-related misconduct without an opportunity for the Commission to review the circumstances of each case and make a determination that allowing SBS Entities to permit those persons to effect or be involved in effecting security-based swaps is consistent with the public interest may pose risks to counterparties and security-based swap markets.

3. No Relief for CFTC, SRO, or Registered Futures Association Review

Rule of Practice 194 allows SBS Entities to permit statutorily disqualified persons to effect or be involved in effecting security-based swaps on their behalf without an application to the Commission, if the associated person’s membership, association, registration or listing as a principal has been granted or otherwise approved by the CFTC, an SRO, or a registered futures association. The Commission could adopt an alternative approach under which such SBS

³¹⁶ See, e.g., Kelvin Law & Lillian F. Mills, *Do Financial Gatekeepers Under-Protect Investors? Evidence from Criminal Background Checks* (Working Paper, April 27, 2018), available at <https://ssrn.com/abstract=3075305>, last accessed Aug. 18, 2018; Robert Davidson, Aiysha Dey, & Abbie Smith, *Executives’ “Off-the-job” Behavior, Corporate Culture, and Financial Reporting Risk*, 117 J. Fin. Econ. 5 (2015).

Entities would not automatically be able to permit statutorily disqualified associated persons to effect or be involved in effecting security-based swaps on the SBS Entity's behalf, either on a permanent or temporary basis, based on a determination by the CFTC, an SRO, or a registered futures association. Instead, such SBS Entities would have to apply for a substantive review by the Commission under Rule of Practice 194.³¹⁷ However, the exclusion for all associated person entities would still apply, as in the approach being adopted.

This alternative approach would allow the Commission to review the facts and circumstances of each case and make an individualized public interest determination as to whether each statutorily disqualified associated person should be permitted to effect or be involved in effecting security-based swaps on behalf of SBS Entities, and under which conditions. If fewer SBS Entities choose to go through a separate review by the Commission, this alternative may result in a smaller number of statutorily disqualified associated persons effecting or involved in effecting security-based swaps than the adopted approach. To the extent that statutory disqualification, and terms and conditions of reassociation imposed as a result of individualized Commission review, reduce compliance and counterparty risks, this alternative may improve compliance and counterparty protections for security-based swap market participants.

However, this alternative may increase costs for SBS Entities. Specifically, this alternative would require SBS Entities to incur the application costs under Rule of Practice 194 with respect to associated persons that have already been approved by the CFTC, an SRO, or a registered futures association, or to incur the costs of restructuring the business or disassociating

³¹⁷ See Americans for Financial Reform Letter; Better Markets Letter; Public Citizen Letter; Cummings Letter.

from such persons. If the application is denied, SBS Entities would need to restructure the business or disassociate from the associated person. In addition, in light of the high degree of integration among swap and security-based swap markets and expected cross-registration, many SBS Entities are expected to transact across swap, security-based swap and reference security markets, and some SBS Entities may be relying on the same personnel and entities in effecting, for instance, single name and index CDS. This alternative approach would limit SBS Entity flexibility in hiring and retaining statutorily disqualified associated persons where the SBS Entity believes the person's quality and expertise outweigh the potential reputational costs of associating with a disqualified person and where the CFTC, an SRO, or a registered futures association has made a favorable finding with respect to the associated person.

The effects of this alternative on security-based swap markets will depend on: (i) the extent to which SBS Entities rely on disqualified persons approved by the CFTC, an SRO, or a registered futures association; (ii) the magnitude of any business restructuring costs; (iii) the significance of bilateral counterparty relationships, and (iv) the severity of compliance and counterparty risks posed by statutorily disqualified associated persons. As discussed in earlier sections, we lack data or other information to quantify these effects with any degree of certainty.

