ALERT MEMORANDUM

New Cross-Border Proposal: SEC Takes Critical Step Towards Completing Dodd-Frank's SBS Regime

May 22, 2019

On May 10, 2019, the Securities and Exchange Commission ("**SEC**") proposed supplemental guidance and rule amendments (the "**Proposal**")[1] addressing the cross-border application of certain rules regulating security-based swaps ("**SBS**") pursuant to Title VII of the Dodd-Frank Act. In particular, the Proposal includes:

— ***"Market Color" Guidance.*** Guidance excluding certain "market color" provided by U.S. personnel from triggering Title VII rules applicable to SBS transactions between non-U.S. persons that are arranged, negotiated, or executed by personnel located in a U.S. branch or office of a non-U.S. SBS dealer ("**SBSD**") or its agent ("**ANE Transactions**");

— ***De Minimis Counting Exception for Certain ANE Transactions.*** Two alternatives for a conditional exception from the requirement that a non-U.S. SBSD count ANE Transactions towards its *de minimis* registration threshold, each premised on the U.S. personnel involved in the ANE Transactions being associated with an SEC registrant;

— ***Requests for Comment Regarding ANE Transactions.*** Requests for comment regarding the application of reporting and external business conduct rules to ANE Transactions;

— ***Guidance on Non-U.S. SBSD Certifications and Legal Opinions.*** Guidance regarding the requirement that a non-U.S. SBSD, upon registration with the SEC, provide a certification and legal opinion that the SEC can promptly access the SBSD's books and records and conduct on-site inspections and exams, as well as a conditional registration framework allowing a non-U.S. SBSD to provide the certification and opinion up to 24 months after the initial SBSD registration date; and

— ***Statutory Disqualification Relief.*** An exclusion from the statutory disqualification prohibition for non-U.S. associated persons ("**APs**") of an SBSD who do not effect and are not involved in effecting SBS transactions with U.S. counterparties, as well as exceptions from requirements to make and keep information regarding potential statutory disqualifications for APs who fall within this exclusion or where making or keeping such information would violate local law in the jurisdiction where an AP is employed or located.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors

NEW YORK

Colin D. Lloyd
+1 212 225 2809
clloyd@cgsh.com

Michelle Chun
+1 212 225 2536
mchun@cgsh.com

Adrianna C. ScheerCook
+1 212 225 2247
ascheercook@cgsh.com

[1] *See* "Proposed Rule Amendments and Guidance Addressing Cross-Border Application of Certain Security-Based Swap Requirements," Release No. 34-85823; File No. S7-07-19.

The Proposal is a critical step towards completing the SEC's implementation of the Dodd-Frank Act's SBS regime. Left unmodified and unclarified, the rules covered by the Proposal would have serious negative effects on the U.S. SBS market. Non-U.S. SBSDs, which comprise a very significant portion of the market, would in many instances need to withdraw from the market because foreign laws would prevent them from providing the required certification and legal opinion or conducting the statutory disqualification checks required in order to register with the SEC. Not only would these SBSDs have to cease entering into SBS transactions with U.S. persons, but they also would need to relocate U.S. personnel whose involvement in ANE Transactions would trigger registration.

The Proposal reflects a thoughtful effort to craft exceptions and guidance designed to ensure that the SEC can achieve the principal objectives of the rules covered by the Proposal without causing these disruptive changes to the U.S. SBS market. That said, the Proposal is not without issues or ambiguities. In addition, more fundamental questions remain regarding the need for the SEC to apply Title VII rules to ANE Transactions or require non-U.S. SBSDs to provide a certification and legal opinion regarding access to books and records and on-site inspections and exams—requirements that the Commodity Futures Trading Commission ("**CFTC**") has not imposed as part of its parallel Dodd-Frank regime for swaps. One might also question why it is necessary for the SEC to require statutory disqualification checks for a far broader population of APs than the CFTC requires.

The following memorandum provides more details regarding these issues and other aspects of the Proposal. Comments on the Proposal are due 60 days after its forthcoming publication in the Federal Register.

ANE TRANSACTIONS

(1) Background

— Under the previously adopted SEC rules, SBS transactions with a non-U.S. counterparty that are "arranged, negotiated, or executed" by personnel of a non-U.S. person (or its agent) located in a U.S. branch or office are (i) included in counting towards the threshold for the *de minimis* exception from the SBSD definition[2] and (ii) subject to certain Title VII requirements, such as business conduct standards and reporting requirements.

