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Alert Memo

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CFTC Adopts External Business Conduct Standards

On January 11, 2012, the Commodity Futures Trading Commission (the "**CFTC**") approved final rules (the "**Final CFTC Rules**") implementing the provisions of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**") relating to external business conduct standards for swap dealers ("**SDs**") and major swap participants ("**MSPs**" and, together with SDs, "**Swap Entities**").[1] The Final CFTC Rules will require extensive changes to existing swap documentation and the adoption of comprehensive policies and procedures potentially as early as October 14, 2012.

The Final CFTC Rules follow a rule proposal published in December 2010 by the CFTC (the "**CFTC Proposal**").[2] Market participants commented that the CFTC Proposal would have imposed several unworkable requirements and restrictions. When the Securities and Exchange Commission (the "**SEC**") published a parallel proposal on business conduct rules (the "**SEC Proposal**")[3] applicable to security-based swap dealers ("**SBSDs**") and major security-based swap participants ("**MSBSPs**" and, together with SBSDs, "**SBS Entities**") in June 2011, it was widely regarded as having benefited from the comments submitted in response to the CFTC Proposal.

In adopting the Final CFTC Rules, the CFTC took several steps to respond to the comments it had received and to harmonize its rules with the SEC Proposal.[4] Consistent with the SEC Proposal, the CFTC excluded MSPs from many of the requirements not mandated by Dodd-Frank. The CFTC also added several safe harbors, clarified many ambiguous standards and deleted some of its proposed requirements that were not mandated by Dodd-Frank.

As required under Dodd-Frank and proposed by the CFTC, the requirements of the Final CFTC Rules vary depending on whether the Swap Entity's counterparty is a "Special Entity," whether the Swap Entity's relationship with its counterparty is advisory and whether the Swap Entity makes a recommendation. The chart below provides a "roadmap" to these variations in required conduct under the Final CFTC Rules, and it is followed by a discussion and analysis of key obligations.

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1 77 Fed. Reg. 9734 (Feb. 17, 2012) ("**Final CFTC Rules**").

2 75 Fed. Reg. 80638 (Dec. 22, 2010).

3 76 Fed. Reg. 42396 (July 18, 2011).

4 A detailed comparison of the Final CFTC Rules and the SEC Proposal is included in the attached **Appendix**.

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FINAL CFTC RULES: VARIATIONS IN REQUIRED CONDUCT

Applicable to All Counterparties

Base Requirements	Recommendations to any Counterparty
• General prohibition on fraud, manipulation and other abusive practices. • Requirements to "know your counterparty," verify eligibility of counterparties, disclose material information about the swap, and, for certain swaps, to provide a scenario analysis and daily marks. • Requirement to protect confidential counterparty information and comply with fair dealing standards.	• Recommendations trigger a duty by an SD (but not an MSP) to undertake "reasonable diligence" to understand the "risks and rewards" of a swap and to have a "reasonable basis" to believe the swap is "suitable" to the counterparty's needs. • Suitability requirements are met where (i) the counterparty represents it is exercising independent judgment, (ii) the SD represents it is not evaluating the suitability of any recommendation, and (iii) where the SD is "acting as an advisor to a Special Entity," additional requirements are satisfied.

Applicable to Special Entity Counterparties

Special Entity Requirements	SD is an Advisor to a Special Entity
• A Swap Entity must have a reasonable basis to believe that the Special Entity has a qualified independent representative or a fiduciary under the Employee Retirement Income Security Act of 1979 ("**ERISA**"). • A Swap Entity must disclose to the Special Entity the capacity in which it is acting in connection with the swap, and the differences with other capacities in which it does business with the Special Entity. • An SD (but not an MSP) must comply with "pay-to-play" restrictions with respect to governmental Special Entities.	• An SD (but not an MSP) must act in the "best interests" of the Special Entity and undertake "reasonable efforts" to obtain information necessary to determine that a recommended swap is in the best interests of the Special Entity. • May comply with a safe harbor to avoid advisor status.

DISCUSSION AND ANALYSIS OF KEY OBLIGATIONS

I. KEY DATES AND GRANDFATHERING

A. Effective and Compliance Dates. The Final CFTC Rules will become effective on April 17, 2012. Compliance will be required by the later of October 14, 2012 (180 days after the effective date) or the date on which Swap Entities are required to register with the CFTC (which will be the later of the effective dates of the pending swap and Swap Entity definitional rulemakings).

B. Grandfathering. Although the preamble to the Final CFTC Rules states that they do not apply to unexpired swaps executed prior to the effective date, the rules do not provide complete grandfathering.

1. *For swaps entered into after April 17, 2012, the obligations that apply over the life cycle of a swap (such as daily mark disclosures) will begin to apply starting on the rules' compliance date, but those obligations that apply before a swap is offered or entered into (such as risk disclosures) will not.*

2. *The Final CFTC Rules' pay-to-play restrictions and independence qualifications for representatives of Special Entities will require Swap Entities to take into account conduct that occurred during the prior one or two years, respectively. However, it is not clear whether those look-back periods cover conduct that takes place before the effective date or compliance date of the Final CFTC Rules.*

3. *The preamble states that any "material amendment" to the terms of a swap will be considered a new swap subject to the Final CFTC Rules. However, the CFTC did not address or provide examples of the types of amendments that will be considered "material" for these purposes.*

II. OBLIGATIONS APPLICABLE TO ALL COUNTERPARTIES

A. Trading and Related Obligations.

1. *Prohibition on Fraud, Manipulation and Other Abusive Practices.* The Final CFTC Rules generally prohibit Swap Entities from engaging in any practice that is fraudulent, deceptive or manipulative.

   a. According to the CFTC, proof of scienter is not required for a Swap Entity to be found liable under this broad anti-fraud prohibition. While the statutory heading suggests that this anti-fraud provision was intended by Congress to be limited to situations where the SD acts as an advisor, the CFTC rejected suggestions to limit the provision to advisory relationships.

b. The CFTC has provided a limited affirmative defense to allegations that a Swap Entity engaged in fraudulent, deceptive or manipulative conduct in connection with a violation of the Final CFTC Rules. This defense is only available if the Swap Entity (1) did not act intentionally or recklessly in connection with the alleged violation and (2) complied in good faith with reasonably designed policies and procedures designed to meet the particular requirement that is the basis for the alleged violation.

- *Read literally, the affirmative defense should be available against allegations that the Swap Entity violated this general anti-fraud prohibition, so long as the Swap Entity (1) did not act intentionally or recklessly and (2) complied in good faith with policies and procedures reasonably designed to prevent fraudulent, deceptive or manipulative conduct.*

- *The affirmative defense would not by its terms apply to allegations that the Swap Entity committed a technical violation of a disclosure, suitability or other requirement contained in the Final CFTC Rules without committing fraud.*

- *In this connection, the CFTC expressly declined to address the availability of potential private rights of action for violations of the Final CFTC Rules.*[5] *Section 22(a)(1) of the Commodity Exchange Act (the "**CEA**") provides for a private right of action against a Swap Entity that violates or willfully aids in a violation of the CEA. The concern regarding the availability of private rights of action arises in the case of CFTC rules referenced in statutory provisions that expressly prohibit persons from violating the relevant CFTC rules.*

- *Additionally, Dodd-Frank amended Section 22(a)(4) of the CEA to carve back prior statutory limitations on the ability of an eligible contract participant ("**ECP**") to rescind swap transactions based on a violation of the CEA.*

2. *Counterparty Confidential Information; Trading Ahead and Front Running.* The Final CFTC Rules prohibit disclosure or use of any material

[5] According to the CFTC, it lacks the statutory authority to exempt Swap Entities from private rights of action under CEA Section 22. Final CFTC Rules at 9744. This is the first CFTC Commission in our experience to express this view generally or with respect to violations of the CEA for which the CFTC has exemptive authority. *See* CEA § 4(c).

confidential information obtained from a counterparty that would be materially adverse to the interests of the counterparty, unless such disclosure or use is authorized in writing by the counterparty or is necessary: (i) for the effective execution of any swap for or with the counterparty; (ii) to hedge or mitigate any exposure created by such swap; or (iii) to comply with a request of the CFTC, Department of Justice, any self-regulatory organization ("**SRO**") designated by the CFTC, or an applicable prudential regulator, or is otherwise required by law.

The Final CFTC Rules dropped proposed prohibitions specific to trading ahead and front running. The CFTC instead determined that front running and trading ahead were adequately addressed through the new general anti-fraud and confidentiality provisions. However, the confidentiality obligations potentially raise some of the same issues as the discarded trading ahead and front running prohibitions. In particular, while the preamble to the Final CFTC Rules explains that a Swap Entity could use a counterparty's information for appropriate purposes, such as in connection with market making activities, the actual text of the rule appears to be significantly more restrictive.

3. *Best Execution – Not Adopted.* The Final CFTC Rules dropped the proposed obligation of a Swap Entity or other CFTC registrants to execute certain swaps with customers on terms reasonably related to the best available.

*The CFTC indicated that best execution standards may be proposed in a future rulemaking. It should be noted that the CFTC separately proposed in March 2011 to prohibit any person from buying a contract on a swap execution facility ("**SEF**") at a price that is higher than the lowest available offer on the SEF or selling a contract at a price that is lower than the highest available bid on the SEF.[6] If adopted, this proposal would essentially impose a price and time priority requirement across quotes on each SEF.*

B. Fair and Balanced Communication. Swap Entities have a duty to communicate with counterparties in a "fair and balanced manner." To comply with this duty a Swap Entity must (i) provide the counterparty with a sound basis for evaluating the swap (ii) avoid making exaggerated or unwarranted claims and (iii) balance any statement about potential advantages with statements of corresponding risks.

C. Reliance on Representations. Swap Entities are generally permitted to satisfy due diligence obligations (including safe harbor requirements) through reliance on counterparty representations included in relationship documentation, unless the

[6] *See* 76 Fed. Reg. 14943 (Mar. 18, 2011).

Swap Entity has information that would cause a reasonable person to question the accuracy of the representation.