4. No Relief for Associated Person Entities from Exchange Act Section 15F(b)(6)

The Commission could establish a uniform prohibition on associated person entities subject to statutory disqualification effecting or being involved in effecting security-based swaps on behalf of SBS Entities, without the availability of any application review process, and regardless of the reason for the disqualification or whether the CFTC, an SRO, or a registered futures association has permitted such associated person entities to participate in the market. Under this alternative approach, all statutorily disqualified associated person entities not covered

by the exemption in the final SBS Entity registration rules³¹⁸ would be barred from intermediating security-based swaps on behalf of SBS Entities.³¹⁹ To the extent that past disqualifications can point to higher compliance and counterparty risks, this alternative could potentially strengthen counterparty protections. Further, the inability to participate in various markets due to disqualification disincentivizes misconduct. Adopting this approach would strengthen these incentive effects, but only to the degree that reputational incentives and capital market discipline may currently not be sufficiently strong disincentives against misconduct for some entities. However, as discussed in detail in the economic baseline, evidence from other market suggests that market participants, even retail investors, pay close attention to disclosures of disciplinary history and vote with their feet, such that market participants suffer significant and sticky reputation costs around revelations of misconduct.

We recognize that this market discipline effect may be partly mitigated due to the concentrated nature of current security-based swap dealing activity discussed above. But we also note that market concentration is itself endogenous to market participants' counterparty selection and customer demand. That is, counterparties trade off the potentially higher counterparty risk of transacting with SBS Entities that rely on disqualified associated persons against the attractiveness of security-based swaps (price and non-price terms) that they may offer. If a large number of counterparties choose to move their business to SBS Entities that do not rely on

³¹⁸ As discussed in the economic baseline, under Exchange Act Rule 15Fb6-1, unless otherwise ordered by the Commission, an SBS Entity may permit statutorily disqualified associated person entities to effect or be involved in effecting security-based swaps on its behalf, provided that the statutory disqualification occurred prior to the compliance date set forth in the Registration Adopting Release, and provided that the SBS Entity identifies each such associated person on the applicable registration form.

³¹⁹ See, e.g., Public Citizen Letter.

disqualified associated persons (including those SBS Entities that may currently have lower market share), market concentration itself can decrease.

Barring all statutorily disqualified associated person entities from effecting or being involved in effecting security-based swaps on behalf of SBS Entities would impose costs of business restructuring for a number of SBS Entities, which may in turn affect market quality. Specifically, in the event of a disqualification after the compliance date of the final SBS Entity registration rules, SBS Entities would be required to cease intermediating security-based swaps and restructure their business to disassociate from all disqualified entities, posing a risk of business disruptions during the restructuring. If a number of entities associated with different SBS Entities become disqualified at the same time, a number of SBS Entities may, in turn, become temporarily unable to effect security-based swaps due to disqualification. As discussed elsewhere, the subset of SBS Entities that are major security-based swap participants are expected to hold large security-based swap positions, and their activities in security-based swap markets may pose market and counterparty risks.³²⁰ As discussed in the economic baseline, the remaining SBS Entities that are SBS Dealers play a central role in security-based swap markets, intermediating trades with hundreds of counterparties and representing a significant portion of trading activity in security-based swaps.

If some SBS Entities are temporarily unable to effect security-based swaps, transaction costs may increase and other terms of security-based swaps available to counterparties may deteriorate. For example, security-based swaps are often renegotiated during the life of the contract and, in the event of a disruption to the bilateral relationship with the SBS Entity related to an associated entity disqualification, counterparties may find themselves unable to modify

³²⁰ See Business Conduct Adopting Release, 81 FR at 30111.

contracts. Absent relief for associated person entities, counterparties may price such potential future constraints in larger spreads.

We note that other SBS Entities are likely to step in to pick up the market share, and, to the extent that statutory disqualification of associated person entities may indicate ongoing compliance and counterparty risks of SBS Entities, SBS Entities with potentially lower compliance and counterparty risks would be intermediating security-based swaps. However, as discussed above, SBS Entities that capture the newly available market share may be able to consolidate market power while the disqualified SBS Entity is undergoing restructuring or awaiting a relief determination. As a result, competition in security-based swap markets may, at least temporarily, decrease, and pricing power of remaining SBS Entities may increase. The overall economic effects of the alternative would depend on: (i) the costs and the required length of time for business restructuring; (ii) which SBS Entities would be able to pick up the newly available market share; and (iii) the relative importance of bilateral relationships between SBS Entities and counterparties.