(2) "Market Color" Guidance

— The Proposal provides additional guidance regarding "market color," which would include information on pricing or market conditions with respect to a particular instrument or markets more generally, and would encompass current and historic pricing information, information on volatility and trends or predictions regarding pricing or volatility.

The Proposal requests comment regarding the treatment of arranging or finalizing non-pricing aspects of transactions, such as the underlier, notional amount or tenor. However, the Proposal does not address providing indicative pricing information, nor does it address activity relating to the "execution" of transactions.[3]

— Under this proposed guidance, personnel located in the U.S. who provide such "market color" would not be considered "arranging" or "negotiating" if those U.S. personnel: (i) exercise no client responsibility in connection with the transaction and (ii) do not receive compensation based on or otherwise linked to the completion of the transaction. These restrictions seem designed to apply mostly to salespeople who might otherwise receive commissions or sales credits tied to a specific client relationship or transaction. However, designation of U.S. personnel as salespeople or traders would not preclude them from providing market color in reliance on this guidance. In addition, the Proposal explicitly notes that the limitation on receiving compensation is not intended to encompass profit-sharing arrangements or compensation practices that account for aggregated profits or to restrict the ability of firms to risk manage their SBS positions on a global basis.

(3) *De Minimis* Counting Exception

— The Proposal sets forth two potential alternatives for a conditional exception from counting ANE Transactions towards the *de minimis* threshold[4] for SBSD registration.

— Both alternatives require that, to qualify for the exception, "arranging, negotiating, or executing" activity conducted by the U.S.-located personnel of a non-U.S. entity (or its agent) be conducted in such personnel's capacity as an AP of a majority-owned affiliate that is registered with the SEC (the "**U.S. Entity**"). This condition would ensure that certain requirements (such as supervision and

[2] The Proposal notes that a non-U.S. person's SBS transactions with the foreign branch of a registered U.S. SBSD do not need to be counted towards the *de minimis* threshold so long as they are not "arranged, negotiated, or executed" by the foreign branch's U.S. personnel, and the "market color" guidance summarized below would also apply in that context.

[3] The SEC previously provided guidance that the term "execute" refers to a market-facing act that, in connection with a particular transaction, causes the person to become irrevocably bound under the SBS transactions under applicable law. *See* "Security-Based Swap Transactions Connected with a Non-U.S. Person's Dealing Activity That Are Arranged, Negotiated, or Executed By Personnel Located in a U.S. Branch or Office or in a U.S. Branch or Office of an Agent; Security-Based Swap Dealer *De Minimis* Exception," 81 Fed. Reg. 8598, 8622 (Feb. 19, 2016).

[4] Such ANE Transactions also would not count towards the *de minimis* thresholds applicable to affiliates under common control and would, unlike other ANE Transactions, be eligible for the counting exception for certain cleared, anonymous SBS transactions.

chief compliance officer requirements) apply to the "arranging, negotiating, or executing" activity.

U.S. Entity Conducting ANE Activity

— The first alternative for the *de minimis* counting exception requires that the U.S. Entity be an SBSD registered with the SEC ("**Alternative 1**"), while the second alternative allows the entity to be either a broker-dealer registered with the SEC or an SBSD registered with the SEC ("**Alternative 2**").

- The Proposal also would clarify that a registered broker-dealer acting as the U.S. Entity would not need to count the relevant ANE Transactions towards its *de minimis* thresholds for registration as an SBSD.

The need for this clarification is not clear since "dealing" activity is typically regarded as activity entered into by a person as principal, not agent.

- The SEC notes that this "arranging, negotiating, or executing" activity would generally constitute "broker" activity under the Securities Exchange Act of 1934 (the "**Exchange Act**") and would therefore require registration as a broker unless the entity qualified for an exemption from broker status.

If a U.S. Entity was a registered SBSD but not a registered broker-dealer, the "arranging, negotiating, or executing" activities of its APs would subject the U.S. Entity to the SEC's registration requirements for broker-dealers unless it qualified for an exception or exemption (*e.g.*, for banks acting as brokers in "identified banking products" as defined by the Gramm-Leach-Bliley Act). As a result, Alternative 1 may require that the U.S. Entity be dually registered with the SEC as both an SBSD and a broker-dealer, which would subject the entity to significantly higher minimum net capital requirements under the SEC's pending capital proposal for nonbank SBSDs.

