Securities Regulation Daily Wrap Up, TOP STORY—SEC adopts waiver process for disqualified swaps actors, proposes risk mitigation for uncleared swaps, and 'fund of funds' changes, (Dec. 19, 2018)

Securities Regulation Daily Wrap Up

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The SEC took further steps in fulfilling its rulemaking mandate under Title VII of the Dodd-Frank Act, adopting final rules creating a process for individuals who have been statutorily disqualified to seek waivers from the Commission to continue trading in the security-based swap markets. The Commission also voted to propose rules requiring the application of risk mitigation techniques to portfolios of uncleared security-based swaps, while proposing a new rule designed to streamline the regulatory framework for "fund of funds" arrangements. Finally, the Commission approved the 2019 budget and the related annual accounting support fee for the PCAOB.

Rule of Practice 194. Adopted by a 3-2 vote, new Rule of Practice 194 creates a comprehensive process for a registered security-based swap dealer or major security-based swap participant (collectively, SBS Entities) to apply to the SEC for an order permitting an associated person who is a natural person subject to a statutory disqualification under Exchange Act Section 15F(b)(6) to effect security-based swaps on behalf of the SBS Entity. Rule of Practice 194 also provides an exclusion from the general prohibition in Exchange Act Section 15F(b)(6) with respect to all associated person entities.

For the SEC to issue an order granting relief under Rule of Practice 194, an SBS Entity is required to show under Paragraph (b) that it would be consistent with the public interest to permit the statutorily disqualified natural person to effect security-based swaps on behalf of the SBS Entity, notwithstanding the statutory disqualification. Paragraphs (d) and (e) of the rule specify the form of the application and the items to be addressed in the accompanying written statement. Paragraph (f) requires an applicant to provide as part of any application any order, notice, or other document reflecting the grant, denial, or other disposition of any prior application concerning the associated person under Rule of Practice 194 and other similar processes.

Paragraph (h), however, provides that, where certain conditions are met, an SBS Entity does not need to file an application under Rule of Practice 194 when the SEC, the CFTC, an SRO such as FINRA, or a registered futures association has granted prior relief from a statutory disqualification with respect to that associated person. In these cases, the SBS Entity will be permitted to file a notice with the SEC in lieu of an application.

SEC Chairman Jay Clayton praised the rule's adoption, saying that it represents the SEC staff's shared commitment with staff at the CFTC to achieve greater harmonization of Title VII rules. Commissioner Robert Jackson, Jr. dissented, however, saying that the securities-based swaps market is especially ill-suited for reliance on other regulators or investors when it comes to deterring bad actors. Jackson quoted findings in the adopting release showing that the top five dealer accounts engaged in over 55 percent of transactions in this market in 2017—"leaving aggrieved investors few ways to vote with their feet." Commissioner Stein also voted against the rule, questioning among other things the provisions providing an automatic exception even to companies that may have committed fraud or other crimes.

Rule of Practice 194 is effective 60 days after publication in the Federal Register, although the compliance date for the SBS Entity registration rules depends on the adoption of two pending rules.

Risk mitigation techniques for uncleared security-based swaps. By a 5-0 vote, the Commission proposed rules requiring the application of risk mitigation techniques to portfolios of uncleared security-based swaps. Proposed Rules 15Fi-3 through 15Fi-5 would require registered security-based swap dealers and major security-based swap participants (SBS Entities) to:

- Reconcile outstanding security-based swaps with applicable counter parties on a periodic basis;
- Engage in certain forms of portfolio compression exercises, as appropriate; and
- Execute written security-based swap trading relationship documentation with each of its counter parties prior to, or contemporaneously with, executing a security-based swap transaction.

According to the SEC's fact sheet describing the proposal, the rules seek to increase operational efficiency and reduce risk for SBS Entities. Provisions requiring SBS Entities to document the terms of their trading relationship with each of their counter parties are designed to foster greater transparency and legal certainty by allowing market participants to have a clear understanding of each other's rights and obligations from the outset of the transaction. The portfolio reconciliation provisions seek to provide counter parties with a means for identifying any discrepancies in the terms of a transaction throughout the life of the trade, while portfolio compression allows market participants to reduce their total number of open contracts, resulting in fewer trades to manage, maintain, and settle.

"These are a series of common sense rules that should aid all participants in our swaps markets improve operational efficiency and reduce back-office risks," said Chairman Clayton. The comment period for the proposal will be 90 days after publication in the Federal Register.

Fund of funds arrangements. The commissioners also voted unanimously to propose a new rule and related amendments designed to streamline and enhance the regulatory framework for "funds of funds," which are created when a mutual fund or other type of fund invests in shares of another fund. The proposal, which would rescind Investment Company Act Rule 12d1-2 as well as a series of exemptive orders issued since the 1990s, would allow a fund to acquire the shares of another fund in excess of the limits of the Investment Company Act without obtaining an individual exemptive order from the Commission, subject to certain conditions.

Proposed Investment Company Act Rule 12d1-4 would prohibit an acquiring fund from controlling an acquired fund and would require an acquiring fund that holds more than 3 percent of an acquired fund's outstanding voting securities to vote those securities in a prescribed manner to minimize the influence that an acquiring fund may exercise over an acquired fund. An acquiring fund that is part of the same fund group as the acquired fund and an acquiring fund that has a sub-adviser that acts as adviser to the acquired fund would not be subject to the control and voting conditions.

To prevent acquiring funds from exerting undue influence through the threat of large scale redemptions, the proposed rule would prohibit an acquiring fund that acquires more than 3 percent of an acquired fund's outstanding shares from redeeming more than 3 percent of the acquired fund's total outstanding shares in any 30-day period. In addition, the proposal seeks to prevent duplicative and excessive fees by requiring an evaluation of aggregate fees associated with the investment in the acquired fund and the complexity of the fund of funds arrangement. The rule would also generally prohibit funds from creating three-tier fund of funds structures, except in certain limited circumstances.

In supporting the proposal, Commissioner Stein noted that funds investing in other funds has been the subject of debate since the 1920s, and the regulatory response over the ensuing years has resulted in a patchwork quilt of exemptive relief, rules, and guidance. "The proposed rule would clean up a lot of the unique and bespoke patches of that quilt, help level the playing field, and help clarify for investors, regulators, and other funds which set of conditions a fund should or is relying upon," stated Commissioner Stein.

The comment period for the proposed rule and amendments will be 90 days after publication in the Federal Register.

PCAOB budget. Finally, the Commission unanimously approved a budget for the PCAOB in 2019 of $273.7 million along with an accounting support fee of $262.9 million. The 2019 budget, which funds 838 positions, represents a 5.4 percent increase from the prior year.

PCAOB Chairman William D. Duhnke said that 2018 has been a year of transition for the PCAOB, with the appointment of five new board members and the development of a new strategic plan. Duhnke expects 2019, however, to be a year of implementation and change, and said that the 2019 budget funds the PCAOB's core

oversight and operations at levels similar to 2018 with adjustments to support implementation of its strategic plan and related transformation efforts.

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