In addition, SBS Entities cross-registered as Swap Entities with the CFTC would not experience economies of scope in associating with persons that are entities and would be unable to rely on the same associated person entities in transactions with the same counterparties across integrated swap and security-based swap markets. As discussed in the economic baseline, approximately 46 out of 50 entities likely to register with the Commission as SBS Dealers are already registered with the CFTC as Swap Dealers. In addition, as discussed above, two thirds of accounts transacting in single-name CDS also transact in index CDS. Under the alternative, counterparty relationships with dually registered Swap and SBS Entities could be disrupted, potentially requiring counterparties to establish new dealer relationships solely for the purpose of

security-based swap transactions. Lastly, this alternative may decrease the number of entities seeking to associate with SBS Entities since statutorily disqualified associated person entities will no longer be able to effect or be involved in effecting security-based swaps. Such disqualified entities may seek to associate with security-based swap market participants that are not required to register (entities falling within the *de minimis* exception set forth in Exchange Act Rule 3a71-2³²¹). The alternative has the potential to significantly reduce competition among associated person entities engaging in security-based swap transactions on behalf of SBS Entities.³²² Reduced competition may increase the pricing power of remaining market participants vis-à-vis their activities on behalf of SBS Entities in security-based swap markets, and such costs are likely to be passed on to counterparties.

5. Form of Applications to be Submitted: Time Period

The final Rule of Practice 194 requires applications to include certain types of information and supporting materials concerning disciplinary sanctions and other events over the preceding five years. In response to a comment received,³²³ we have considered an alternative approach, under which the Commission would require applicants to address disciplinary events with a longer time period (*e.g.*, ten years) for certain items specified in Rule of Practice 194. In considering this alternative, we note that Rule of Practice 194, as adopted, does not specify a time period with respect to certain other items relating to disciplinary history, including, among other things, (i) a copy of the order or other applicable document that resulted in the associated person being subject to a statutory disqualification; and (ii) a copy of the questionnaire or

³²¹ See 17 CFR 240.3a-71-2.

³²² See, *e.g.*, Berk & van Binsbergen (2017).

³²³ See Better Markets Letter, at 6.

application for employment required by Exchange Act Rule 15Fb6-2(b). In addition, under final Rule of Practice 194, the Commission has reserved the right to request from the applicant supplementary information to assist in its review, which could include information outside of the five-year time period, where appropriate.

Requiring applicants to provide information concerning a longer time period could potentially provide additional information regarding ongoing counterparty and compliance risks. Also, requiring filing of information concerning disciplinary sanctions, compliance and disciplinary history, litigation concerning investment or investment-related activities and unsatisfied judgments and supporting materials for a longer period of time as part of applications under Rule of Practice 194 may enhance the review process and its counterparty protections benefits. At the same time, requiring SBS Entities to provide older materials and documents may increase application burdens under the Rule of Practice 194. Importantly, older misconduct may be less important in predicting future misconduct than recent offenses. Additionally, as discussed above, the five-year time period is more consistent with the current practice in other contexts. The approach being adopted provides the Commission with the benefit of a longer look-back period, where necessary, without uniformly imposing that burden on all SBS Entities applying for relief.

6. Public Availability of Applications and Supporting Materials

Under Rule of Practice 194, as adopted, orders and notices will be made publicly available on the Commission's website, whereas applications and supporting materials provided pursuant to Rule of Practice 194 will be kept confidential, subject to the existing statutory and regulatory framework with respect to the public availability of such materials, including the

FOIA,³²⁴ the Exchange Act,³²⁵ and applicable Commission rules.³²⁶ As an alternative approach, applications and supporting materials could be made publicly available. We have considered comments about how this alternative may affect applicants, other SBS Entities, and non-SBS Entity market participants.³²⁷

Making application and supporting materials publicly available on the Commission's website may enable market participants to independently assess ongoing compliance and counterparty risks as they pertain to individual security-based swaps. To the extent that applications and supporting materials contain more information than orders and notices, and to the extent that this additional information enables market participants to better assess counterparty risks, this alternative could strengthen market discipline and the reputational disincentives against misconduct, increasing counterparty protections. However, it is not clear that applications and supporting materials would contain significant additional information relevant for counterparty selection, given the fact that the information about misconduct that gives rise to disqualification is public, and that notices prepared by SBS Entities and Commission orders will be made public.