Compliance with SBSD Requirements

— The *de minimis* counting exception is conditioned on the U.S. Entity's compliance with the following Title VII requirements applicable to SBSDs as if the U.S. Entity were a counterparty to its non-U.S. affiliate's SBS transactions (and, for a registered broker that is not registered as an SBSD, as if it were a registered SBSD).

- **Disclosure of Material Information.** The U.S. Entity would be required to provide disclosures to the foreign counterparty regarding the material risks and characteristics of the SBS transaction and any material incentives or conflicts of interest (including those of the non-U.S. SBSD relying on this exception) as required under SEC Rule 15Fh-3(b).

The SEC permits these disclosures to be provided on a standardized, relationship-wide basis in many circumstances. Also, unlike the CFTC, the SEC does not require the counterparty to agree in writing to the manner of disclosure, so long as disclosure is provided in a format that is understandable but not unduly burdensome for the counterparty.

- **Suitability.** The U.S. Entity would be required to comply with SEC Rule 15Fh-3(f), pursuant to which it must either:
  - have a reasonable basis to believe that any SBS-related recommendation provided by its APs is suitable for the counterparty based on relevant information about the counterparty, including its investment profile, trading objectives and ability to absorb losses; or
  - for certain institutional counterparties, obtain written representations from the counterparty (or its agent) that it is

exercising independent judgment and disclose to the counterparty that the non-U.S. entity relying on this exception is acting in its capacity as a counterparty and is not undertaking to assess the suitability of the SBS transaction or trading strategy.

The Proposal asks for comment on implementation issues raised by this condition, such as the relationship between APs of the U.S. Entity and foreign counterparties and any challenges to obtaining required suitability information. The SEC also requests comment on whether, given the institutional nature of the SBS market, this condition should be limited to requiring the U.S. Entity to disclose that it is acting in its capacity as a counterparty and is not undertaking to assess the suitability of the SBS transaction or trading strategy.

Additionally, if the U.S. Entity is a registered broker, it would be subject to the suitability requirements for securities transactions and investment strategies under the Financial Industry Regulatory Authority's ("**FINRA**") Rule 2111 with respect to any SBS-related recommendations, absent exemptive relief for the inclusion of SBS in the definition of "security" under the Exchange Act.

- **Fair and Balanced Communications.** The U.S. Entity would be required to ensure its APs communicate with the counterparties in a fair and balanced manner based on principles of fair dealing and good faith as required under SEC Rule 15Fh-3(g).
- **Trade Acknowledgement and Verification.** The U.S. Entity would be required to provide the counterparty with a trade acknowledgement and obtain prompt verification thereof pursuant to SEC Rules 15Fi-1 and 15Fi-2.

If the U.S. Entity is a registered broker-dealer, it would also be subject to the confirmation requirements for securities transactions under SEC Rule 10b-10 and FINRA Rule 2232, absent exemptive relief for the inclusion of SBS in the definition of "security" under the Exchange Act. The Proposal requests comments regarding whether it would be sufficient to condition the exception on such a broker-dealer complying with Rule 10b-10 as if the SBS counterparty was a "customer" of the broker-dealer or whether it would be necessary to modify the information required to be confirmed under Rule 10b-10 to accommodate SBS.

Because the ANE Transactions subject to this exception would also frequently be subject to foreign trade confirmation requirements, a foreign counterparty might, under the Proposal, receive duplicate trade confirmations from the U.S. Entity and its non-U.S. SBSD affiliate unless the SEC permits the U.S. Entity to substitute compliance with those foreign requirements.

- **Portfolio Reconciliation.** The U.S. Entity would be required to comply with SBSD portfolio reconciliation requirements as if the ANE Transactions were included in the U.S. Entity's SBS portfolio, but only the first time such transaction was reconciled.

The Proposal notes that the above portfolio reconciliation requirement is intended to promote accurate reporting to SBS data repositories. However, this rationale presupposes that such ANE Transactions will be subject to Regulation SBSR,[5] which market

[5] *See* "Regulation SBSR–Reporting and Dissemination of Security-Based Swap Information," 81 Fed. Reg. 53546 (Aug. 12, 2016).

participants have separately recommended should not be the case.