1. *The CFTC did not clarify whether individuals involved in the execution of a swap need to inquire further within their organization for information about the accuracy of counterparty representations, or whether information barriers will be respected, despite comments requesting such clarification.*

2. *According to the CFTC, a Swap Entity may only rely on counterparty representations, or deem such representations renewed if the Swap Entity:*

    a. *Obtains covenants from its counterparty to update promptly any material changes to its representations (presumably with respect to those representations on which the Swap Entity relies for compliance with the Final CFTC Rules; and*

    b. *Puts in place procedures for at least an annual review of the accuracy of representations by the chief compliance officer ("**CCO**"),[7] according to the CFTC's "best practice."*[8]

3. *The Final CFTC Rules do not specifically address circumstances in which representations are made on behalf of a counterparty by its fiduciary. Presumably, representations made by a duly authorized fiduciary on behalf of a counterparty may be relied upon as though made by the counterparty.*

D. **Know Your Counterparty.** The Final CFTC Rules require SDs (but not MSPs) to have policies and procedures reasonably designed to obtain and retain a record of essential facts concerning a known counterparty, including: (i) facts required to comply with applicable law and to ensure compliance with the SD's internal credit and operational risk management policies; and (ii) information regarding the authority of any person acting for the counterparty. Both SDs and MSPs are required to obtain and retain a record of the true name and address of the counterparty, guarantors and any persons exercising control with respect to the positions of such counterparty. For rules based on existing SRO rules, such as "know your counterparty" obligations, the CFTC has indicated that it intends to be guided (although not bound) by SRO interpretations.[9]

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[7] It is unclear how the CFTC expects this to be done for 10,000 relationships, every year, or how it expects the CCO to be aware of changes for counterparty facts that call into question specific recommendations. We assume it would be acceptable for the CCO to establish a procedure for polling those with a direct relationship with the firm's counterparties as to any relevant changes.

[8] Final CFTC Rules at 9749.

[9] Final CFTC Rules at 9742.

E. Eligibility Verification. Before "offering to enter into"[10] or entering into a swap, a Swap Entity must (i) verify that its counterparty is an ECP and (ii) determine whether its counterparty is a Special Entity, or eligible to elect to be treated as a Special Entity. A Swap Entity is entitled to rely on written representations of a counterparty where such representations reference the specific provision(s) of the definition of ECP applicable to it.

F. Disclosure Requirements. The Final CFTC Rules require a Swap Entity to disclose certain information to all non-Swap/SBS Entity counterparties at a "reasonably sufficient" time prior to entering into a swap. The parties may agree on the manner in which the disclosures may be provided, including in a master agreement under which the disclosures are deemed subsequently renewed.

1. *Material Risks.* Swap Entities must disclose the material risks of a swap, which include market, credit, liquidity, foreign currency, legal, operational and any other applicable risks.

   a. For standardized swaps, standardized risk disclosure in counterparty relationship documentation should be appropriate. For bespoke swaps, more detailed disclosure may be required depending on the complexity of the transaction, the degree and nature of any leverage, the potential for periods of significantly reduced liquidity and the lack of price transparency.

   b. Generally, risk disclosure relates to the risks intrinsic to the contract itself and not the risk of the underlying asset. Yet, where payments or cash-flows are materially affected by the performance of an underlying asset for which there is not publicly available information (*e.g.*, a total return swap on a broad-based index composed of unique assets that the Swap Entity created or acquired), the Final CFTC Rules would require disclosure about the underlier. Note also that disclosure about the Swap Entity's activities in the underlier may be required under the conflicts disclosure requirement discussed below.

   c. *It is not clear how the CFTC's clarification that disclosure is generally limited to the economic terms of the swap and not to the underlier is to be reconciled with provisions in the preamble discussing the need to disclose material "economic factors" and "events".*[11]

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[10] The CFTC confirmed the term "offer" has the same meaning as in contract law, such that, if accepted, the terms of the offer would form a binding contract. Final CFTC Rules at 9741.

[11] Final CFTC Rules at 9760.

d. *It is not clear how the requirement to provide disclosure at a time "reasonably sufficient" prior to execution, and the application of this requirement to execution on a "request-for-quote" ("**RFQ**") SEF (as discussed in Part V. C. below), is to be reconciled with the commercial necessity to limit the time during which responses to RFQs are actionable.*

2. *Scenario Analysis.* For swaps not subject to Dodd-Frank's mandatory SEF trading requirement, an SD (but not an MSP) must offer to provide a scenario analysis, and must provide the analysis if the counterparty requests it. The SD is required to design the scenario analysis in consultation with the counterparty. In addition, in designing the analysis the SD must consider analyses it undertakes for its own risk management purposes, including its new product policy. The SD must also disclose all material assumptions and calculation methodologies used to perform the analysis, although it is not required to disclose any confidential, proprietary information about any model used to prepare the analysis.

   a. *The CFTC believes that scenario analyses performed consistent with the rule should not "unduly" expose SDs to liability because the analyses are to be designed in consultation with counterparties and subject to appropriate warnings as to the assumptions and limitations of the analyses. As a practical matter, however, the likely evaluation of scenario analyses in hindsight after a counterparty has lost money on a trade may well present litigation risks even if the SD's analysis is accompanied by robust warnings.*

   b. *It is not clear how the CFTC intends to resolve circumstances in which the use of proprietary methodologies would be material to the results of the affected scenario analysis. SDs may wish to consider disclosure that proprietary features of its models may overstate or understate market factor sensitivities vis-à-vis other statutory models, depending on the relevant circumstances.*

3. *Material Contract Characteristics.* A Swap Entity must disclose information designed to allow its counterparty to assess the material economic terms of the swap, the terms relating to the operation of the swap and the parties' rights and obligations during the term of the swap.

   The CFTC declined to determine whether exchange of swap documentation itself may be sufficient to satisfy this requirement. Instead, it indicated that additional disclosure may be required for swaps that contain caps, collars, floors, knock-ins, knock-outs, range accrual features, embedded optionality, embedded volatility or other features that increase the complexity of the swap.

4. *Material Incentives and Conflicts of Interest.* A Swap Entity must provide information reasonably designed to allow its counterparty to assess the Swap Entity's material incentives and conflicts of interest. For example, (i) when disclosing the price of the swap, the Swap Entity must also disclose the swap's mid-market mark and (ii) the Swap Entity must disclose any compensation or other incentive from any source other than the counterparty that the Swap Entity may receive in connection with the swap.

    a. If a Swap Entity "recommends" more than one swap strategy to a counterparty, the CFTC contemplates that the Swap Entity should disclose whether its compensation related to a particular swap would be greater than the compensation for another instrument with similar economic terms offered by the same Swap Entity.

    b. Incentives paid to Swap Entities by SEFs or other market infrastructures are required to be disclosed.

    c. The CFTC "decline[d] to state categorically that swap dealers and major swap participants will be required to separately price each standardized component of a customized swap,"[12] leaving ambiguity as to whether a Swap Entity will in fact be required to do so without providing any guidance about what circumstances may make such disclosure necessary.

    d. Depending on the facts and circumstances, particularly where an SD recommends a swap, the CFTC indicated that a Swap Entity may be required to provide disclosure about its other activity in the underlying commodity and other similarly non-public information, such as whether the swap is part of a strategy for the Swap Entity to decrease its position.

    e. *The real question presented by the Final CFTC Rules is whether the CFTC intends to require disclosure of an actual conflict that exists, as opposed to the industry practice of disclosing the possibility/likelihood of a conflict – in order to avoid the prejudicial disclosure of confidential information regarding a Swap Entity's proprietary positions.*

5. *Daily Marks.* For swaps cleared by a derivatives clearing organization ("**DCO**"), a Swap Entity will be required to notify a non-Swap/SBS Entity counterparty of its right to receive the DCO's daily mark. For uncleared swaps, a Swap Entity will be required to provide such counterparty with a daily mark, which would be the mid-market mark of the swap. Swap

[12] Final CFTC Rules at 9766.

Entities will be required to disclose the assumptions and methodology used by them to prepare the daily marks for uncleared swaps.

a. *It is unclear whether the current practice of marking positions through an overnight batch process and disclosing those marks during the next day will satisfy this requirement.*

b. *The level of detail with which marking methodologies and assumptions must be disclosed is unclear. In noting that it does not intend for proprietary information to be disclosed in connection with the daily mark, the CFTC explained that it contemplated that the marketplace will adopt standardized "reference models" to be used in connection with pricing methodologies.*

6. *Clearing.* If a swap is subject to mandatory clearing, a Swap Entity will be required to notify a non-Swap/SBS Entity counterparty of its right to select the DCO. If the swap is not subject to mandatory clearing, the Swap Entity will be required to notify such counterparty of its right to elect to require the swap to be cleared and to select the DCO.

The Final CFTC Rules do not limit the counterparty's choice of DCO to ones in which the Swap Entity is a clearing member or has clearing privileges. The CFTC refused to provide guidance at this time as to whether the counterparty's election to have a swap cleared and its choice of DCO can affect the price of the swap.

G. Suitability Requirement. An SD (but not an MSP) that makes any "recommendation" of any swap or swap trading strategy (whether or not customized) to any non-Swap/SBS Entity counterparty will be required to:

- undertake reasonable diligence to understand the risks and rewards of the recommended swap or strategy; and
- have a "reasonable basis" to believe that such swap or trading strategy is "suitable" for that counterparty, based on information regarding the counterparty's investment profile, trading objectives and ability to absorb potential losses associated with the recommendation.

1. *Definition of "Recommendation."* A "recommendation" includes "any communication" by which an SD "provides information to a counterparty about a particular swap or trading strategy that is tailored to the needs or characteristics of the counterparty." For example, the CFTC distinguishes between a research report sent to counterparties generally – which would not be a recommendation – and a research report accompanied by a written or oral message that the counterparty should act on the report.

2. *Safe Harbor*. SDs will in most circumstances rely on the safe harbor provided in the Final CFTC Rules because whether a particular communication constitutes a recommendation is a facts and circumstances determination. Under this safe harbor, an SD would fulfill its suitability obligations in circumstances where:

   a. The SD reasonably determines that the counterparty (or its agent) is capable of independently evaluating the investment risks of the relevant swap or trading strategy involving a swap. This requirement may be satisfied in the case of agents to non-Special Entities through written representation that the counterparty has complied with written policies designed to ensure that its agent is capable of making such decisions. For agents of Special Entities, this requirement may be satisfied by compliance with the qualified independent representative ("**QIR**") or fiduciary safe harbor applicable to Special Entity counterparties. Those safe harbors are described below;

   b. The counterparty or its agent represents in writing that it is exercising independent judgment in evaluating the SD's recommendation;

   c. The SD discloses in writing that it is not undertaking to assess the suitability of the SD's recommendation; and

   d. Where the recommendation would cause the SD to be deemed to act as an advisor to a Special Entity, and the SD does not rely on the safe harbor from being deemed to act as an advisor, the SD complies with the requirements applicable to advisors to Special Entities.

III. OBLIGATIONS TO SPECIAL ENTITIES

A. Coordination with the Department of Labor. The CFTC took several steps, including adopting the safe harbors described below, to address concerns that the Final CFTC Rules might be inconsistent with the fiduciary regulations administered by the Department of Labor ("**DOL**").