We recognize that the public nature of such filings may affect SBS Entity reputation and bilateral relationships in security-based swap markets. Under this alternative, more SBS Entities are likely to disassociate from disqualified natural persons instead of filing with the Commission an application for relief under Rule of Practice 194. To the extent that associations with

³²⁴ See 5 U.S.C. 552, *et seq.*

³²⁵ See 15 U.S.C. 78x.

³²⁶ See, *e.g.*, 17 CFR 200.80; 17 CFR 201.190; 17 CFR 240.24b-2.

³²⁷ See Better Markets Letter, at 6; Americans for Financial Reform Letter, at 3-4; Cummings Letter, at 3.

disqualified persons may pose ongoing compliance and counterparty risks, this could potentially benefit market participants and strength counterparty protections. However, confidentiality and reputational concerns may also deter an SBS Entity from filing an application even where it would be consistent with the public interest to permit the associated person subject to a statutory disqualification to effect or be involved in effecting security-based swaps on behalf of the SBS Entity, reducing the expected benefits of the review process. We continue to note that, as discussed throughout the release, the range of conduct that gives rise to statutory disqualification is broad and may not always be indicative of higher probability of counterparty risks and investor losses.

Further, as a result of reputational and confidentiality concerns, making applications and supporting materials publicly available on the Commission's website may lead SBS Entities to make less informative disclosures, which may influence the effectiveness of the review process. In addition, we are sensitive to the concern that applications and supporting materials under Rule of Practice 194 may reveal commercial or financial information that is confidential or privileged, and information that would invade an individual's personal privacy. We recognize that costs may be incurred by SBS Entities to redact confidential information from any application and supporting materials if they were to be made publicly available on the Commission's website.

Accordingly, under the approach being adopted, where counterparties, which may be institutional market participants,³²⁸ or other interested persons believe that applications or

³²⁸ The Commission has classified market participants transacting in single name CDS reported to TIW to include private funds, registered investment companies, banks, insurance companies, ISDA recognized dealers, foreign sovereigns, non-financial corporations, finance companies, special entities and other account holders (such as hedge funds, private equity and venture capital funds). As can be seen from Table 2 in the economic baseline, approximately 94 percent of market participants transacted in

supporting materials contain information beyond any information that is publicly available, such persons would be able to submit a FOIA request to seek to obtain those materials—in accordance with the existing statutory and regulatory framework with respect to the public availability of such materials.³²⁹ As discussed in Sections I and II, the Commission continues to believe the existing statutory and regulatory framework sets forth a detailed and well-established process for the Commission to make available application materials³³⁰ to members of the public, upon request, but to keep certain information contained in those materials confidential, where appropriate.³³¹

VI. REGULATORY FLEXIBILITY ACT CERTIFICATION

A. Regulatory Framework

The Regulatory Flexibility Act (“RFA”)³³² requires federal agencies, in promulgating rules, to consider the impact of those rules on small entities. Section 603(a)³³³ of the Administrative Procedure Act,³³⁴ as amended by the RFA, generally requires the Commission to undertake a regulatory flexibility analysis of all proposed rules, or proposed rule amendments, to

single name CDS through investment advisers between 2006-2017. Over the same time period, investment advisers, banks, insurance companies, pension funds and ISDA recognized dealers represented approximately 94.1 percent of transacting agents and 99.8 percent of total trading activity.

³²⁹ Alternatively, such counterparties could also request such information directly from SBS Entities.

³³⁰ See 15 U.S.C. 78x(a) (for purposes of 5 U.S.C. 552, “the term ‘records’ includes all applications, notices, and other documents filed with or otherwise obtained by the Commission pursuant to the [Exchange Act] or otherwise”).

³³¹ See, e.g., 17 CFR 200.80(a)(4), (b).

³³² 5 U.S.C. 601 *et seq.*

³³³ 5 U.S.C. 603(a).

³³⁴ 5 U.S.C. 551 *et seq.*

determine the impact of such rulemaking on “small entities.”³³⁵ Section 605(b) of the RFA 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.³³⁶

The Commission certified that the proposed Rule of Practice 194, if adopted, would not have a significant economic impact on a substantial number of small entities for purposes of the RFA.³³⁷ Although we encouraged written comments regarding this certification, no commenters responded to this request.

