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CFTC's Proposed Business Conduct Regulation: Can the OTC Swap Market Survive the "Cure"?

On December 22, 2010, the U.S. Commodity Futures Trading Commission (the "CFTC") issued a proposed regulation to implement the provisions of Title VII[1] of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") related to external business conduct standards for swap dealers and major swap participants ("MSPs").[2] In addition to proposing new requirements for all swap dealers, the Business Conduct Proposal imposes particularly stringent business conduct standards for swap dealers in their dealings with "Special Entities," including employee benefit plans and governmental plans within the meaning of Section 3 of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), as well as endowments.[3]

As summarized in **Appendix A** and discussed in detail below, the Business Conduct Proposal would impose different conduct requirements based on the identity of the counterparty and the swap dealer's relationship with the counterparty.[4]

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[1] While Section 731(h) of Title VII imposes requirements on the CFTC, Section 764(h) of Title VII requires the Securities and Exchange Commission ("SEC") to issue regulations on the business conduct standards for registered security-based swap dealers and major security-based swap participants.

[2] Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 75 Fed Reg. 80638 (Dec. 22, 2010) (the "Business Conduct Proposal"). While the Business Conduct Proposal applies to both swap dealers and "major swap participants" (which include non-dealers who maintain "substantial positions" in swaps, non-dealers whose outstanding swaps create "substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets" and non-dealer "financial entities" that are "highly leveraged relative to the amount of capital [they] hold" and maintain "substantial positions" in swaps), this memorandum focuses on the effects of the Business Conduct Proposal on swap dealers.

[3] Under the Business Conduct Proposal, "Special Entity" includes: 1) a Federal agency; 2) a State, State agency, city, county, municipality, or other political subdivision of a State; 3) an employee benefit plan, as defined in Section 3 of ERISA; 4) a governmental plan, as defined in Section 3 of ERISA; or 5) an endowment, including an endowment that is an organization described in Section 501(c)(3) of the Internal Revenue Code of 1986.

[4] The Business Conduct Proposal also includes requirements for policies and procedures reasonably designed to ensure compliance with the proposed rules and to prevent evasion of the Commodity Exchange Act ("CEA") or any regulation thereunder. The CFTC has also proposed certain other "internal" business conduct standards. *See* 75 Fed. Reg. 70881 (Nov. 19, 2010) (requirements regarding a swap dealer or MSP's chief compliance officer and compliance program); 75 Fed. Reg. 71397 (Nov. 23, 2010) (requirements regarding swap dealer and MSP risk management procedures, monitoring of position limits, diligent supervision, business continuity and disaster recovery, disclosure to and ability of regulators to obtain general information, and antitrust considerations); 75 Fed. Reg. 71391 (Nov. 23, 2010) (implementation of swap dealer and MSP conflicts of interest policies and procedures); 75 Fed. Reg. 76666 (Dec. 9, 2010) (swap dealer and MSP

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- **Swap dealer to any counterparty, including a Special Entity**. A swap dealer would be required to "know [its] customer," disclose material information about the swap and the swap dealer's incentives and conflicts of interest, and provide scenario analyses and daily marks for certain swaps. A swap dealer would be prohibited from disclosing confidential counterparty information, trading ahead of and front running its counterparty and would be subject to certain fair dealing and execution standards.

- **Swap dealer that makes recommendations to any counterparty, including a Special Entity**. A swap dealer would be required to have a reasonable basis to believe that any recommendation it makes concerning a swap or trading strategy involving swaps is "suitable" for the counterparty's particular needs and financial condition.

- **Swap dealer that is a counterparty to a Special Entity**. A swap dealer would be required to have a "reasonable basis" to believe that the Special Entity has a "qualified independent representative" and to disclose to the Special Entity the capacity in which it is acting in connection with the swap.

- **Swap dealer that "acts as an advisor" to a Special Entity**. A swap dealer would be required to act in the "best interests" of the Special Entity and to undertake "reasonable efforts" to obtain information necessary to determine that a recommended swap is in the best interests of the Special Entity.