1. The DOL provided the CFTC with a letter explaining that the Final CFTC Rules "do not require" Swap Entities to engage in activity that would make them fiduciaries under the DOL's current five-part test.[13] The DOL went on

[13] A person may be treated as an ERISA fiduciary by rendering investment advice. For advice to qualify as "investment advice," an advisor without discretionary authority or control over the purchase or sale of securities or other property for the plan must (i) render advice as to the value of securities or other property, or make recommendations as to the advisability of investing in, purchasing or selling securities or other property, (ii) on a regular basis, (iii) pursuant to a mutual agreement, arrangement or understanding, with the plan or a plan fiduciary, (iv) the advice will serve as a

to note that the rules do not "conflict with" the DOL's existing regulations, nor do they "compel" Swap Entities to engage in fiduciary conduct. The CFTC noted in the preamble to the Final CFTC Rules that compliance with the rules "will not, by itself, cause a swap dealer or major swap participant to be an ERISA fiduciary to an ERISA plan."[14] It is expected that SDs will ensure compliance with ERISA by operating within the suitability and advisory safe harbors provided by the Final CFTC Rules.

2. Further, the DOL has said that it plans to re-propose rules on the definition of fiduciary.[15] While the DOL has indicated its intent to harmonize such future DOL regulations with the Final CFTC Rules, the extent and manner of such harmonization are unclear.

B. Definition of Special Entity. "Special Entity" includes:

- a Federal agency;
- a State, State agency, city, county, municipality, or other political subdivision of a State;
- an employee benefit plan subject to Title I of ERISA;
- a governmental plan, as defined in Section 3 of ERISA;
- any endowment, including an endowment that is an organization described in Section 501(c)(3) of the Internal Revenue Code of 1986; or
- any employee benefit plan defined in Section 3 of ERISA, not otherwise defined as a Special Entity, that elects to be a Special Entity by notifying an SD or MSP of its election prior to entering into a swap with such SD or MSP.

1. Absent counterparty election, only ERISA plans that are subject to ERISA must be treated as Special Entities. In the case of counterparties that meet the definition of an "employee benefit plan" under, but are not subject to, ERISA (*e.g.*, certain foreign pension plans), Swap Entities must notify such counterparties of their right to elect to be treated as Special Entities.

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primary basis for investment decisions with respect to plan assets, and (v) the advice will be individualized based on the particular needs of the plan. 29 C.F.R. § 2510.3-21(c).

[14] Final CFTC Rules at 9738.

[15] DOL News Release, U.S. Dept. of Labor, U.S. Labor Department's EBSA to re-propose rule on definition of a fiduciary (Sept. 19, 2011), available at http://www.dol.gov/opa/media/press/ebsa/EBSA20111382.htm.

2. The CFTC clarified that a charitable organization that has entered into a swap for which its counterparty has recourse to the organization's endowment would not be a Special Entity.

3. The CFTC further clarified that it will not "look-through" an entity that is an investment vehicle, *e.g.*, a bank collective trust fund or a plan asset hedge fund, to underlying investors in determining Special Entity status.

4. Notably, the SEC Proposal did not contain any of these clarifications, although the SEC did request comment on each of them.

C. Counterparties to Special Entities.

1. *Non-ERISA Special Entities: Requirements for QIRs.* Any Swap Entity that offers to enter into or enters into a swap with a Special Entity other than an ERISA plan is required to have a reasonable basis to believe that the Special Entity has a QIR.

   a. Independence. A QIR is "independent" from a Swap Entity where:

   - the representative is not an associated person of the Swap Entity (with a one-year look-back);
   - there is no "principal" relationship between the representative and the Swap Entity;[16]
   - the representative provides timely and effective disclosures to the Special Entity of all material conflicts of interest that could reasonably affect the judgment or decision making of the representative with respect to its obligations to the Special Entity, and complies with policies and procedures reasonably designed to manage and mitigate such material conflicts of interest;
   - the representative is not directly or indirectly, through one or more persons, controlled by, or in control of, or under common control with, the Swap Entity; and
   - the Swap Entity did not refer, recommend, or introduce the representative to the Special Entity within one year of the representative's representation of the Special Entity in connection with the swap.

[16] "Principal" is defined to include partners, directors, officers or other managers or other persons holding a similar status and ten percent or greater owners or shareholders.

b. *While it is a dramatic improvement from the ambiguous "material business relationship" test originally proposed by the CFTC, the final independence standard will require QIRs to develop extensive disclosure practices and conflicts policies relating to such matters as their compensation arrangements and other business relationships with Swap Entities. Further, Swap Entities will need to curtail any referral, recommendation or introduction of potential advisors to Special Entities absent further clarification from the CFTC.*

c. *In addition, the Final CFTC Rules take a different approach to establishing a QIR's independence than the SEC Proposal, which defined a QIR's independence based on affiliation with the SBS Entity and the percentage of annual gross revenues received by the QIR from the SBS Entity. As a result, dual Swap/SBS Entities may potentially have two different sets of rules to apply for evaluating the independence of the same representative.*

d. Safe Harbor. A Swap Entity shall be deemed to have a reasonable basis to believe that a Special Entity (other than an ERISA plan) has a QIR if:

- the Special Entity represents in writing to the Swap Entity that it has complied in good faith with written policies and procedures reasonably designed to ensure that it has selected a representative that satisfies the QIR requirements, and that such policies and procedures provide for ongoing monitoring of the performance of the representative consistent with those requirements; and

- the representative represents in writing to the Special Entity and Swap Entity that it (a) has policies and procedures reasonably designed to ensure that it satisfies the QIR requirements; (b) is "independent" from the Swap Entity; and (c) is legally obligated to comply with the QIR requirements by agreement, condition of employment, law, rule, regulation, or other enforceable duty.

e. *The QIR safe harbor effectively will require Special Entities and their representatives to establish and maintain the specified policies and procedures, even though they may not themselves be regulated by the CFTC.*

2. *ERISA Plans: Requirements for Fiduciaries.* A Swap Entity that offers to enter into or enters into a swap with a Special Entity that is an ERISA plan is required to have a reasonable basis to believe that the Special Entity has a representative that is a fiduciary under ERISA.

Safe Harbor. A Swap Entity shall be deemed to have a reasonable basis to believe that a Special Entity that is an ERISA plan has a representative that is a fiduciary under ERISA, provided that the ERISA plan (i) provides in writing to the Swap Entity the representative's name and contact information and (ii) represents in writing that the representative is a fiduciary under ERISA.

3. *CCO Review.* If a Swap Entity initially determines that it does not have a reasonable basis to believe that the representative of a Special Entity is qualified (either as a QIR or an ERISA fiduciary, as applicable), the Swap Entity must make a written record of the basis for such determination and submit such determination to its CCO for review to ensure that the Swap Entity has a substantial, unbiased basis for the determination. The CFTC clarified that it does not believe that this requirement gives the Swap Entity authority to determine whether the representative meets the QIR requirements of the Final CFTC Rules; rather the CCO is merely evaluating the reasonableness of the basis for the Swap Entity's evaluation of the representative.

D. Acting as an Advisor to a Special Entity. An SD (but not an MSP) that "acts as an advisor" to a Special Entity has a duty to act in the "best interests" of the Special Entity and to undertake reasonable efforts to obtain information necessary to determine that a swap is in the best interests of the Special Entity.

1. *"Acts as an Advisor."* An SD is deemed to "act as an advisor" when it recommends to a Special Entity a swap or a trading strategy that involves a swap that is tailored to the particular needs or characteristics of the Special Entity (*i.e.*, "bespoke swaps," rather than standardized swaps that are subject to Dodd-Frank's mandatory SEF trading requirement).

2. *Safe Harbor for All Special Entities.* An SD will not be deemed to "act as an advisor" to a Special Entity if:

   - the SD limits its recommendations to (i) standardized swaps and (ii) bespoke swaps as to which it does not express an opinion as to whether the Special Entity should enter into the recommended bespoke swap;

   - the Special Entity represents in writing that it will not rely on recommendations provided by the SD and will rely on advice from a QIR; and

   - the SD discloses to the Special Entity that it is not undertaking to act in the best interests of the Special Entity (as otherwise required when an SD acts as an advisor).

b. *Compliance with this safe harbor will require rigorous policies and procedures surrounding counterparty communications (e.g., chaperoning, monitoring of electronic communications, etc.). In addition, SDs should consider obtaining representations from counterparties that no communication from the SD will be treated as an opinion to enter into a recommended bespoke swap. This contrasts with the SEC Proposal, which does not include any restrictions on permissible communications as part of its analogous safe harbor.*

3. *Safe Harbor for ERISA Plans.* An SD will not "act as an advisor" to an ERISA plan if:

- the Special Entity represents in writing that it (a) has a fiduciary under ERISA that is responsible for representing the Special Entity in connection with the swap transaction and (b) will comply in good faith with written policies and procedures reasonably designed to ensure that any recommendation the Special Entity receives from the SD materially affecting a swap transaction is evaluated by a fiduciary before the transaction, or any such recommendation will be evaluated by a fiduciary before that transaction occurs; and

- the fiduciary represents in writing that it will not rely on recommendations provided by the SD.

b. *This safe harbor will require ERISA plan sponsors to establish and maintain express written policies to ensure that any material SD recommendations are evaluated by its fiduciary. In addition, ERISA plan sponsors will presumably enter into arrangements with their fiduciary to make the safe harbor representations on their behalf so that the plan sponsor can avoid the need for the fiduciary and SD to obtain approvals from it on a swap-by-swap basis.*

E. Capacity Disclosure. Before the initiation of a swap with a Special Entity, a Swap Entity must disclose to the Special Entity the capacity in which it is acting in connection with the swap. If a Swap Entity engages in business with a Special Entity in more than one capacity – even capacities totally unrelated to the swap – the Swap Entity must also disclose the material differences between such capacities.

Absent further CFTC clarification, an SD trader operating from a trading desk that is walled-off from access to information regarding the SD's other relationships with a Special Entity would appear to be required to obtain information and provide disclosure regarding relationships to which it is not privy. Ultimately, this requirement is likely to result in broad disclosure practices that cover a wide range of business lines in which multiservice financial firms regularly engage.

F. **Pay-to-Play Restrictions.** The Final CFTC Rules prohibit an SD from entering into swaps with "governmental Special Entities" if the SD or one of its covered associates makes or has made certain political contributions to officials of such entities.