B. Assessment of Impact

Rule of Practice 194, as adopted, establishes rules concerning an application by SBS Entity to the Commission for an order permitting an associated person that is a natural person who is subject to a statutorily disqualification to effect or be involved in effecting security-based swaps on behalf of an SBS Entity. With respect to SBS Entities, based on feedback from market participants and our information about the security-based swap markets, the Commission continues to believe, as we stated in the proposal,³³⁸ 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

³³⁵ Although Section 601(b) of the RFA defines the term “small entity,” the statute permits the Commission to formulate its own definition. 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, 17 CFR 240.0-10. See Exchange Act Release No. 18451, 47 FR 5212 (Feb. 4, 1982).

³³⁶ See 5 U.S.C. 605(b).

³³⁷ See Proposing Release, 80 FR at 51718.

³³⁸ See *id.*

of the RFA,³³⁹ and (2) the types of entities that may have security-based swap positions above the level required to be a “major security-based swap participant” would not be “small entities” for purposes of the RFA.³⁴⁰

C. Certification

For the foregoing reasons, the Commission certifies that Rule of Practice 194, as adopted, will not have a significant economic impact on a substantial number of small entities for purposes of the RFA.

VII. STATUTORY AUTHORITY

The Commission is adopting Rule of Practice 194 pursuant to Exchange Act Section 15F(b)(4) and (6),³⁴¹ as added by Section 764(a) of the Dodd-Frank Act, and Exchange Act Section 23(a).³⁴²

List of Subjects in 17 CFR Parts 201 and 240

Administrative practice and procedure, Reporting and recordkeeping requirements, Securities.

TEXT OF THE RULE

In accordance with the foregoing, the Securities and Exchange Commission is amending title 17, chapter II of the Code of Federal Regulations as follows:

³³⁹ See, e.g., Cross-Border Adopting Release, 79 FR at 47368. See also Economic Analysis Section V.B.1.b., *supra*. For example, and as explained above, 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 intermediated transactions with a gross notional amount of approximately \$2.9 trillion, approximately 55 percent of which was intermediated by the top five dealer accounts. See *id*.

³⁴⁰ See Cross-Border Adopting Release, 79 FR at 47368.

³⁴¹ 15 U.S.C. 78o-10(b)(4), (6).

³⁴² 15 U.S.C. 78w(a).

PART 201 – RULES OF PRACTICE

1. The general authority citation for subpart D is revised to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77h-1, 77j, 77s, 77u, 77sss, 77ttt, 78(c)(b), 78d-1, 78d-2, 78l, 78m, 78n, 78o(d), 78o-3, 78o-10(b)(6), 78s, 78u-2, 78u-3, 78v, 78w, 80a-8, 80a-9, 80a-37, 80a-38, 80a-39, 80a-40, 80a-41, 80a-44, 80b-3, 80b-9, 80b-11, 80b-12, 7202, 7215, and 7217.

* * * * *

2. Add § 201.194 to subpart D before the undesignated center heading “Initiation of Proceedings and Prehearing Rules” to read as follows:

§ 201.194 Applications by security-based swap dealers or major security-based swap participants for statutorily disqualified associated persons to effect or be involved in effecting security-based swaps.

A security-based swap dealer or major security-based swap participant making an application under this section should refer to paragraph (i) of this section.

(a) *Scope of rule.* Applications by a security-based swap dealer or major security-based swap participant for the Commission to permit an associated person (as provided in 15 U.S.C. 78c(a)(70)) to effect or be involved in effecting security-based swaps on behalf of a registered security-based swap dealer or major security-based swap participant, or to change the terms and conditions thereof, may be made pursuant to this section where the associated person is subject to a statutory disqualification and thereby prohibited from effecting or being involved in effecting security-based swaps on behalf of a security-based swap dealer or major security-based swap participant under Exchange Act Section 15F(b)(6) (15 U.S.C. 78o-10(b)(6)).

(b) *Required showing.* The applicant shall make a showing that it would be consistent with the public interest to permit the person associated with the security-based swap dealer or

major security-based swap participant who is subject to a statutory disqualification to effect or be involved in effecting security-based swaps on behalf of the security-based swap dealer or major security-based swap participant.

(c) *Exclusion for other persons.* The security-based swap dealer or major security-based swap participant shall be excluded from the prohibition in Section 15F(b)(6) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-10(b)(6)) with respect to an associated person that is not a natural person who is subject to a statutory disqualification.