The Business Conduct Proposal would result in a number of adverse and presumably unintended consequences. For instance, because it includes swap dealers and MSPs within the scope of counterparties covered by many of its requirements, the Business Conduct Proposal would, among other things, ironically impose upon each party in a transaction between two swap dealers a duty to provide daily marks to the other swap dealer.[5] The prohibition on trading ahead and front running would, as currently drafted, likely have the perverse consequence of prohibiting hedging and other legitimate trading activity, thereby reducing liquidity to and increasing prices for the very counterparties it is intended to protect. Similarly, pre-execution requirements to conduct extensive diligence, obtain detailed representations, and provide extensive disclosure – much of which cannot be accomplished fully until the terms of the transaction have already been agreed – could in many cases actually harm counterparties by unnecessarily delaying execution and thereby exposing counterparties unnecessarily to ongoing market risk.

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reporting, recordkeeping, and daily trading records requirements); and 75 Fed. Reg. 81519 (Dec. 28, 2010) (swap dealer and MSP confirmation, portfolio reconciliation, and portfolio compression requirements).

[5] In the Business Conduct Proposal and this memorandum, the term "counterparty" generally includes any prospective counterparty as well.

More generally, the overall theme of the Business Conduct Proposal is to increase the degree to which counterparties rely upon the swap dealers whom they face on the contra-side of transactions for services and information, which would appear contrary to the result intended by Congress. The CFTC further requires a number of disclosures, which, in certain cases, would themselves require additional disclosure so as to not be misleading.

Notably, the provisions of the Business Conduct Proposal are not coordinated with the provisions of either the existing or the recently proposed Department of Labor ("DOL") fiduciary regulations.[6] In subjecting swap dealers that deal with employee benefit plans subject to ERISA (the "ERISA Plans") to fiduciary-like responsibilities, the requirements under the Business Conduct Proposal would likely cause swap dealers – and particularly swap dealers that provide recommendations to Special Entities – to fall within the definition of an ERISA "fiduciary" under the DOL Regulations. If swap dealers are treated as fiduciaries under the DOL Regulations, then any swap transaction with ERISA Plans will immediately become a prohibited transaction under ERISA.[7]

The CFTC states in the Business Conduct Proposal that the proposal is not intended to preclude, *per se*, a swap dealer from both recommending a swap to a Special Entity and entering into that swap with the same Special Entity. The CFTC notes that the DOL staff has "advised that any determination of status under the Dodd-Frank Act is *separate and distinct* from the determination of whether an entity is a fiduciary under ERISA (emphasis added)."[8] However, the reference to the separate and distinct standard is offered without any attempt by the DOL or the CFTC to apply the fiduciary standard under either the Current DOL Regulation or the Proposed DOL Regulation to the new conduct that is required of swap dealers under the Business Conduct Proposal.

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[6] The current regulation, Definition of "Fiduciary," 29 CFR § 2510.3-21(c) (1975), has been in force since 1975 (the "Current DOL Regulation"). If adopted, the proposed regulation, Definition of the Term "Fiduciary," 75 Fed Reg. 65263 (Oct. 22, 2010) (the "Proposed DOL Regulation" and, together with the Current DOL Regulation, the "DOL Regulations") would become effective 180 days after the publication of the final regulation in the Federal Register. Under the Proposed DOL Regulation, an investment adviser (as defined in section 202(a)(11) of the Investment Advisers Act of 1940) would be a *per se* fiduciary. All other service providers would be fiduciaries if they render any advice that is individualized and that may be used in connection with the investment decision of an employee benefit plan subject to ERISA, with a limited exception for advice to a counterparty where the service recipient reasonably knows the advice is not impartial investment advice.

[7] Under ERISA, a fiduciary has the duty to act prudently for the exclusive purpose of providing ERISA Plan benefits and defraying ERISA Plan costs and must not engage in conflict of interest transactions by: dealing with the assets of the ERISA Plan in its own interest or for its own account; acting in any transaction involving the ERISA Plan on behalf of a party whose interests are adverse to the interests of the ERISA Plan, its participants or beneficiaries; or receiving any consideration from a third party dealing with an ERISA Plan in connection with a transaction involving ERISA Plan assets. Furthermore, a fiduciary must not cause an ERISA Plan to engage in virtually any transaction with persons providing services to or otherwise related to an ERISA Plan, unless an exemption is available.

[8] Business Conduct Proposal at 80650, note 101 (emphasis added).

In addition, the CFTC has requested comments on whether swap dealers should be subject to "an explicit fiduciary duty" when making a recommendation to a counterparty or acting as an advisor to a Special Entity. It is important to note that Congress considered and explicitly rejected such a rule under Dodd-Frank,[9] which, if it had been adopted, would have ensured that no swap dealer would ever enter into a swap with an ERISA Plan.