— Neither Alternative 1 nor Alternative 2 conditions the exception on compliance with "eligible contract participant" ("**ECP**") verification requirements or "know your counterparty" requirements. Additionally, registered entities would not be required to comply with certain risk mitigation rules (such as trading relationship documentation or portfolio compression requirements) or to provide foreign counterparties with disclosure on clearing rights or daily marks. However, these ANE Transactions would still be subject to the anti-fraud provisions of the federal securities laws and the limitations on off-exchange transactions with counterparties that are not ECPs.

SEC Access to Books and Records

— Like foreign broker-dealers relying on SEC Rule 15(a)(6)(3) for an exemption from registration as a broker-dealer, the non-U.S. SBSD relying on this *de minimis* counting exception must, upon request: (i) promptly provide the SEC with any information or documents within its possession, custody or control; (ii) promptly make its foreign APs available for testimony; and (iii) provide any requested assistance in taking the evidence of other persons, wherever located.

If the non-U.S. SBSD was, after exercising its best efforts, prohibited by applicable foreign law or regulation from providing such information, documents, testimony or assistance, then it could continue to rely on the exception until and unless the SEC issued an order modifying or withdrawing the "listed jurisdiction" determination discussed below.

— This exception is also conditioned on the U.S. Entity creating (or obtaining from its non-U.S. SBSD affiliate, as applicable) and maintaining (i) all required books and records relating to the ANE Transactions subject to this exception (*e.g.*, order tickets and records of written communications by the U.S. Entity's APs); (ii) all trading relationship documentation with respect to the ANE Transactions; and (iii) written consent to service of process for any civil action brought by or proceeding before the SEC.

Additional Disclosures

— The proposed exception is conditioned on the U.S. Entity notifying the SBS counterparty that the non-U.S. SBSD is not registered with the SEC and therefore certain SBS regulations would not apply to the ANE Transaction, including those affording clearing rights to counterparties.[6]

— These disclosures must be made by the U.S. Entity concurrently with (and in the same manner as) the "arranging, negotiating, or executing" activity.

Requiring a U.S. Entity to provide such disclosure in this manner is likely to inhibit effective communication with counterparties and execution of transactions by interrupting the normal flow of conversations. It is not entirely clear why the Proposal would, in this way, impose a more restrictive standard for how U.S. Entities may provide this disclosure than analogous disclosures (*e.g.*, regarding clearing rights) which a registered SBSD may provide on a relationship-wide basis.

Regulation in a "Listed Jurisdiction"

— The non-U.S. entity relying on this exception would be subject to the margin and capital requirements of a "listed jurisdiction." Under the Proposal, "listed jurisdictions" are any jurisdiction

[6] This disclosure requirement would not apply in circumstances where the U.S. Entity does not know the identity of the counterparty.

designated as such by SEC order, and these designations may be conditional or unconditional.

— Similar to requests for substituted compliance, both foreign regulators and parties seeking to rely on the exception may submit an application for a potential "listed jurisdiction" to the SEC. The SEC would consider relevant criteria including the jurisdiction's applicable margin and capital requirements and the effectiveness of the foreign regime's supervisory compliance program and enforcement authority.

— The Proposal notes that, as an initial matter, "listed jurisdictions" may include some or all of the following: Australia, Canada, France, Germany, Hong Kong, Japan, Singapore, Switzerland and the United Kingdom.

— The SEC may, by order, after notice and opportunity for comment, modify or withdraw a jurisdiction's status as a "listed jurisdiction." Such modification or withdrawal may be based on the above criteria or on any law that prevents the SEC's prompt access to documents and information, ability to obtain foreign APs' testimony or ability to obtain assistance in taking the evidence of other persons.

(4) Requests for Comment Regarding ANE Transactions

— As noted above, the Proposal requests comment on the application of Regulation SBSR to ANE Transactions, including whether to allow ANE Transactions to be reported pursuant to the requirements of the jurisdiction of the non-U.S. SBSD. The SEC also queries whether applying reporting requirements to ANE Transactions would cause non-U.S. counterparties to avoid transacting with non-U.S. SBSDs who use U.S. personnel to arrange, negotiate, or execute SBS transactions.