(d) *Form of application.* Each application with respect to an associated person that is a natural person who is subject to a statutory disqualification shall be supported by a written statement, signed by a knowledgeable person authorized by the security-based swap dealer or major security-based swap participant, which addresses the items set forth in paragraph (e) of this section. The application shall be filed pursuant to Rules of Practice 151, 152, and 153 (17 CFR 201.151, 201.152, and 201.153). Each application shall include as exhibits:

(1) A copy of the order or other applicable document that resulted in the associated person being subject to a statutory disqualification;

(2) An undertaking by the applicant to notify promptly the Commission in writing if any information submitted in support of the application becomes materially false or misleading while the application is pending;

(3) A copy of the questionnaire or application for employment specified in 17 CFR 240.15Fb6-2(b), with respect to the associated person; and

(4) If the associated person has been the subject of any proceeding resulting in the imposition of disciplinary sanctions during the five years preceding the filing of the application or is the subject of a pending proceeding by the Commission, the Commodity Futures Trading

Commission, any federal or state regulatory or law enforcement agency, registered futures association (as provided in 7 U.S.C. 21), foreign financial regulatory authority, registered national securities association, or any other self-regulatory organization (as provided in 15 U.S.C. 78c(a)(26)), or commodities exchange, or any court, the applicant should include a copy of any order, decision, or document issued by the court, agency, self-regulatory organization (as provided in 15 U.S.C. 78c(a)(26)), or other relevant authority involved.

(e) *Written statement.* The written statement required by paragraph (d) of this section shall address each of the following, to the extent applicable:

(1) The associated person's compliance with any order resulting in statutory disqualification, including whether the associated person has paid fines or penalties, disgorged monies, made restitution or paid any other monetary compensation required by any such order;

(2) The associated person's employment during the period subsequent to becoming subject to a statutory disqualification;

(3) The capacity or position in which the person subject to a statutory disqualification proposes to be associated with the security-based swap dealer or major security-based swap participant;

(4) The terms and conditions of employment and supervision to be exercised over such associated person and, where applicable, by such associated person;

(5) The qualifications, experience, and disciplinary history of the proposed supervisor(s) of the associated person;

(6) The compliance and disciplinary history, during the five years preceding the filing of the application, of the applicant;

(7) The names of any other associated persons at the applicant who have previously been

subject to a statutory disqualification and whether they are to be supervised by the associated person;

(8) Any relevant courses, seminars, examinations or other actions completed by the associated person subsequent to becoming subject to a statutory disqualification to prepare for his or her participation in the security-based swap business;

(9) A detailed statement of why the associated person should be permitted to effect or be involved in effecting security-based swaps on behalf of the security-based swap dealer or major security-based swap participant, notwithstanding the event resulting in statutory disqualification, including what steps the associated person or applicant has taken, or will take, to ensure that the statutory disqualification does not negatively affect the ability of the associated person to effect or be involved in effecting security-based swaps on behalf of the security-based swap dealer or major security-based swap participant in compliance with the applicable statutory and regulatory framework;

(10) Whether the associated person has been involved in any litigation during the five years preceding the filing of the application concerning investment or investment-related activities or whether there are any unsatisfied judgments outstanding against the associated person concerning investment or investment-related activities, to the extent not otherwise covered by paragraph (e)(9) of this section. If so, the applicant should provide details regarding such litigation or unsatisfied judgments; and

(11) Any other information that the applicant believes to be material to the application.

(f) *Prior applications or processes.* In addition to the information specified above, any person making an application under this rule shall provide any order, notice or other applicable document reflecting the grant, denial or other disposition (including any dispositions on appeal)

of any prior application or process concerning the associated person:

- (1) Pursuant to this section;
- (2) Pursuant to Rule of Practice 193 (17 CFR 201.193);
- (3) Pursuant to Investment Company Act Section 9(c) (15 U.S.C. 80a-9(c));
- (4) Pursuant to Section 19(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78s(d)), Rule 19h-1 under the Securities Exchange Act of 1934 (17 CFR 240.19h-1), or a proceeding by a self-regulatory organization (as provided in 15 U.S.C. 78c(a)(26)) for a person to become or remain a member, or an associated person of a member, notwithstanding the existence of a statutory disqualification; or