The combination of the requirements in the Business Conduct Proposal and the proposed changes to the DOL's definition of fiduciary creates significant uncertainty for swap dealers who deal with ERISA Plans and other Special Entities. Consequently, absent a clear statement from the DOL that compliance with the Business Conduct Proposal will not result in the swap dealer becoming a fiduciary, swap dealers will likely refuse to engage in swap transactions with ERISA Plans to avoid the risks of costly ERISA violations, which include rescission of transactions and potentially significant excise taxes.

This memorandum highlights the key provisions of the Business Conduct Proposal and considers the practical applications and consequences of the proposed changes. The comment period for the Business Conduct Proposal closes on **February 22, 2011**.

I. Dealing with Counterparties Generally.

The Business Conduct Proposal sets forth certain rules for swap dealers dealing with counterparties generally, including requirements designed to ensure compliance with the new business conduct rules. The Business Conduct Proposal would impose additional requirements for swap dealers that provide "recommendations" to counterparties. The table below summarizes these requirements, which are also discussed in detail below.

Any counterparty	Recommendations to any counterparty
▪ Prohibition on trading ahead of and front running the counterparty. ▪ General requirements to "know your customer," disclose material information about the swap, and, for certain swaps, to provide scenario analyses and daily marks. ▪ Requirement to protect confidential counterparty information and comply with certain fair dealing and execution standards.	▪ Recommendations must be "suitable" to the counterparty's particular needs and financial condition. ▪ The suitability requirement would be met if the counterparty (or its advisor) indicates that it is exercising independent judgment and the swap dealer has a reasonable basis to believe that (i) the counterparty has the capacity to absorb potential losses and (ii) the counterparty (or its advisor) is capable of evaluating the risks.

[9] Congress ultimately rejected a provision that would have explicitly imposed a fiduciary duty on "a swap dealer that provides advice regarding, or offers to enter into, or enters into a swap with a pension plan, endowment, or retirement plan." H.R. 4173, 111th Cong. § 731 (as reported to Conf., June 10, 2010).

A. **Swap Dealer to Any Counterparty**.

1. **Prohibition on Fraud, Manipulation and Other Abusive Practices**. The Business Conduct Proposal would prohibit swap dealers from engaging in any act, practice or course of business that is fraudulent, deceptive or manipulative, and also would prohibit the following acts:

- **Disclosure of Confidential Counterparty Information**. The Business Conduct Proposal would make it unlawful for a swap dealer to disclose any material confidential information obtained from a counterparty, unless (i) such disclosure is necessary for the effective execution of any swap or to hedge any exposure created by such swap, and the counterparty specifically consents to such disclosure, or (ii) the CFTC, Department of Justice, or an applicable prudential regulator requests such information.
    - The exceptions for regulatory disclosures are inadequate, as they do not cover disclosures to a self-regulatory organization, even though the CFTC has separately proposed to require that swap dealers join the National Futures Association ("NFA").[10] The exceptions also would not cover disclosures subject to confidential treatment, *e.g.*, disclosures to vendors who provide processing services.
    - Moreover, counterparties extensively negotiate the treatment, use, and disclosure of confidential information. The Business Conduct Proposal would effectively convert contract interpretation and enforcement to federal law. Although the CFTC refers to a colloquy by Senator Lincoln and vaguely references consultations with stakeholders as justifying this requirement,[11] it is unclear why, given the absence of any express statutory mandate in Dodd-Frank, the CFTC deemed it necessary or appropriate to preempt the ability of counterparties to negotiate their own terms or alternatively assume the role of contract interpreter.
- **Trading Ahead and Front Running**. The Business Conduct Proposal would make it unlawful for a swap dealer to enter "knowingly" and without specific counterparty consent into a transaction for its own benefit ahead of (i) any executable order for a swap received from a counterparty, or (ii) any swap that is the subject of a negotiation with a counterparty.

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[10] *See* 75 Fed. Reg. 71379 (Nov. 23, 2010) (proposal regarding registration of swap dealers and MSPs).

[11] Business Conduct Proposal at 80642.