*While the CFTC has largely coordinated its pay-to-play rules with the SEC Proposal, both rules currently differ in important respects from the proposed Municipal Securities Rulemaking Board ("**MSRB**") regulations on the subject (e.g., the scope of the CFTC's pay-to-play rules is generally broader than the MSRB's proposed rules).*[17] *As a result, registrants may ultimately be required to comply with two different sets of rules.*[18]

IV. CTA EXEMPTION

Exemption from CTA Registration for SDs. As amended by Dodd-Frank, the CEA generally provides that a person who, for compensation or profit, engages in the business of advising others as to the value of or advisability of trading in swaps is potentially subject to registration with the CFTC as a commodity trading advisor ("**CTA**"). As part of the Final CFTC Rules, however, the CFTC added an exclusion for an SD whose recommendations or advice to counterparties are "solely incidental" to its business as an SD.

"Solely incidental" activity includes recommendations made to a counterparty or customizing a swap for a counterparty. In contrast, situations where an SD is given trading discretion for a counterparty or receives separate compensation for advice would not be considered "solely incidental."

V. SPECIAL TRANSACTION ISSUES

A. **Transactions Negotiated by Agents or Third Parties.** The Final CFTC Rules apply to persons acting on behalf of SDs and MSPs, respectively, including their associated persons.[19]

In some cases – such as derivatives prime brokerage – multiple SDs may be involved, as principal, in the same transaction. In this connection, the CFTC has indicated that it expects SDs engaged in prime brokerage relationships to allocate compliance responsibilities. In analogous circumstances (such as fully disclosed

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17 *See*, MSRB Rule G-37, Political Contributions and Prohibitions on Municipal Securities Business.

18 Relatedly, SEC-registered municipal advisors are subject generally to the rules of the MSRB, while CFTC-registered CTAs "who are providing advice related to swaps" are expressly excluded from municipal advisor registration and the associated rules. The CFTC has indicated that it will work with the SEC to harmonize regulations with respect to dealers and advisors to municipalities more broadly going forward.

19 "Associated person" is defined to include partners, officers, employees and other agents associated with an SD or MSP in any capacity that involves the solicitation or acceptance of swaps or the supervision of any person or persons so engaged, except for persons whose functions are solely clerical or ministerial.

clearing arrangements), the parties typically document their agreed allocation. SDs will also want to consider appropriate policies and procedures to mitigate their compliance liabilities with respect to allocated compliance responsibilities.

B. Inter-affiliate Transactions. The CFTC explained that it will not require compliance with the Final CFTC Rules for swaps entered into with a Swap Entity's affiliates that are not "publicly reportable swap transactions" under previously adopted real-time reporting rules.[20] Notably, those rules would exclude only those transactions with affiliates that are not conducted at "arm's length."

1. *The guidance that the CFTC has provided on inter-affiliate transactions conducted on market terms (e.g., transactions between a bank and its affiliate conducted in accordance with Federal Reserve Act Sections 23A and 23B) suggests that such transactions may be covered by the Final CFTC Rules.*

2. *Applying the Final CFTC Rules to inter-affiliate transactions under the arm's length standard serves no practical purpose. Indeed, in some cases, it could require a single dual-hatted trader acting on each side of an inter-affiliate transaction to provide disclosure to him or herself. In contrast with current market practice, extensive documentation may now be required for inter-affiliate transactions in order to comply with the Final CFTC Rules.*

C. Electronically Executed Swaps. Transactions executed on designated contract markets ("**DCMs**") and SEFs are exempt from diligence and disclosure requirements only where the identity of the counterparty is unknown prior to execution.

Disclosure and due diligence requirements will apply even where the identity of the counterparty is only known immediately prior to execution, such as in the case of a swap executed on an RFQ SEF or a non-SEF trading platform (e.g., a single-dealer platform). The CFTC anticipates that market participants, including DCMs and SEFs, will develop basic standard format disclosure sufficient to meet disclosure requirements in a compressed timeframe, such as some form of click-through disclosure prior to execution of such trades.

VI. NEXT STEPS TO CONSIDER

A. Swap Entities.

1. **Documentation.** *Swap Entities should review and modify as appropriate current documentation to ensure compliance with new requirements under the Final CFTC Rules. Generally, standardized language will be sufficient.*

[20] 77 Fed. Reg. 1182 (Jan. 9, 2012).

However, in other cases – such as permitted uses of confidential information – more individualized negotiations may be necessary. Swap Entities should keep in mind how long such negotiations may take, particularly if they lead to the re-opening of unrelated commercial issues.

2. **Disclosure.** *The Final CFTC Rules clearly contemplate the development of industry standard disclosure practices, at least for standardized swaps. Existing disclosures in similar markets, such as listed options and futures, provides some precedent. Additional disclosure relevant to more customizable terms (such as optionality and accrual features) or less liquid markets should also be developed. More challenging, however, will be developing robust disclosures for the range of potentially relevant material incentives and conflicts of interest. For instance, it is important that those disclosures contain sufficient specificity to satisfy the rules, but, where permissible, not so much specificity as to disclose potentially prejudicial non-public transactions, positions or risk profiles.*

3. **Policies and Procedures.** *Swap Entities will need to develop extensive policies and procedures designed to ensure compliance with the Final CFTC Rules. Comprehensive policies are particularly important because the CFTC has said that a Swap Entity will have an affirmative defense against enforcement actions if it can demonstrate good faith compliance with written policies and procedures designed to meet the particular requirement of the rule that is the basis for the alleged violation. In addition, the Final CFTC Rules explicitly require Swap Entities to adopt policies and procedures reasonably designed to prevent evasion of the CEA and rules thereunder. However, the CFTC's proposed definition for evasion – which is whether a transaction is "willfully structured to evade" Dodd-Frank – leaves market participants with very little guidance as to how, as a practical matter, they are to design anti-evasion policies.*

B. Special Entities and Other End Users.

1. **Representations.** *Swap counterparties generally should expect to be asked to provide SDs with representations to satisfy know your counterparty requirements, verification requirements and the suitability safe harbor, and to undertake an obligation to update representations based on any material changes. In addition, Special Entities should expect to be asked to provide representations to satisfy the QIR/ERISA fiduciary safe harbors and the advisor safe harbor.*

2. **Policies and Procedures.** *The Final CFTC Rules will require Special Entities and other end users to adopt certain written policies and procedures, including:*

   a. *For an ERISA plan, policies and procedures reasonably designed to ensure that any recommendation received from the SD materially*

affecting a swap is evaluated by a fiduciary before the transaction occurs.

b. *For a non-ERISA plan Special Entity, policies and procedures reasonably designed to ensure that it has selected a representative that satisfies the QIR requirements and that provide for ongoing monitoring of the QIR's performance consistent with those requirements.*

c. *For a non-Special Entity counterparty, policies and procedures reasonably designed to ensure that the persons responsible for evaluating SDs' recommendations and making trading decisions are capable of doing so.*

C. QIRs. *QIRs will need to develop and maintain policies and procedures to mitigate conflicts of interest and ensure that they are acting in the best interest of clients. As part of these duties, QIRs should specifically take steps to ensure that proper compensation structures are in place, that business relationships with Swap Entities are appropriately managed to avoid conflicts of interest, and that appropriate disclosure practices are in place. QIRs must also consider whether to register as a CTA or whether they qualify under an applicable exception. Finally, QIRs to governmental Special Entities must be subject to restrictions on political contributions.*

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Please call any of your regular contacts at the firm or any of the partners and counsel listed under either Employee Benefits or Derivatives in the Practices section of our website (www.cgsh.com) if you have any questions.

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Appendix – Comparison of SEC Proposal with Final CFTC Rules

Provision	SEC Proposal	Final CFTC Rules	Key Differences/Issues/Comments
Scope and Definitions SEC: 15Fh-1, 15Fh-2; CFTC: 23.400, 23.401	The SEC Proposal would apply to SBSDs and MSBSPs in connection with entering into SBS and, as relevant, over the term of the SBS.	The Final CFTC Rules apply to transactions in swaps as well as swaps that are offered but not entered into.	The Final CFTC Rules define "offer" by reference to contract law standards.
	The SEC Proposal would not apply to SBS executed prior to the compliance date of the Final CFTC Rules.	The Final CFTC Rules will not apply to unexpired swaps executed before the effective date; however, a material amendment to the terms of a swap will be considered to be a new swap and subject to the Final CFTC Rules.	For post-effective date swaps, obligations that apply over the life cycle of a swap (*e.g.*, daily mark disclosures) will begin to apply on the compliance date, but obligations that apply before a swap is offered or entered into (*e.g.*, risk disclosures) will not. Also, the CFTC did not address or provide examples of the types of amendments that will be considered to be "material."
	The definitions of SBSD and MSBSP include, "where relevant," an associated person of the SBSD or MSBSP. "Associated person" is defined to include: (i) any partner, officer, director or branch manager; (ii) any person directly or indirectly controlling, controlled by or under common control with the SBSD or MSBSP; and (iii) any employee of the SBSD or MSPSP, in each case excepting persons whose functions are solely clerical or ministerial.	The definitions for SD and MSP cover persons acting on behalf of SDs and MSPs, respectively, including their associated persons. "Associated person" is defined to include partners, officers, employees and other agents associated with an SD or MSP in any capacity that involves the solicitation or acceptance of swaps or the supervision of any person or persons so engaged, except for persons whose functions are solely clerical or ministerial.	The inclusion of "associated persons" and other agents of a Swap/SBS Entity will subject affiliates of Swap/SBS Entities to the rules, even if not otherwise subject to CFTC/SEC regulation.

Provision	SEC Proposal	Final CFTC Rules	Key Differences/Issues/Comments
Private Right of Action/Right of Rescission	The SEC states in the preamble that "Section 15F(h) of the Exchange Act does not, by its terms, create a new private right of action or right of rescission, nor do we anticipate that the proposal would create any new private right of action or right of rescission."	The CFTC expressly declined to address the availability of potential private rights of action for violations of the Final CFTC Rules. Section 22(a)(1) of the CEA provides for a private right of action against a Swap Entity that violates or willfully aids in a violation of the CEA. The concern regarding the availability of private rights of action arises in the case of CFTC rules referenced in statutory provisions that expressly prohibit persons from violating the relevant CFTC rules. Additionally, Dodd-Frank amended Section 22(a)(4) of the CEA to carve back prior statutory limitations on the ability of an ECP to rescind swap transactions based on a violation of the CEA.	The Final CFTC Rules provide an affirmative defense for SDs and MSPs in cases alleging non-scienter violations of anti-fraud provisions of the Final CFTC Rules for failure to comply with any requirements in the Final CFTC Rules. The defense enables SDs and MPSs to defend against such allegations by establishing that they complied in good faith with written policies and procedures designed to meet the requirements of the rule that is the basis for the alleged violation. The CFTC, unlike the SEC, expressly refused to opine on the availability of a private right of action under the Final CFTC Rules, and so there is a risk that failure to comply could result in liability to private litigants.