In considering these requests for comment, market participants might also want to consider Regulation SBSR's parallel treatment of SBS transactions effected by or through a registered broker-dealer.

— The Proposal seeks comment on the application of the SBS business conduct requirements to ANE Transactions, including comments on potential exemptive relief for ANE Transactions that qualify for the above described *de minimis* counting exception or an exception similar to the exception for foreign broker-dealers under SEC Rule 15a-6(a)(3).

CERTIFICATION AND OPINION GUIDANCE

(1) Background

— The SEC previously adopted rules requiring a non-U.S. SBSD to certify and provide a legal opinion relating to the SEC's ability to promptly access the SBSD's books and records directly and to conduct on-site inspections and examinations.

(2) Proposed Guidance

— The Proposal would clarify: (i) what laws are covered by the certification and opinion; (ii) what records are covered by the certification and opinion; (iii) the treatment of open contracts; (iv) the relevance of counterparty or employee consents; and (v) the relevance of approvals by foreign regulators or their agreements with the SEC. The Proposal makes clear, however, that this guidance would not limit the scope or application of the SEC books and records requirements for SBSDs, including requirements to provide the SEC with direct access to those books and records.

Covered Foreign Laws

— The Proposal would require a non-U.S. SBSD to obtain a certification and opinion of counsel with respect to the laws where such SBSD maintains its "covered books and records" (as defined below).

— If the jurisdiction where a non-U.S. SBSD maintains its covered books and records is its jurisdiction of incorporation or principal place of business, then the certification and opinion of

counsel would only need to address that jurisdiction.

— If the non-U.S. SBSD maintains its covered books and records in a different jurisdiction, then the certification and opinion would address that jurisdiction, so long as the SBSD's jurisdiction of incorporation or principal place of business does not impose limitations on the SBSD opening its covered books and records to the SEC or allowing the SEC to conduct on-site examinations.

Covered Books and Records

— The Proposal would define "**covered books and records**" to be:

- books and records relating to the "U.S. business" (as defined in SEC Rule 3a71-3(a)(8)) of the non-U.S. SBSD, which would include both an SBSD's transactions with U.S. persons and ANE Transactions; and
- financial records necessary for the SEC to assess the non-U.S. SBSD's compliance with the SEC's margin and capital requirements, if applicable.

The proposed definition of covered books and records would not encompass records relating to non-U.S. SBS transactions that are guaranteed by a U.S. entity.

The Proposal does not provide details on what specific types of records would be captured as relating to an SBSD's U.S. business. However, to the extent such records could encompass personal identifying information of individuals, an SBSD's local privacy and other laws may prohibit direct access or on-site inspection by the SEC.

The Proposal also does not address whether covered books and records includes the financial records of an SBSD relying on substituted compliance with respect to the SEC's margin and capital requirements.

Relevance of Open Contracts

— Under the Proposal, the certification and opinion of counsel would not need to address books and records for SBS transactions entered into prior to the date the non-U.S. SBSD submits an application for registration.

— However, open contracts would remain subject to the recordkeeping requirements and the guidance related to consents as discussed below.

Relevance of Consents

— If the non-U.S. SBSD is required to obtain the prior consent of the persons whose information is or will be included in covered books and records in order to provide the SEC with direct access to its covered books and records, including allowing on-site inspections and examinations of such covered books and records, the certification and opinion of counsel could be predicated on any such required consents.

— The Proposal does, however, provide guidance that a non-U.S. SBSD should obtain any such required consents prior to registration with the SEC and continue to obtain any such required consents on an ongoing basis after registration. If the SBSD fails to obtain any required consents, such SBSD may have to cease trading with the relevant counterparty.

The Proposal does not specifically address whether the requirement to obtain such consents prior to registration also applies to open contracts or non-U.S. counterparties.

The Proposal also requests comments regarding whether consents provide a feasible long-term solution to providing the SEC with direct access to covered books and records (*e.g.*, due to guidance under the European Union's General Data Protection Regulation restricting reliance on employee consent).

Relevance of MOUs with Foreign Regulators

— The certification and opinion of counsel could rely on a foreign regulatory authority's approval or arrangement with the SEC (*e.g.*, a Memorandum of Understanding), so long as such approval or arrangement allows the SEC direct access to covered books and records.