- In explaining this provision, the CFTC analogizes to prohibitions applicable to introducing brokers and futures commission merchants. While that analogy may be appropriate when a swap dealer is – like an introducing broker or futures commission merchant – acting as agent for a counterparty and therefore has a duty to that counterparty, the analogy breaks down when the swap dealer is acting as principal, and the issues become more nuanced and complex.

- Further, the broad prohibition against any "transaction" clearly restricts a far greater range of activity than is workable or necessary. Any such prohibition would need to define the required nexus between pending swap transactions and restricted swap transactions.

- The CFTC has requested comments as to whether there should be a limit on the time during which the swap dealer must refrain from trading on the counterparty's information, particularly if the counterparty discusses a potential swap but does not immediately enter into the swap with the swap dealer. While such a limitation would make the provision relatively more workable, the provision should instead, at a minimum, be limited to cases where the swap dealer has received an executable order, and it should not apply to trades made by other parts of an organization that are not privy to customers' trade information.

- The provision would also put a premium on obtaining advance "specific" consent before even discussing a swap, but the Business Conduct Proposal provides no guidance on whether the reference to "specific" consent is intended to mean consent to a "specific" transaction.

- The CFTC also requested comments as to whether the swap dealer should be required to disclose to a counterparty its pre-existing positions in a type of swap prior to entering into the same type of swap with the counterparty. Requiring such disclosure would not only be impractical, it would seriously discourage swap dealers from providing liquidity.

2. General Requirements for All Swap Dealers.

- **Know Your Counterparty**. The Business Conduct Proposal would require the swap dealer to use reasonable due diligence to know and retain a record of the essential facts concerning the counterparty.

  - However, the Business Conduct Proposal would go much further beyond existing "know your customer" rules in other markets by requiring the swap dealer to obtain information necessary to "effectively service the counterparty" and "evaluate" the "flexibility" and "purposes" (as distinct

from trading objectives) of the counterparty. As with many aspects of the Business Conduct Proposal, these vague standards present the unfortunate prospect of hindsight judgment in the context of not only regulatory enforcement authority, but also broad private rights of actions and rescission rights.

- Additionally, the Business Conduct Proposal would require a swap dealer to obtain facts necessary to "implement any special instructions of the counterparty." This could also present serious issues when evaluated with a hindsight bias. A more appropriate requirement – consistent with standards applicable to other financial intermediaries – would be to require the swap dealer to maintain a record of any special instructions it has agreed to implement in connection with the executed transaction.[12]

- **Verification of Counterparty Eligibility**. Swap dealers would be required to verify that a counterparty is an eligible contract participant ("ECP")[13] and determine whether a counterparty is a Special Entity prior to offering or entering into a swap.

- **Reliance on Representations from Counterparty to Satisfy Requirements**. A swap dealer that seeks to rely on the written representations of a counterparty to satisfy any requirement under the Business Conduct Proposal would be required to have a "reasonable basis" to believe that the sufficiently detailed representations are reliable.

  - By requiring that a swap dealer have a "reasonable basis" to believe that representations are accurate, the Business Conduct Proposal would appear to impose an undefined and unworkable affirmative obligation on swap dealers to proactively investigate representations. A more workable standard would permit a swap dealer to rely on the representations of its counterparty absent notice of countervailing facts (or facts that reasonably should have put a swap dealer on notice), which would trigger a consequent duty to inquire further.

  - The Business Conduct Proposal would require lengthy representations by the counterparty (that will be the product of an iterative question and answer process) in order to ensure that all the relevant information about the counterparty is obtained and the required record is preserved. Such a process will substantially delay the execution of trades.

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[12] *See, e.g.*, 17 C.F.R. § 240.17a-3(a)(6) (2011).

[13] ECPs generally include employee benefit plans and certain governmental entities that meet defined thresholds.

- **Clearing**. If a swap is subject to mandatory clearing, the swap dealer would be required to notify a counterparty other than a swap dealer or MSP of its right to select the designated clearing organization ("DCO"). If the swap is not subject to mandatory clearing, the swap dealer would also be required to notify the counterparty of its right to elect to require the swap to be cleared and to select the DCO. However, the CFTC provides no guidance regarding the scope of the counterparty's rights to select the DCO. For instance, could the price be contingent on the choice of a DCO that the swap dealer is a member of? Could a swap dealer be required to clear a trade in a foreign DCO?