Provision	SEC Proposal	Final CFTC Rules	Key Differences/Issues/Comments
Reliance on Counterparty Representations Generally CFTC: 23.402(d)	The SEC proposed two alternative standards for reliance on representations. Under the first standard, an SBS Entity could rely on a representation unless it knows that the representation is not accurate. Under the second standard, an SBS Entity would need to make further reasonable inquiry to verify the accuracy of a representation if the SBS Entity has information that would cause a reasonable person to question its accuracy. Representations may not simply identify the relevant statutory or rule provision in a conclusory fashion (*e.g.*, a counterparty must represent that it has $10 million in assets, not that it is an "eligible contract participant," and a counterparty must state that it is not one of the types of entities included in the definition of Special Entity, not merely that it is not a Special Entity).	Swap Entities are generally permitted to satisfy due diligence obligations (including safe harbor requirements) through reliance on counterparty representations included in relationship documentation (including relationship documentation executed in advance of individual transactions), unless the Swap Entity has information that would cause a reasonable person to question the accuracy of the representation. The types of representations required are specified in a non-conclusory fashion similar to the SEC Proposal.	The Final CFTC Rules adopt a reasonable reliance standard for all counterparty representations, similar to the second proposed standard from the SEC Proposal. However, neither the CFTC nor the SEC has clarified whether the individuals specifically involved in execution of the swap or SBS must have knowledge of the information in question.

Provision	SEC Proposal	Final CFTC Rules	Key Differences/Issues/Comments
Know Your Counterparty SEC: 15Fh-3(e); CFTC: 23.402(b)	The SEC Proposal would require an SBSD to have policies and procedures reasonably designed to obtain and retain a record of the essential facts concerning a known counterparty that are necessary to (i) comply with applicable laws, regulations and rules, and (ii) effectuate the SBSD's credit and operational risk management policies in connection with transactions entered into with such counterparty. Additionally, "essential facts" include (i) information regarding the authority of any person acting for such counterparty and (ii) if the counterparty is a Special Entity, such background information regarding the independent representative as the SBSD reasonably deems appropriate.	The Final CFTC Rules require SDs (but not MSPs) to have policies and procedures reasonably designed to obtain and retain a record of essential facts concerning a known counterparty, including: (i) facts required to comply with applicable law and to ensure compliance with the SD's internal credit and operational risk management policies; and (ii) information regarding the authority of any person acting for the counterparty. Both SDs and MSPs are required to obtain and retain a record of the true name and address of the counterparty, guarantors and any persons exercising control with respect to the positions of such counterparty.	The Final CFTC Rules eliminate many subjective and intrusive inquiries included in the CFTC Proposal. Both the SEC Proposal and the Final CFTC Rules call for objective information that can be obtained through simple representations.

Provision	SEC Proposal	Final CFTC Rules	Key Differences/Issues/Comments
Anti-Fraud SEC: 15Fh-4(a); CFTC: 23.410(a)	The SEC Proposal would adopt verbatim the Exchange Act's special anti-fraud provision for SBSDs acting as advisors to Special Entities (Section 15F(h)(4)(A)) but it appears from the preamble that the anti-fraud provision would apply to all SBS Entities regardless of whether they are advisors to Special Entities.	The Final CFTC Rules prohibit Swap Entities from engaging in any practice that is fraudulent, deceptive or manipulative. The Final CFTC Rules eliminate the previously proposed express limitation on front running and trading ahead. The CFTC determined that the general prohibition against fraud and counterparty confidentiality obligations sufficiently protect counterparties against potential abuse.	The Final CFTC Rules do not require proof of scienter for a violation or apply only when an SD is acting as an advisor to a Special Entity. However, the CFTC did provide an affirmative defense for Swap Entities in cases alleging non-scienter violations of the anti-fraud provisions in the Final CFTC Rules for failure to comply with any requirements in the Final CFTC Rules. The defense enables Swap Entities to defend against such allegations by establishing that they complied in good faith with written policies and procedures designed to meet the requirements of the rule that is the basis for the alleged violation. The affirmative defense would not apply to allegations that the Swap Entity committed a technical violation of a disclosure, suitability or other requirement contained in the Final CFTC Rules without committing fraud.

Provision	SEC Proposal	Final CFTC Rules	Key Differences/Issues/Comments
Confidential Treatment of Counterparty Information SEC: no rule; CFTC: 23.410(c)	No similar requirement.	The Final CFTC Rules prohibit disclosure or use of any material confidential information obtained from a counterparty or use of confidential information that would be materially adverse to the interests of the counterparty, unless such disclosure or use is authorized in writing by the counterparty or is necessary: (i) for the effective execution of any swap for or with the counterparty; (ii) to hedge or mitigate any exposure created by such swap; or (iii) to comply with a request of the CFTC, Department of Justice, any SRO designated by the CFTC, or an applicable prudential regulator, or is otherwise required by law.	The SEC Proposal would leave counterparties free to negotiate the treatment of transactional information, subject to the SBS Entity's conflicts of interest policies. Although the Final CFTC Rules are more flexible than the CFTC Proposal (e.g., permitting counterparties to authorize any disclosure), they are more expansive in that they prohibit improper uses of confidential information. In this regard, the preamble explains that a Swap Entity could use a counterparty's information for appropriate purposes, such as in connection with market making activities, but the actual text of the rule appears to be significantly more restrictive.

Provision	SEC Proposal	Final CFTC Rules	Key Differences/Issues/Comments
Verification of Counterparty Status – ECP; Special Entity SEC: 15Fh-3(a); CFTC: 23.430	The SEC Proposal would require an SBS Entity to verify that a counterparty whose identity is known to an SBS Entity prior to execution is an ECP before entering into an SBS other than on a registered exchange or on a security-based SEF ("SBSEF"). The SEC Proposal would also require an SBS Entity to verify whether a counterparty (whose identity is known to the SBS Entity) is a Special Entity prior to executing an SBS transaction with such counterparty, regardless of how the transaction is executed. The SEC would permit reliance on representations but would not permit conclusory representations stating simply that the counterparty is an ECP.	Swap Entities must verify that a counterparty is an ECP and determine whether a counterparty is a Special Entity, or eligible to elect to be a Special Entity before "offering to enter" or entering into a swap.[1] The verification requirements do not apply to transactions executed on a DCM or SEF, unless, for swaps executed on a SEF, the Swap Entity knows the identity of the counterparty prior to execution.	Representations as to counterparty status are likely to be addressed in master documentation and deemed to be renewed upon execution, although the Final CFTC Rules would require a Swap Entity to evaluate the accuracy of those representations regularly, and recommends such evaluation be performed on at least an annual basis.

[1] A Swap Entity is entitled to rely on written representations of a counterparty where such representations reference the specific provision(s) of the definition of ECP applicable to it.

Provision	SEC Proposal	Final CFTC Rules	Key Differences/Issues/Comments
Fair and Balanced Communications SEC: 15Fh-3(g); CFTC: 23.433	The SEC Proposal would require that an SBS Entity's communications (i) provide a sound basis for evaluating the facts with respect to any SBS, (ii) do not make unwarranted claims, and (iii) are balanced (*i.e.*, express the risks to the same extent as the benefits).	Swap Entities have a duty to communicate with counterparties in a "fair and balanced manner." In order to comply with this duty, the CFTC expects that a swaps counterparty will consider such factors as whether the communication: (i) provides the counterparty with a sound basis for evaluating the swap; (ii) avoids making exaggerated or unwarranted claims; and (iii) balances any statement about potential advantages with statements of corresponding risks.	The text of the Final CFTC Rules merely requires fair and balanced communications, but in the preamble the CFTC defines "fair and balanced" as the SEC does in the text of its proposed rules.
Execution Standards for Exchange Traded Swaps/SBS FINRA: Rule 2320; CFTC: not adopted	The SEC did not propose a best execution rule for exchange-traded SBS. However, under current NASD Rule 2310 and FINRA Rule 5310, which will replace NASD Rule 2310 beginning May 31, 2012, a registered broker-dealer must use reasonable diligence to ascertain the best market for a subject security (*e.g.*, an exchange-traded SBS) and buy or sell in such market that provides as favorable a price as possible under prevailing market conditions.	The Final CFTC Rules do not adopt the best execution standard included in the CFTC Proposal but the CFTC has indicated that it may re-propose a best execution rule in the future.	Best execution standards for exchange-traded markets have typically focused on price as the primary consideration. For swaps and SBS executed on a principal-to-principal basis, however, non-price factors can be highly relevant. Such factors include a registrant's appetite for assuming the relevant risk to the counterparty, the relative profitability of other alternatives for the utilization of its credit capacity with the counterparty, its exposure to the underlier in its portfolio and risk management considerations.

Provision	SEC Proposal	Final CFTC Rules	Key Differences/Issues/Comments
		Disclosures	
Timing and Manner of Disclosures SEC: 15Fh-3(b); CFTC: 23.402(e)-(f)	The SEC Proposal would require disclosure prior to execution in a manner reasonably designed to allow the counterparty to assess the information provided. Any reasonable means of disclosure would be permitted, provided that a record of any unwritten required disclosure is provided no later than delivery of the trade acknowledgment. The SEC expects that certain required disclosures of material information may be disclosed to counterparties in a master agreement or other document accompanying such agreement, but that even such forms of disclosure will require certain provisions to be tailored to the particular transaction, most notably pricing and other transaction-specific terms.	At a "reasonably sufficient" time prior to entering into a swap, the parties to a swap will be permitted by written agreement to provide the required information and representations in any reasonable manner, including a master agreement between the parties, which may be deemed subsequently renewed, satisfying the requirements for swaps on a forward-looking basis. Depending on the facts and circumstances, standardized disclosure in counterparty relationship documentation may be appropriate, particularly for standardized swaps. More detailed disclosure may be required in some cases depending on the complexity of the transaction, the degree and nature of any leverage, potential for periods of significantly reduced liquidity, and the lack of price transparency.	The SEC seeks comment on disclosure requirements when the SBS is SBSEF/exchange-executed or when the identity of the counterparty is known only immediately prior or after execution. In such circumstances, the CFTC contemplates that market participants, together with DCMs and SEFs, will develop basic standard format disclosure sufficient to meet disclosure requirements in a compressed timeframe, such as some form of click-through disclosure prior to execution of such trades. Note further that for transactions initiated on a DCM or SEF, written agreement by the counterparty regarding the means of disclosure is not required.