This approach is different from how some existing Memoranda of Understanding are drafted and seems more targeted at facilitating on-site examinations, which the Proposal states could be premised on notification to the relevant foreign regulator, whose staff could accompany SEC staff on the examination.

(3) 24-Month Transition Period

— The Proposal would allow a non-U.S. SBSD that is unable to provide a certification and opinion of counsel to conditionally register for up to 24 months.

This aspect of the Proposal is intended to provide time for foreign regulators to grant requisite approvals or enter into the requisite arrangements with the SEC. If a non-U.S. SBSD could not provide the certification or opinion after two months, the SEC could institute proceedings to determine whether ongoing registration should be denied.

The Proposal request comments regarding whether a non-U.S. SBSD should be permitted to operate without consents in place until it provides the certification and opinion, rather than until it is conditionally registered.

(4) Substituted Compliance Applications

— SEC Rule 3a71-6 requires that an application by an SBSD for a substituted compliance determination by a party other than a foreign regulatory authority must be accompanied by the above described certification and opinion of counsel. The SEC notes that it welcomes such applications prior to the submission of a certification and opinion of counsel, although the Proposal declines to state whether the SEC will grant any application until it receives the certification and opinion or related assurance from the relevant foreign regulator.

As noted in the Proposal, upon becoming conditionally registered, the SBSD would be subject to the entire SBSD regulatory regime. Consequently, the 24-month conditional registration period may not be effective unless the SEC is willing to grant substituted compliance (perhaps on a similar conditional basis) before receiving the requisite certification and opinion, as non-U.S. SBSDs will not want to register if doing so will subject them to overlapping U.S. and home country rules.

STATUTORY DISQUALIFICATION RELIEF

(1) Background

— SEC Rule 15Fb6-2 requires (i) an SBSD to certify that it neither knows, nor in the exercise of reasonable care should have known, that any of its APs who effect or are involved in effecting SBS transactions on behalf of the SBSD are statutorily disqualified and (ii) the chief compliance officer of an SBSD (or his or her designee) to review and sign employment questionnaires or applications, which are to serve as the basis for a background check.

— The SEC's Rule of Practice 194 establishes a process by which an SBSD may seek an exemption from the prohibition against APs subject to a statutory disqualification.

(2) Relief for Certain Non-U.S. APs

— The Proposal would amend Rule of Practice 194 to provide an exclusion for an AP of an SBSD subject to a statutory disqualification who (i) is not a U.S. person and (ii) does not effect and is not

involved in effecting SBS transactions with or for U.S. counterparties, other than through a foreign branch of such U.S. counterparties. This exclusion is conditioned on the AP not being currently subject to an order prohibiting participation in the U.S. financial markets or a foreign financial market where the individual is employed or located.

(3) Requests for Comment Regarding Other Categories of APs

— In the Proposal, the SEC requests comment on whether it should provide an exclusion for any other categories of APs. Specifically, the SEC notes that pursuant to the proposed exclusion, the AP cannot be "involved in effecting [SBS]," which generally encompasses all functions necessary to facilitate the SBS business, including both front and back-office activities, such as drafting and negotiating master agreements and confirmations, pricing SBS positions and managing collateral for the SBSD.

The exclusion for certain APs is designed to align more closely with the CFTC's requirements. However, the CFTC's exclusion for APs is limited to front-office personnel, while the SEC's exclusion encompasses anyone "involved in effecting [SBS]," which is significantly broader.

(4) Recordkeeping Relief

— With respect to the requirement that an SBSD make and keep employment questionnaires, the Proposal adds exceptions for:

- any AP who is excluded from the statutory disqualification prohibition; and
- certain information in the employment questionnaire for a foreign AP that effects, or is involved in effecting, SBS transactions with both U.S. and foreign counterparties, <u>if</u> receiving or maintaining such information would violate the law of the jurisdiction in which such person is located or employed.

With respect to the second exemption, the SEC notes that the SBSD must still have sufficient comfort that an AP is not subject to a statutory disqualification in every instance in which an AP is not subject to an exclusion from such statutory disqualification requirement. In instances where receiving or maintaining such information is prohibited by the law of the jurisdiction in which the AP is located or employed, the SBSD may be able to review public records or take other steps to obtain such comfort. In addition, the SBSD's chief compliance officer (or his or her designee) would remain obligated to review each such AP's questionnaire or application for employment.

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