- **Communications – Fair Dealing**. Swap dealers would 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 swap dealer would 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. Moreover, the CFTC expects that to deal fairly would require the swap dealer or MSP to treat counterparties (including potentially other swap dealers and MSPs) in such a way so as not to advantage one counterparty or group of counterparties over another. Presumably, the CFTC means only to prohibit those advantages that would unfairly discriminate against a counterparty or group of counterparties, and not perceived "advantages" that derive from counterparty credit, changing market conditions, illiquidity and other circumstances that could result in one counterparty or group of counterparties being treated differently than another.

3. Disclosure of Material Risks, Characteristics, Material Incentives and Conflicts of Interest Regarding the Swap. At a "reasonably sufficient" time prior to entering into a swap, a swap dealer would have to disclose material information concerning the swap in a manner reasonably designed to allow the counterparty to assess:

- **Material Risks of the Swap**. Material risks would include market, credit, liquidity, foreign currency, legal, operational, and any other applicable risks. In addition, for certain swaps, the swap dealer would be required to provide a scenario analysis to the counterparty.

  - **Scenario Analysis**. For bilateral swaps that are not available for trading on a designated contract market ("DCM") or a swap execution facility ("SEF"), swap dealers would be required to notify counterparties that they can request scenario analyses and to provide scenario analyses upon request. For "high-risk complex bilateral swaps" (a subjective standard) with a counterparty, a swap dealer would be required to provide a scenario analysis designed in consultation with the counterparty to allow the counterparty to assess its

potential exposure in connection with the swap. While this requirement tracks industry best practices, those best practices were designed to be aspirational in nature, and were never intended to subject market participants to liability if violated.

- The Business Conduct Proposal does not define scenario analysis, a term that encompasses the modeling of a broad range of events beyond mere changes in underlying market factors. The CFTC should clarify that the term scenario analysis is limited to stress testing of underlying market factors.

- The Business Conduct Proposal does not define "high-risk complex bilateral swap," but rather offers relevant criteria that a swap dealer would be required to consider when establishing procedures to identify such swaps. The criteria include: (i) the degree and nature of leverage, (ii) the potential for periods of significantly reduced liquidity, and (iii) the lack of price transparency. Under this highly subjective formulation, the swap dealer could be liable for failing to provide a scenario analysis even if its policies did not identify the swap as a high-risk complex bilateral swap.

- Swap dealers would be required to disclose all material assumptions underlying a given scenario and its impact on swap valuation but would not need to disclose proprietary information about any pricing models. Somewhat contradictorily, however, the CFTC suggests that, in designing the required scenario analysis, a swap dealer should consider any analysis done by the swap dealer for its own risk management purposes. This requirement subjects the swap dealer to the risk that any internal communication could be taken out of context in an "after the fact review" in order to prove that the swap dealer should have disclosed additional risks. Moreover, a swap dealer's internal risk management practices (including any Value-at-Risk calculation) are generally calibrated based on the dealer's unique composition of its portfolio risk profile (including non-swap positions), and so would often be misleading if used to inform disclosure for an individual swap.

- The requirement to perform a scenario analysis could cause the swap dealer to be a fiduciary under the DOL Regulations. A scenario analysis is clearly intended to be used in connection with (and perhaps may be used as a primary basis for) an investment decision, particularly since under the Business Conduct Proposal, the scenario analysis is to be designed in consultation with the counterparty. To qualify for the counterparty exception under the Proposed DOL Regulation, the swap

dealer would have to ensure that the counterparty knows that, in providing the scenario analysis, the swap dealer is not providing "impartial advice," a proposition that is at odds with the Business Conduct Proposal.

- **Material Characteristics of the Particular Swap**. A swap dealer would be required to disclose material information concerning the swap in a manner reasonably designed to allow the counterparty to assess 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. It is not clear what would have to be disclosed beyond those terms expressly agreed to in the swap confirmation and master documentation. The idea that an ECP would have to be provided with information "reasonably designed to allow the counterparty to assess" its "rights and obligations" under a swap contract that it has presumably read, reviewed and subscribed to is itself troubling.

- **Material Incentives and Conflicts of Interest of the Swap Dealer**. The swap dealer would have to provide information reasonably designed to allow the counterparty to assess the swap dealer's conflicts and incentives, including compensation from any source other than the counterparty that the swap dealer "may" receive in connection with the swap as well as other incentives related to the transaction. The CFTC contemplates that a swap dealer would be expected to disclose whether its compensation related to the recommended swap would be greater than the compensation for another instrument with similar economic terms offered by the same swap dealer.