Provision	SEC Proposal	Final CFTC Rules	Key Differences/Issues/Comments
Material Risks and Characteristics SEC: 15Fh-3(b)(1); CFTC: 23.431(a)(1)	The SEC Proposal would require disclosure to a non-Swap/SBS Entity counterparty of the material risks and characteristics of the particular SBS, including, but not limited to: (i) the material factors that influence the day-to-day changes in valuation; (ii) the factors or events that might lead to significant losses; (iii) the sensitivities of the SBS to those factors and conditions; and (iv) the approximate magnitude of the gains or losses the SBS will experience under specified circumstances.	SDs must disclose material risks, which would include market, credit, liquidity, foreign currency, legal, operational, and any other applicable risks to any counterparty other than a Swap/SBS Entity. An SD must disclose information concerning the material economic terms of the swap, the terms relating to the operation of the swap, and the rights and obligations of the parties during the term of the swap.	The SEC and CFTC contemplate that these disclosures should be tailored to the unique risks and characteristics of the particular product but not tailored to the characteristics of the particular counterparty. In addition, the CFTC declined to determine whether exchange of documentation may satisfy the requirement to disclose material characteristics, noting instead that additional disclosure may be required for swaps that contain caps, collars, floors, knock-ins, knock-outs, range accrual features, embedded optionality or embedded volatility that may increase the complexity of the swap.

Provision	SEC Proposal	Final CFTC Rules	Key Differences/Issues/Comments
Scenario Analysis SEC: no rule; CFTC: 23.431(b)	While scenario analysis is not required under the SEC Proposal, the SEC states that scenario analysis can be an appropriate means of disclosing the risks and characteristics of an SBS.	For bilateral swaps that are not "available for trading" on a DCM or SEF, SDs will be required to notify counterparties that they can request scenario analyses and to provide scenario analyses upon request. Where requested, an SD must provide a scenario analysis designed in consultation with the counterparty to allow the counterparty to assess its potential exposure. If the counterparty does not request a specific type of scenario analysis, an SD is to follow industry best practice recommendations and consider any relevant analyses that the SD undertakes for its own risk management purposes, including analyses performed as part of its new product policy.	The CFTC states that the Final CFTC Rules do not require SDs to disclose "confidential, proprietary information about any model it may use to prepare the scenario analysis," and that it "does not consider scenario analysis and its material assumptions and calculation methodologies to be confidential, proprietary information." In addition, the CFTC notes that scenario analyses performed consistent with the rule should not "unduly" expose SDs to liability because the analyses are to be designed in consultation with counterparties and subject to appropriate warnings as to the assumptions and limitations of the analyses.

Provision	SEC Proposal	Final CFTC Rules	Key Differences/Issues/Comments
Material Incentives and Conflicts of Interest SEC: 15Fh-3(b)(2); CFTC: 23.431(a)(3)	The SEC Proposal would require an SBS Entity to disclose to a non-Swap/SBS Entity counterparty any material incentives or conflicts of interest it may have in connection with the SBS, including any compensation or other incentives from any source other than the counterparty in connection with the SBS to be entered into with the counterparty.	A Swap Entity must provide information reasonably designed to allow a non-Swap/SBS Entity counterparty to assess the Swap Entity's conflicts and incentives, including compensation from any source other than the counterparty that the Swap Entity "may" receive in connection with the swap as well as other incentives related to the transaction. The CFTC contemplates that a Swap Entity should disclose whether its compensation related to the particular swap would be greater than the compensation for another instrument with similar economic terms offered by the same Swap Entity, but only where the Swap Entity "recommends" more than one swap or swap strategy to the counterparty. A Swap Entity may also in some circumstances be required to disclose separate pricing for each standardized component of a customized swap.	The CFTC indicated that, depending on the facts and circumstances (particularly when an SD recommends a swap), a Swap Entity may be required to disclose other activity of the Swap Entity in the underlying commodity and other similar non-public information, such as whether the swap is part of a strategy for the Swap Entity to decrease its position. The SEC, for its part, makes clear that "incentive" does not refer to expected profits from the SBS itself, but rather to arrangements pursuant to which an SBS Entity may have an incentive to encourage the counterparty to enter into the transaction. In light of this CFTC/SEC guidance, it will be important when designing standardized disclosure to anticipate and effectively identify the potential incentives or conflicts of interest that could be relevant in specific transactions.
Daily Mark SEC: 15Fh-3(c)(1); CFTC: 23.431(d)(1)-(3)	For cleared SBS, an SBS Entity would be required to provide the counterparty, upon request, with the end-of-day settlement price the SBS Entity receives from the clearing agency.	For swaps cleared by a DCO, an SD will be required to notify a non-Swap/SBS Entity counterparty of its right to receive a daily mark from the DCO.	The Final CFTC Rules are ambiguous as to whether the current practice of matching positions through an overnight batch process and disclosing those marks during the next day will satisfy this requirement.

Provision	SEC Proposal	Final CFTC Rules	Key Differences/Issues/Comments
	For uncleared SBS, an SBS Entity would be required to provide the counterparty with the midpoint between the bid and offer, or a calculated equivalent, as well as the methodology and assumptions used to prepare the daily mark.	For uncleared swaps, a Swap Entity will be required to provide its counterparty with a daily mark, which would be the mid-market mark of the swap. Swap Entities will be required to disclose the assumptions and methodology used to prepare the daily mark for uncleared swaps. Additionally, Swap Entities will be required to provide fair and balanced communication with respect to the daily mark, including, where appropriate, a warning that it may not reflect the price at which either the counterparty or the Swap Entity would agree to replace or terminate the swap, the value used for margin calls, or the value marked on the books of the Swap Entity.	The CFTC also contemplates that the marketplace will adopt standardized "reference models" to be used in connection with pricing methodologies.
Clearing SEC: 15Fh-3(d); CFTC: 23.432	The SEC Proposal would require an SBS Entity to notify any non-Swap/SBS Entity counterparty of: (i) its right to elect to have a swap cleared (if not required to be cleared); (ii) the clearing agencies for which the SBS Entity has clearing privileges (either directly or indirectly); and (iii) its right to select the clearing agency from the list provided.	If a swap is subject to mandatory clearing, the Swap Entity will be required to notify any non-Swap/SBS Entity counterparty of its right to select the DCO. If the swap is not subject to mandatory clearing, the SD will also be required to notify the counterparty of its right to elect to require the swap to be cleared and to select the DCO.	The SEC Proposal, unlike the Final CFTC Rules, would limit the counterparty's choice of clearing agencies to ones in which the SBS Entity is a clearing member or has clearing privileges and clarifies that the counterparty is to express its intent to exercise its clearing rights prior to execution. Neither the SEC nor the CFTC is clear as to whether the counterparty's election to have a swap/SBS cleared and its choice of the clearing agency can affect the price of the swap/SBS.

Provision	SEC Proposal	Final CFTC Rules	Key Differences/Issues/Comments
		Institutional Suitability	
Institutional Suitability Requirement SEC: 15Fh-3(f)(1); CFTC: 23.434(a)	The SEC Proposal would require an SBSD that makes any "recommendation" of an SBS or an SBS trading strategy to any non-Swap/SBS Entity counterparty to have a reasonable basis to believe that such SBS or trading strategy is suitable for at least some counterparties and that counterparty in particular. The determination of suitability must be based on reasonable due diligence concerning the counterparty's investment profile (including trading objectives) and its ability to absorb potential losses associated with the recommended SBS or trading strategy.	An SD that makes any "recommendation" of a swap or swap trading strategy (whether or not tailored) to any non-Swap/SBS Entity counterparty will be required to (i) undertake reasonable diligence to understand the risks and rewards of the recommended swap or strategy and (ii) have a "reasonable basis" to believe that such swap or trading strategy is "suitable" for that counterparty, based on information regarding the counterparty's investment profile, trading objectives, and ability to absorb potential losses associated with the recommendation.	Unlike the Final CFTC Rules, the SEC's institutional suitability requirement would not apply to Special Entity counterparties if the SBSD is not acting as an advisor (*e.g.*, by reason of the safe harbor where the Special Entity is represented by a QIR). The institutional suitability requirement would also not apply if the SBSD is acting as an advisor to a Special Entity so long as the SBSD has complied with its best interests duty.

Provision	SEC Proposal	Final CFTC Rules	Key Differences/Issues/Comments
Definition of "Recommendation"	The SEC believes that the determination of whether an SBSD has made a recommendation should turn on the facts and circumstances of the situation, with particular attention to how tailored the communication is to the specific customer or group of customers. This is consistent with FINRA's approach, in which the relevant factors include whether the communication reasonably could be viewed as a "call to action" and whether it would reasonably influence an investor to trade a particular security or group of securities.[2]	A recommendation could include "any communication" by which an SD "provides information to a counterparty about a particular swap or trading strategy that is tailored to the needs or characteristics of the counterparty." Generally, providing general transaction, financial, or market information will not trigger the obligation. The CFTC has further indicated that in analyzing a communication it will consider: (i) an analysis of the content, context and presentation of the particular communication or set of communications; (ii) whether such communication would reasonably be viewed as a "call to action," or suggestion that the counterparty enter into a swap; (iii) an analysis of the underlying substantive information transmitted to the counterparty and any accompanying explanatory message from the SD; and (iv) the extent to which such communication is individually tailored.[3]	The SEC makes it clear that compliance with other business conduct requirements, *e.g.*, disclosure of daily mark or clearing rights, would not in and of itself constitute a recommendation. Both Commissions acknowledge that determining if a communication is a "recommendation" is fact-specific and cannot be described by a bright line rule, and the CFTC specifically sought to harmonize the relevant factors for determining whether a recommendation has been made to existing SEC and FINRA guidance. Nevertheless, the fact-specific nature of this evaluation, and the lack of precedent applying it to the swap/SBS markets, makes it likely that SD/SBSDs will, where possible, rely on available safe harbors.

[2] FINRA Notice to Members 01-23 (Mar. 19, 2001), and Notice of Filing of Proposed Rule Change to Adopt FINRA Rules 2090 (Know Your Customer) and 2111 (Suitability) in the Consolidated FINRA Rulebook, Exchange Act Release No. 62718 (Aug. 13, 2010), 75 Fed. Reg. 51310 (Aug. 19, 2010), as amended, Exchange Act Release No. 62718A (Aug. 20, 2010), 75 Fed. Reg. 52562 (Aug. 26, 2010) (discussing what it means to make a "recommendation").

[3] For instance, the CFTC says that research report would not generally constitute a recommendation, but an accompanying message that the counterparty should act on the report would change the analysis.