(5) By the Commodity Futures Trading Commission or a registered futures association (as provided in 7 U.S.C. 21) for registration, including as an associated person, or listing as a principal, notwithstanding the existence of a statutory disqualification, including:

(i) Any order or other document providing that the associated person may be listed as a principal or registered as an associated person of a futures commission merchant, retail foreign exchange dealer, introducing broker, commodity pool operator, commodity trading advisor, or leverage transaction merchant, or any person registered as a floor broker or a floor trader, notwithstanding that the person is subject to a statutory disqualification from registration under Section 8a(2) or 8a(3) of the Commodity Exchange Act (7 U.S.C. 12a(2), (3)); or

(ii) Any determination by a registered futures association (as provided in 7 U.S.C. 21) that had the associated person applied for registration as an associated person of a swap dealer or a major swap participant, or had a swap dealer or major swap participant listed the associated person as a principal in the swap dealer's or major swap participant's application for registration, notwithstanding statutory disqualification, the application of the associated person or of the swap

dealer or major swap participant, as the case may be, would have been granted or denied.

(g) *Notification to applicant and written statement.* In the event an adverse recommendation is proposed by Commission staff with respect to an application made pursuant to this section, the applicant shall be so advised and provided with a written statement of the reasons for such recommendation. The applicant shall then have 30 days thereafter to submit a written statement in response.

(h) *Notice in lieu of an application.* (1) A security-based swap dealer or major security-based swap participant may permit a person associated with it who is subject to a statutory disqualification to effect or be involved in effecting security-based swaps on its behalf, without making an application pursuant to this section, where the conditions in paragraph (h)(2) of this section are met, and where:

(i) The person has been admitted to or continued in membership, or participation or association with a member, of a self-regulatory organization (as provided in 15 U.S.C. 78c(a)(26)), notwithstanding that such person is subject to a statutory disqualification under Section 3(a)(39)(A) through (F) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(39)(A) through (F));

(ii) The person has been granted consent to associate pursuant to the Rule of Practice 193 (17 CFR 201.193) or otherwise by the Commission;

(iii) The person has been permitted to effect or be involved in effecting security-based swaps on behalf of a security-based swap dealer or major security-based swap participant pursuant to this section; or

(iv) The person has been registered as, or listed as a principal of, a futures commission merchant, retail foreign exchange dealer, introducing broker, commodity pool operator,

commodity trading advisor, or leverage transaction merchant, registered as an associated person of any of the foregoing, registered as or listed as a principal of a swap dealer or major swap participant, or registered as a floor broker or floor trader, notwithstanding that the person is subject to a statutory disqualification under Sections 8a(2) or 8a(3) of the Commodity Exchange Act (7 U.S.C. 12a(2), (3)), and the person is not subject to a Commission bar or suspension pursuant to Sections 15(b), 15B, 15E, 15F, or 17A of the Securities Exchange Act of 1934 (15 U.S.C. 78o(b), 78o-4, 78o-7, 78o-10, 78q-1), Section 9(b) of the Investment Company Act of 1940 (15 U.S.C. 80a-9(b)), or Section 203(f) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3(f)).

(2) A security-based swap dealer or major security-based swap participant may permit a person associated with it who is subject to a statutory disqualification to effect or be involved in effecting security-based swaps on its behalf, without making an application pursuant to this section, as provided in paragraph (h)(1), subject to the following conditions:

(i) All matters giving rise to a statutory disqualification under Section 3(a)(39)(A) through (F) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(39)(A) through (F)) have been subject to a process where the membership, association, registration or listing as a principal has been granted or otherwise approved by the Commission, Commodity Futures Trading Commission, self-regulatory organization (as provided in 15 U.S.C. 78c(a)(26)), or a registered futures association (as provided in 7 U.S.C. 21);

(ii) The terms and conditions of the association with the security-based swap dealer or major security-based swap participant are the same in all material respects as those approved in connection with a previous order, notice or other applicable document granting the membership, association, registration or listing as a principal, as provided in paragraph (h)(1); and

(iii) The security-based swap dealer or major security-based swap participant has filed a notice with the Commission. The notice shall be filed pursuant to Rules of Practice 151, 152, and 153 (17 CFR 201.151, 201.152, and 201.153). The notice must set forth, as appropriate:

(A) The name of the security-based swap dealer or major security-based swap participant;

(B) The name of the associated person subject to a statutory disqualification;

(C) The name of the associated person's prospective supervisor(s) at the security-based swap dealer or major security-based swap participant;

(D) The place of employment for the associated person subject to a statutory disqualification; and

(E) Identification of any agency, self-regulatory organization (as provided in 15 U.S.C. 78c(a)(26)) or a registered futures association (as provided in 7 U.S.C. 21) that has indicated its agreement with the terms and conditions of the proposed association, registration or listing as a principal.