  - In order to satisfy these requirements, it appears that a swap dealer would have to identify and evaluate comparable instruments on behalf of the counterparty. Would these provisions require a swap dealer to do a comparison, for example, between a proposed swap and an exchange-traded future that has similar economic terms? If so, what would be the criteria for determining whether the exchange-traded future has economic terms that are similar to those of the swap?

  - The CFTC also expects a swap dealer that engages in business with a counterparty in more than one capacity to consider whether acting in multiple capacities creates material incentives or conflicts of interest that require disclosure.

  - The CFTC requested comments on whether swap dealers should be required to disclose their profits, and if so, how profitability should be calculated. The focus on dealers' profits is misplaced, however, because the best protection for counterparties is measured not by the profits of the swap dealer but rather

by the price that the counterparty is charged for a swap in relation to prices charged by other swap dealers. Moreover, the profitability of a swap cannot be known at execution and depends on related financing and hedging activities (among other contingencies) as well as relevant changes in market factors.

- **Daily Mark**. For swaps cleared on a DCO, a swap dealer would be required to notify the counterparty of its right to receive a daily mark. For uncleared swaps, a swap dealer would be required to provide the counterparty with a daily mark, which would be the mid-market value of the swap.
  - Swap dealers would be required to disclose the assumptions and methodology used to prepare the daily mark. Additionally, for bespoke transactions, swap dealers would be required to provide a clarifying statement relating to the daily mark warning that it may not accurately reflect the value. The Business Conduct Proposal assumes that a midmarket price is an observable or objectively verifiable computation, which is often not the case for bespoke or illiquid swaps.
  - Since the DOL Proposed Regulation provides that "appraisals" concerning the value of securities or other property are fiduciary advice, there is also a question as to whether a daily mark would be an "appraisal" within the meaning of the DOL Proposed Regulation.

4. Manner of Disclosure. The parties to a swap would be permitted to agree to provide the required information and representations in any reasonable manner, including a master agreement between the parties, which may satisfy the requirements for subsequent swaps. The CFTC noted, however, that "it is unlikely" that standardized disclosure would be adequate to meet all disclosure duties, as, in its view, most bespoke transactions would "require some combination of standardized and particularized disclosures." It is clear, however, that many of the risks associated with the tailoring of swap terms, such as liquidity and valuation impacts, can be generically disclosed.

B. **Swap Dealer That Makes Recommendations to Any Counterparty**.

1. Institutional Suitability. A swap dealer that makes *any* recommendation of a swap or trading strategy to any counterparty would be required to have a "reasonable basis" to believe that such swap or trading strategy is "suitable" for that counterparty.

- The CFTC notes in the Business Conduct Proposal that a recommendation would include "any communication" by which a swap dealer "provides information to a counterparty about a particular swap or trading strategy that is tailored to the

needs or characteristics of the counterparty."[14] Providing general transaction, financial, or market information would not trigger the obligation, nor would providing swap terms in response to a competitive bid request. Aside from these exceptions, however, it is not clear what other communications might trigger the suitability obligation. For instance, would providing swap terms (such as a term sheet) in response to a non-competitive bid request be deemed a "recommendation"? Merely bringing a swap to the counterparty's attention? Providing the scenario analysis required by the Business Conduct Proposal? It is difficult to discern the difference between a scenario analysis required by the Business Conduct Proposal and a "recommendation" that would trigger the additional suitability requirement. While we suspect that the CFTC did not intend this circular result, the breadth of the language leaves open numerous questions.

- The determination of suitability would be required to be based on reasonable due diligence concerning the counterparty's financial situation and needs, objectives, tax status, ability to evaluate the recommendation, liquidity needs, risk tolerance, ability to absorb potential losses related to the recommended swap or trading strategy, and any other information known to the swap dealer.

2. Conditions to Satisfy the Suitability Requirement. A swap dealer would satisfy the suitability requirement if the following three conditions were satisfied:

- The swap dealer had a reasonable basis to believe that the counterparty (or its advisor) was capable of independently evaluating the risks related to the particular recommendation;

- The counterparty (or its advisor) affirmatively indicated that it was exercising independent judgment; and

- The swap dealer had a reasonable basis to believe that the counterparty had the capacity to absorb potential losses related to the strategy.