Provision	SEC Proposal	Final CFTC Rules	Key Differences/Issues/Comments
Safe Harbor for Satisfying the Institutional Suitability Requirement SEC: 15Fh-3(f)(2); CFTC: 23.434(b)	An SBSD would satisfy the requirement if: (i) It reasonably determines that the counterparty (or its agent) is capable of independently evaluating investment risks with regard to the relevant SBS or trading strategy; (ii) The counterparty (or its agent) affirmatively represents in writing that it is exercising independent judgment in evaluating the recommendations by the SBSD; and (iii) The SBSD discloses that it is acting in the capacity of a counterparty, and is not undertaking to assess the suitability of the SBS or trading strategy.	An SD fulfills its suitability obligations where: (i) The SD reasonably determines that the counterparty (or its agent) is capable of independently evaluating investment risks with regard to the relevant swap or trading strategy involving a swap;[4] (ii) The counterparty or its agent represents in writing that it is exercising independent judgment in evaluating the SD's recommendation; (ii) The SD discloses in writing that it is not undertaking to assess the suitability of the SD's recommendation; and (iv) Where the recommendation would cause the SD to act as an advisor to a Special Entity, and the SD does not rely on the Special Entity safe harbor from acting as an advisor, the SD complies with requirements for advisors to Special Entities.	Unlike the suitability safe harbor in the SEC Proposal, the Final CFTC Rules require compliance with advisor to Special Entity requirements where applicable in order to qualify under the safe harbor, either through actual compliance, or through compliance with the Special Entity advisor safe harbor.

[4] This requirement is satisfied for agents to non-Special Entities by written representation that the counterparty has complied with written policies designed to ensure that its agent is capable of making such decisions; and for Special Entities, by compliance with the QIR or fiduciary safe harbor applicable to Special Entity counterparties.

Provision	SEC Proposal	Final CFTC Rules	Key Differences/Issues/Comments
Special Entity Provisions			
Definition of "Special Entity" SEC: 15Fh-2(e); CFTC: 23.401(c)	Special Entity means: (i) A Federal agency; (ii) A State, State agency, city, county, municipality, or other political subdivision of a State; (iii) Any employee benefit plan, as defined in section 3 of ERISA; (iv) Any governmental plan, as defined in section 3(32) of ERISA; or (v) Any endowment, including an endowment that is an organization described in section 501(c)(3) of the Internal Revenue Code.	Special Entity means: (i) A Federal agency; (ii) A State, State agency, city, county, municipality, or other political subdivision of a State; (iii) Any employee benefit plan subject to Title I of ERISA; (iv) Any governmental plan, as defined in section 3 of ERISA; (v) Any endowment, including an endowment that is an organization described in section 501(c)(3) of the Internal Revenue Code; or (vi) Any employee benefit plan, as defined in Section 3 of ERISA, that elects to be a Special Entity.	Whereas the SEC Proposal's definition of Special Entity would capture entities that meet the definition of an ERISA plan without being subject to ERISA (*e.g.*, certain foreign pension plans), the Final CFTC Rules allow such entities to elect at their discretion to be treated as Special Entities. The CFTC has clarified that: • Master trusts sponsored by one or more employers are treated as Special Entities. • Special Entities include a corporation "of or established by a state." • It will not look through an entity that is an investment vehicle, *e.g.*, a bank collective trust fund or a plan asset hedge fund. • A charitable organization that has entered into a swap for which its counterparty has recourse to the organization's endowment is not a Special Entity.

Provision	SEC Proposal	Final CFTC Rules	Key Differences/Issues/Comments
Definition of "Act as an Advisor to a Special Entity" SEC: 15Fh-2(a); CFTC: 23.440(a)	An SBSD acts as an advisor to a Special Entity when it recommends an SBS or a trading strategy that involves the use of an SBS to the Special Entity, unless the following three conditions are met: • The Special Entity represents in writing that: (i) the Special Entity will not rely on recommendations provided by the SBSD; and (ii) the Special Entity will rely on advice from a qualified independent representative; • The SBSD has a reasonable basis to believe that the Special Entity is advised by a qualified independent representative; and • The SBSD discloses to the Special Entity that it is not undertaking to act in the best interests of the Special Entity.	An SD "acts as an advisor" when it recommends to a Special Entity a swap or a trading strategy that involves a swap that is tailored to the particular needs or characteristics of the Special Entity ("bespoke swaps"). For ERISA plans, an SD will not "act as an advisor" if: • The Special Entity represents in writing that: (i) it has a fiduciary under ERISA that is responsible for representing the Special Entity in connection with the swap transaction; and (ii) it will comply in good faith with written policies and procedures reasonably designed to ensure that any recommendation the Special Entity receives from the SD materially affecting a swap transaction is evaluated by a fiduciary before the transaction, or any such recommendation will be evaluated by a fiduciary before that transaction occurs; and • The fiduciary represents in writing that it will not rely on recommendations provided by the SD.	While any recommendation would cause an SBSD to act as an advisor under the SEC Proposal (unless safe harbor requirements are met), under the CFTC Proposal, an SD would act as an advisor only if the recommendation involves a "bespoke swap." Swaps with terms that are designed for a targeted group of Special Entities that share common characteristics, *e.g.*, school districts, are likely to be viewed as "bespoke." However, the CFTC will not generally view a swap that is "made available for trading" on a DCM or SEF as "bespoke." The safe harbor for ERISA plans would require ERISA plans to establish formal policies and procedures regarding its fiduciary's evaluation of an SDs' recommendations.

Provision	SEC Proposal	Final CFTC Rules	Key Differences/Issues/Comments
		For all Special Entities, an SD will not "act as an advisor" if: • The SD does not express an opinion as to whether the Special Entity should enter into a recommended swap or trading strategy involving a swap that is tailored to the particular needs or characteristics of the Special Entity; • The Special Entity represents in writing that it will not rely on recommendations provided by the SD, and will rely on advice from a QIR; and • The SD discloses to the Special Entity that it is not undertaking to act in the best interests of the Special Entity.	The CFTC has explained that an SD may, within the safe harbor for all Special Entities: provide general transaction, financial, educational or market information; offer a swap or trading strategy involving a swap; provide a term sheet; respond to a request for quote; provide trading ideas; and provide marketing materials. Nevertheless, given the possibility for other types of communications, rigorous policies and procedures designed to comply with the safe harbor (including chaperoning by legal or compliance personnel in appropriate circumstances) will be critical to demonstrating compliance to the CFTC and the NFA.

Provision	SEC Proposal	Final CFTC Rules	Key Differences/Issues/Comments
Special Requirements for Dealers acting as Advisors to Special Entities. SEC: 15Fh-4; CFTC: 23.440	An SBSD that acts as an advisor to a Special Entity would be required to act in the best interests of the Special Entity and make reasonable efforts to obtain such information that the SBSD considers necessary to make a reasonable determination that an SBS or trading strategy involving an SBS is in the best interests of the Special Entity. This information shall include, but not be limited to: • The authority of the Special Entity to enter into a swap; • The financial and tax status of the Special Entity; • The investment or financing objectives of the Special Entity; • The experience of the Special Entity with respect to SBS; • Whether the Special Entity has the financial capability to withstand changes in market conditions during the term of the swap; and • Any additional information that may be relevant.	An SD that acts as an advisor to a Special Entity has as a duty to make a reasonable determination that any swap or trading strategy involving a swap recommended by the SD is in the best interests of the Special Entity; and the SD must make reasonable efforts to obtain such information as is necessary to make a reasonable determination that any swap or trading strategy involving a swap recommended by the SD is in the best interests of the Special Entity, including information relating to the Special Entity's • Financial status and tax status; • Hedging, investment, financing or other objectives; • Experience with respect to entering into swaps, generally, and swaps of the type and complexity being recommended; • Financial capability to withstand changes in market conditions during the term of the swap; • And such other information as is relevant to the particular facts and circumstances.	"Best interests" is not defined by the SEC or CFTC; however, the CFTC has indicated that the "best interests" duty is not a fiduciary duty. Further, whether a recommended swap is in the best interests of the Special Entity will turn on the particular facts and circumstances. However, the CFTC will consider an SD "acting as an advisor" to have complied with its duty where it: (i) makes a reasonable effort to obtain necessary information; (ii) acts in good faith and makes full and fair disclosure of all material facts and conflicts of interest with respect to the recommended swap; and (iii) employs reasonable care that any recommendation made to a Special Entity is designed to further the Special Entity's stated objectives. The determination will be based on information known to the SD (after reasonable efforts) at the time the recommendation is made. The "best interests" duty does not prohibit an SD from "making a reasonable profit from its recommended transaction." The "best interests" duty also does not require an ongoing obligation to act in the best interests of the Special Entity, at least in some circumstances (*e.g.*, when determining whether to make additional collateral calls or otherwise exercise contractual rights).

Provision	SEC Proposal	Final CFTC Rules	Key Differences/Issues/Comments
Definition of "Independent Representative of a Special Entity" SEC: 15Fh-2(c); CFTC: 22.450(b)	A representative of a Special Entity would be independent if the representative does not have a relationship with the SBS Entity, whether compensatory or otherwise, that reasonably could affect the independent judgment or decision-making of the representative. A representative of a Special Entity would be deemed to be independent of an SBS Entity if: • The representative is not and, within one year, was not an associated person (for example an affiliate) of the SBS Entity; and • The representative has not received more than ten percent of its gross revenues over the past year, directly or indirectly from the SBS Entity or its affiliates.	"Independent" means, with respect to a QIR of a Special Entity that is not an ERISA plan: • The representative is not an associated person of the Swap Entity (one year look-back); • There is no "principal" relationship between the representative and the Swap Entity; • The representative provides timely and effective disclosures to the Special Entity of all material conflicts of interest that could reasonably affect the judgment or decision making of the representative with respect to its obligations to the Special Entity, and complies with policies and procedures reasonably designed to manage and mitigate such material conflicts of interest; • The representative is not directly or indirectly, through one or more persons, controlled by, or in control of, or under common control with the Swap Entity; and • The Swap Entity did not refer, recommend, or introduce the representative to the Special Entity within one year of the representative's representation of the Special Entity in connection with the swap.	The Final CFTC Rules would require representatives of Special Entities to establish formal policies and procedures designed to address conflicts of interest, including addressing compensation and other business relationships with Swap Entities that might affect the representative's independence. Additionally, the common practice of merely indicating parties who often provide such representation appears to be precluded by the prohibition on referrals, in addition to recommendations, by the Swap Entity. In contrast, the SEC Proposal would apply a gross revenue test for determining whether an unaffiliated representative is sufficiently independent from the Swap Entity.