(i) *Note to § 201.194.* (1) Under Section 15F(b)(6) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-10(b)(6)), except to the extent otherwise specifically provided by rule, regulation, or order of the Commission, it shall be unlawful for a security-based swap dealer or a major security-based swap participant to permit any person associated with a security-based swap dealer or a major security-based swap participant who is subject to a statutory disqualification to effect or be involved in effecting security-based swaps on behalf of the security-based swap dealer or major security-based swap participant, if the security-based swap dealer or major security-based swap participant knew, or in the exercise of reasonable care should have known, of the statutory disqualification.

(2) Subject to the exclusion provided in paragraph (c) of this section, in accordance with

the authority granted in Section 15F(b)(6) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-10(b)(6)), this section governs applications to the Commission by a security-based swap dealer or major security-based swap participant for the Commission to issue an order to permit a natural person who is an associated person of a security-based swap dealer or major security-based swap participant who is subject to a statutory disqualification to effect or be involved in effecting security-based swaps on behalf of the security-based swap dealer or major security-based swap participant.

(3) Applications made pursuant to this section must show that it would be consistent with the public interest to permit the associated person of the security-based swap dealer or major security-based swap participant to effect or be involved in effecting security-based swaps on behalf of the security-based swap dealer or major security-based swap participant. In addition to the information specifically required by the rule, applications should be supplemented, where appropriate, by written statements of individuals who are competent to attest to the associated person's character, employment performance, and other relevant information. In addition to the information required by the rule, the Commission staff may request supplementary information to assist in the Commission's review. Intentional misstatements or omissions of fact may constitute criminal violations of 18 U.S.C. 1001, *et seq.* and other provisions of law. The Commission will not consider any application that attempts to reargue or collaterally attack the findings that resulted in the statutory disqualification.

(4) The nature of the supervision that an associated person will receive or exercise as an associated person with a registered entity is an important matter bearing upon the public interest. In meeting the burden of showing that permitting the associated person to effect or be involved in effecting security-based swaps on behalf of the security-based swap dealer or major security-

based swap participant is consistent with the public interest, the application and supporting documentation must demonstrate that the terms or conditions of association, procedures or proposed supervision, are reasonably designed to ensure that the statutory disqualification does not negatively affect the ability of the associated person to effect or be involved in effecting security-based swaps on behalf of the security-based swap dealer or major security-based swap participant in compliance with the applicable statutory and regulatory framework.

(5) Normally, the applicant's burden of demonstrating that permitting the associated person to effect or be involved in effecting security-based swaps on behalf of the security-based swap dealer or major security-based swap participant is consistent with the public interest will be difficult to meet where the associated person is to be supervised by, or is to supervise, another statutorily disqualified individual. In addition, where there is an absence of supervision over the associated person who is subject to a statutory disqualification, the applicant's burden will be difficult to meet. The associated person may be limited to association in a specified capacity with a particular registered entity and may also be subject to specific terms and conditions.

PART 240 – GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

3. The general authority citation for part 240 continues to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78c-3, 78c-5, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78n-1, 78o, 78o-4, 78o-10, 78p, 78q, 78q-1, 78s, 78u-5, 78w, 78x, 78dd, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, 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. 1887 (2010); and secs. 503 and 602, Pub. L. 112-106, 126 Stat. 326 (2012),

unless otherwise noted.

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§ 240.15Fb6-1 [Removed and Reserved].

4. Remove and reserve § 240.15Fb6-1.

By the Commission.

Dated: December 19, 2018.

Brent J. Fields,
Secretary.

[FR Doc. 2019-02347 Filed: 2/15/2019 8:45 am; Publication Date: 2/19/2019]