  - The swap dealer would have to analyze the counterparty's ability to absorb losses even where the counterparty is represented by a capable advisor that is exercising independent judgment.

  - Because the suitability requirement would obligate the swap dealer to make determinations based upon individual characteristics of the counterparty, there is a risk that such a suitability analysis and determination could be viewed as individualized advice in connection with an ERISA Plan's

14 Business Conduct Proposal at 80647.

investment decisions, which could result in the swap dealer becoming a fiduciary under the DOL Regulations.

II. **Dealing with Special Entities**.

The Business Conduct Proposal imposes additional requirements on swap dealers who enter into swap transactions with or make recommendations to Special Entities, as summarized in the table below.

Counterparty is a Special Entity	Advisor to a Special Entity
▪ Swap dealer must have a reasonable basis to believe that the Special Entity has a qualified independent representative. ▪ Swap dealer must disclose to the Special Entity the capacity in which it is acting in connection with the swap.	▪ A swap dealer would be required to act in the “best interests” of the Special Entity and to undertake “reasonable efforts” to obtain information necessary to determine that a recommended swap is in the best interests of the Special Entity.

A. **Swap Dealer to a Counterparty That Is a Special Entity**.

Under the Business Conduct Proposal, any swap dealer that offers to enter or enters into a swap with a Special Entity would be required to have a reasonable basis to believe that the Special Entity has a qualified representative. This provision would effectively require the swap dealer to second guess the competence of the representative chosen by the Special Entity to represent it. Furthermore, the Business Conduct Proposal would require a swap dealer to disclose to the Special Entity the capacity in which the dealer is acting in connection with the swap.

1. Required Qualifications. The Business Conduct Proposal would require the swap dealer to analyze whether the representative of the Special Entity meets the following requirements:

- The representative has sufficient knowledge to evaluate the transaction and risks;
- The representative is not subject to a statutory disqualification;
  - The Business Conduct Proposal defines “statutory disqualification” as grounds for refusal to register or to revoke, condition or restrict the registration of any registrant or applicant for registration as set forth in Sections 8a(2) and 8a(3) of the CEA.
- The representative is *independent* of the swap dealer or major swap participant;

- The representative undertakes a duty to act in the best interests of the Special Entity it represents;
- The representative makes appropriate and timely disclosures to the Special Entity;
- The representative evaluates, consistent with any guidelines provided by the Special Entity, fair pricing and the appropriateness of the swap;
- In the case of an ERISA Plan, the representative is a fiduciary as defined in Section 3 of ERISA; and
- In the case of a municipal entity, the external representative, if any, is subject to restrictions on certain political contributions imposed by the CFTC, the SEC or a self-regulatory organization.

2. Definition of "Independent". Under the Business Conduct Proposal, "independent" means that (i) the representative is not and was not (within the previous year) an associated person of the swap dealer, (ii) there is no principal relationship between the representative and the swap dealer, and (iii) there is no "material business relationship" between the swap dealer and the representative (whether or not compensatory), which would include any relationship that "reasonably could affect the independent judgment or decision making of the representative," with a one-year look back.[15] Fees paid by the swap dealer to the representative at the written direction of the Special Entity for services provided by the representative in connection with the swap executed between the Special Entity and the swap dealer are not included.

- This independence standard raises a number of questions about what would constitute a "material business relationship." For example, if a broker dealer is underwriter for mutual funds managed by investment adviser, would that constitute a material business relationship? What if a swap dealer has an ownership interest in the adviser of 5%? 10%? 20%?
- The swap dealer would have to ensure that any compensation received by the representative from the swap dealer within one year of an offer to enter into a swap is disclosed to the Special Entity and the Special Entity agrees in writing, in consultation with the representative, that the compensation does not constitute a material business relationship between the representative and the swap dealer. The Business Conduct Proposal does not, however, provide any guidance on the type of compensation that must be disclosed. For instance, if a swap dealer in its

[15] The CFTC also requested comments as to whether the independence requirement should apply to employees of the independent representative.

capacity as broker provided soft dollar research (completely unrelated to any swap transaction) to an ERISA Plan's investment adviser, would disclosure of that soft-dollar compensation be required?

- Moreover, rather than taking existing standards of independence or affiliation, the CFTC devised new independence rules. Just as there are currently detailed negotiations as to whether the swap dealer or the QPAM will bear the representation risk of QPAM independence, so too there will be extensive negotiations about the required independence representations under the Business Conduct Proposal.