Provision	SEC Proposal	Final CFTC Rules	Key Differences/Issues/Comments
Special Requirements for Dealers Acting as Counterparties to Special Entities SEC: 15Fh-5; CFTC: 23.450	An SBS Entity must have a reasonable basis to believe that the Special Entity has a qualified representative that meets the following requirements: • Has sufficient knowledge to evaluate the transaction and risks; • Is not subject to a statutory disqualification; • Is independent of the SBS Entity; • Undertakes a duty to act in the best interests of the Special Entity; • Makes appropriate and timely disclosures to the Special Entity of material information concerning the SBS; • Will provide written representations to the Special Entity regarding fair pricing and the appropriateness of the SBS; and • In the case of employee benefit plans subject to ERISA, is a fiduciary as defined in section 3(21) of ERISA; and	<u>Non-ERISA</u> A Swap Entity that offers to enter or enters into a swap with a Special Entity other than an ERISA plan is required to have a reasonable basis to believe that the Special Entity has representative that: • Has sufficient knowledge to evaluate the transaction and risks; • Is not subject to a statutory disqualification under the CEA; • Is independent of the Swap Entity*;* • Undertakes a duty to act in the best interests of the Special Entity it represents; • Makes appropriate and timely disclosures to the Special Entity; • Evaluates, consistent with any guidelines provided by the Special Entity, fair pricing and the appropriateness of the swap; and • In the case of a Special Entity that is a state or state political subdivision or a governmental plan, is subject to restrictions on certain political contributions imposed by the CFTC, the SEC or an SRO (unless the representative is an employee of the Special Entity).	As discussed above, there are key differences in the determination of "independence" under the SEC proposal and the Final CFTC Rules. The SEC requested comments regarding the qualifications of Special Entities' representatives, including whether a representative should be deemed "qualified" if it is a QPAM, INHAM, a registered municipal advisor or similar qualified professional.

Provision	SEC Proposal	Final CFTC Rules	Key Differences/Issues/Comments
	• In the case of a state, municipal entity or governmental plan, is a person that is subject to rules of the SEC, the CFTC or an SRO subject to the jurisdiction of the SEC or the CFTC prohibiting it from engaging in specified activities if certain political contributions have been made.	ERISA A Swap Entity that offers to enter or enters into a swap with a Special Entity that is an ERISA plan is required to have a reasonable basis to believe that the Special Entity has a representative that is a fiduciary under ERISA.	
Reliance on Representations/ Safe Harbor	While the SEC Proposal does not provide an express safe harbor with regard to qualified representatives, an SBS Entity would be entitled to rely on written representations regarding the various qualifications of the independent representative to form a reasonable basis to believe that the independent representative is "qualified." Upon receiving such representations, the SBS Entity would be entitled to rely on them without further inquiry, unless either (i) it knows that the representation is not accurate or (ii) it has information that would cause a reasonable person to question the accuracy of the representation. The SEC requests comment on whether (i) or (ii) is a more appropriate standard for reliance on representations.	Non-ERISA Special Entities A Swap Entity will be deemed to have a reasonable basis to believe that a Special Entity (other than an ERISA plan) has a QIR if: • The Special Entity represents in writing to the Swap Entity that it has complied in good faith with written policies and procedures reasonably designed to ensure that it has selected a representative that satisfies the QIR requirements, and that such policies and procedures provide for ongoing monitoring of the performance of the representative consistent with those requirements • The representative represents in writing to the Special Entity and Swap Entity that the representative:	Although the Final CFTC Rules generally permit reasonable reliance on representations, they will require the representative and the Special Entity to establish several policies and procedures and for the representative to be legally obligated to comply with the QIR requirements. The SEC, in turn, posed numerous questions regarding reliance on representations from either the Special Entity or its representative, including whether additional diligence should be required for some or all Special Entities.

Provision	SEC Proposal	Final CFTC Rules	Key Differences/Issues/Comments
		○ Has policies and procedures reasonably designed to ensure that it satisfies the QIR requirements; ○ Meets the independence test; and ○ Is legally obligated to comply with the QIR requirements by agreement, condition of employment, law, rule, regulation, or other enforceable duty. <u>ERISA Special Entities</u> A Swap Entity shall be deemed to have a reasonable basis to believe that a Special Entity that is an ERISA plan has a representative that is a fiduciary under ERISA, provided that the ERISA plan: • Provides in writing to the Swap Entity the representative's name and contact information. • Represents in writing that the representative is a fiduciary under ERISA.	If an SD or MSP initially determines that it does not have a reasonable basis to believe that the representative of a Special Entity is qualified (either as a QIR or an ERISA fiduciary, as applicable), the Swap Entity must make a written record of the basis for such determination and submit such determination to its CCO for review to ensure that the Swap Entity has a substantial, unbiased basis for the determination. The CFTC clarified that it does not believe that this requirement gives the Swap Entity authority to determine whether the representative meets the requirements of the Final CFTC Rules; rather the CCO is merely evaluating the reasonableness of the basis for the Swap Entity's evaluation of the representative.

Provision	SEC Proposal	Final CFTC Rules	Key Differences/Issues/Comments
Disclosure of Capacity	Before initiation of an SBS, an SBS Entity would be required to disclose to the Special Entity in writing the capacity in which it is acting. If the SBS Entity engages in business, or has engaged in business within the last twelve months, with the counterparty in more than one capacity, the SBS Entity would be required to disclose the material differences between such capacities in connection with the SBS and any other financial transaction or service involving the counterparty.	Before the initiation of the swap, a Swap Entity must disclose to the Special Entity the capacity in which it is acting in connection with the swap. If a Swap Entity engages in business with a Special Entity in more than one capacity, the Swap Entity must also disclose the material differences between such capacities.	The CFTC clarifies that this requirement does not only apply to different capacities with respect to a specific transaction. The CFTC, as an example, notes that an SD that is also a registered futures commission merchant ("**FCM**") would have to disclose that when it acts as an FCM it is the Special Entity's agent with respect to executing orders, but that, when it acts as an SD, it is the Special Entity's counterparty and its interests are adverse to the Special Entity's. Such disclosures could be made on a relationship basis in counterparty relationship documentation. Because SDs typically have multiple business relationships with Special Entities (as advisers, underwriters, broker-dealers, FCMs, etc.), this will require the development of broad disclosure practices.
Exchange-Traded Swaps/SBS	These requirements would not apply if the transaction is: (i) executed on a registered SBSEF or exchange; and (ii) the SBS Entity does not know the identity of the counterparty, at any time up to and including execution of the transaction.	These requirements would not apply if the transaction is: (i) initiated on a DCM or SEF; and (ii) the Swap Entity does not know the identity of the counterparty to the transaction prior to execution.	The SEC has requested comment regarding transactions where the counterparty's identity is only known immediately prior to execution, whereas the Final CFTC Rules expressly require disclosures under such circumstances. The CFTC suggests that market participants, together with DCMs and SEFs, will develop basic standard format disclosure sufficient to meet disclosure requirements in a compressed timeframe, such as some form of click-through disclosure prior to execution of such trades.

Provision	SEC Proposal	Final CFTC Rules	Key Differences/Issues/Comments
Compliance, Supervision, and Pay-to-Play			
Supervision SEC: 15Fh-3(h); CFTC: 23.402(a)(2)	The SEC Proposal would require an SBS Entity to establish a system to supervise all personnel and activities relating to SBS and identify an appropriate person(s) with the authority to carry out the supervisory responsibilities. This system, including the supervisory personnel, must be described in writing.[5] An SBS Entity or associated person would not have failed diligently to supervise a person if two conditions are met: (i) the SBS Entity has established policies and procedures reasonably designed to detect and prevent violations of the securities law related to SBS; and (ii) the supervisor has reasonably discharged his or her duties under the supervisory system without a reasonable basis to believe that the established procedures were not being followed.	SDs and MSPs will be required to implement and monitor compliance with policies and procedures under the Final CFTC Rules as part of their supervision and risk management requirements specified in CFTC Regulations Part 23, Subpart J. Those rules require that Swap Entities develop a system to diligently supervise business activities performed by all employees and agents to ensure compliance with the CEA and CFTC Regulations. In addition, SDs and MSPs will be required to have written policies and procedures to prevent evasion or facilitation of evasion of any provision of the CEA or CFTC Regulations.	The SEC proposal is modeled on SRO rules and other rules applicable to broker-dealers. While the SEC proposal is more prescriptive than the Final CFTC Rules, the CFTC and the NFA may also look to SRO rules in enforcing compliance with the CFTC proposal. However, the Final CFTC Rules go far beyond existing requirements by requiring policies and procedures designed to prevent evasion of any provision of the CEA or rules thereunder, without clearly defining the types of conduct considered to constitute evasion.

[5] Additionally, an SBS Entity must adopt written policies and procedures reasonably designed to achieve compliance with applicable securities laws, rules and regulations, and must include, at a minimum, procedures: (i) for the review by a supervisor of all transactions for which registration as an SBS Entity is required and all related communications with counterparties; (ii) for a periodic review of the SBS business in which it engages; (iii) to conduct reasonable investigation into the background of associated persons; (iv) to monitor employee personal accounts held at another SBS Entity, broker, dealer, investment adviser, or other financial institution; (v) prohibiting supervisors from supervising their own activities or reporting to, or having their compensation or continued employment determined by, a person or persons they are supervising; (vi) preventing the standards of supervision from being reduced due to any conflicts of interest that may be present with respect to the associated person being supervised.

Provision	SEC Proposal	Final CFTC Rules	Key Differences/Issues/Comments
Political Contributions SEC: 15h-6; CFTC: 23.451(b)(1)	The SEC Proposal would prohibit: (i) SBS activity with a municipal entity for two years following any contribution to an official of such municipal entity made by an SBSD or any covered associate of the SBSD; (ii) paying a third party who is not a "regulated person" to solicit municipal entities; and (iii) soliciting or coordinating contributions to officials of a municipal entity with which an SBSD engages in or seeks to engage in SBS activity. The prohibition would not be triggered for covered associates who make contributions of no more than $350 per election to any one official for whom the individual is allowed to vote and no more than $150 to an official for whom the individual is not entitled to vote.	The Final CFTC Rules prohibit an SD from entering into swaps with "governmental Special Entities" if the SD makes certain political contributions to officials of such entities. The Final CFTC Rules makes it unlawful for an SD to: (i) enter into or offer to enter into a swap with a governmental Special Entity for a two-year period after the dealer or a covered associate makes a contribution to an official of the governmental Special Entity; (ii) pay a third party who is not a "regulated person" to solicit governmental Special Entity to enter into a swap; or (iii) solicit or coordinate contributions to officials of a governmental Special Entity with which the SD is seeking to enter into or has entered into a swap, or make payments to a political party of a state or locality with which the SD is seeking to enter or has entered into a swap. The prohibition would not be triggered for covered associates who make contributions of no more than $350 per election to any one official for whom the individual is allowed to vote and no more than $150 to an official for whom the individual is not entitled to vote.	Because the SEC/CFTC proposals differ somewhat from the proposed MSRB regulations (*e.g.*, broader definition of "solicit", and application to swaps that are "offered" but not entered into) registrants would be required to comply with two sets of rules.[6]

[6] *See* MSRB Rule G-37, Political Contributions and Prohibitions on Municipal Securities Business.

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