3. Reasonable Reliance on Representations to Satisfy the "Reasonable Basis" Requirement. A swap dealer would be able to rely on written representations of the Special Entity to satisfy its obligation to have a "reasonable basis" to believe that the Special Entity has a qualified representative, so long as (i) the swap dealer has a reasonable basis to believe that the representations are reliable and (ii) the representations are sufficiently detailed for the swap dealer to reasonably consider and evaluate:

- The nature of the relationship between the Special Entity and the representative;
- The representative's capability to make hedging or trading decisions;
- The use by the representative of one or more consultants;
- The general level of experience of the representative in financial markets and specific experience with the instruments under considerations;
- The representative's ability to understand the economic features of the swap involved;
- The representative's ability to evaluate how market developments would affect the swap; and
- The complexity of the swap involved.

As with the other representation requirements, this provision will require lengthy disclosure and iterative discussions that will delay the execution of trades.

4. Unqualified Representative. If a swap dealer determines that the representative of a Special Entity does not meet the criteria described above, the swap dealer would be required make a written record of the basis for such determination and submit such determination to its chief compliance officer for review to ensure that the swap dealer has a substantial, unbiased basis for the determination.

- The Business Conduct Proposal presumably then prohibits the swap dealer from engaging in transactions with the Special Entity. In addition to placing the swap dealer in the position of second-guessing the competence of the representative chosen by the Special Entity (which has customer relations implications), the Business Conduct Proposal also raises questions as to whether the swap dealer's power to implicitly cause the Special Entity to replace its adviser would violate the QPAM prohibition on swap dealers having power to hire or fire advisers. Similarly, under the DOL Proposed Regulation, anyone who advises an ERISA Plan as to the selection of a manager to manage ERSA Plan assets is treated as providing fiduciary advice. Could making a determination that a counterparty's representative is not qualified render the swap dealer a fiduciary under the Proposed DOL Regulation?

5. Disclosure of Capacity in Which a Swap Dealer Is Acting. Before the initiation of the swap, a swap dealer would be required to disclose to the Special Entity the capacity in which it is acting in connection with the swap.

- If a swap dealer engages in business with a Special Entity in more than one capacity, the swap dealer would also be required to disclose "the material differences between such capacities in connection with the swap and any other financial transaction or service involving the Special Entity."[16] The CFTC notes that this provision would apply, for example, "when the swap dealer acts both as an advisor and as a counterparty to the Special Entity, or when firms act as both underwriters in a bond offering and as counterparties in swaps used to hedge such financing."[17]

- Read literally, and absent clarification that this disclosure is limited to multiple business relationships connected to the swap, this requirement would apply to all business done with the Special Entity. For example, if a swap dealer is approached by an ERISA Plan to negotiate a swap on the S&P 500, would the dealer have to describe all other relationships with the ERISA Plan (for example, that it also provides brokerage, investment advisory and other services to the ERISA Plan) or only those relationships that are related to the swap being undertaken?

B. **Swap Dealer Is an "Advisor" to a Special Entity**.

The Business Conduct Proposal would impose additional obligations on a swap dealer that "acts as an advisor" to a Special Entity.

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[16] Business Conduct Proposal at 80661.

[17] Business Conduct Proposal at 80645.

1. "Acts as an Advisor." Under the Business Conduct Proposal, a swap dealer would be deemed to "act as an advisor" on any transaction in which the swap dealer recommends to a Special Entity a swap or a trading strategy that involves the use of swaps.

- The term "recommends" appears to include any instance in which the swap dealer provides "information to a counterparty about a particular swap or trading strategy that is tailored to the needs or characteristics of the counterparty,"[18] subject to the very limited exceptions noted above for counterparties generally regarding information that is of a general nature or swap terms provided in response to a competitive bid request.

- Reliance on the recommendation is not required, and a swap dealer could potentially be deemed to be acting as an advisor even in circumstances where the Special Entity has a qualified independent representative and the transaction documentation confirms that the swap dealer is not acting as an advisor and the counterparty is not relying on advice from the swap dealer.

2. Best Interests. If the swap dealer acts as an advisor, then the swap dealer would be required to (i) act in the "best interests" of the Special Entity and (ii) 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 swap dealer is in the best interests of the Special Entity.

- While the CFTC decided not to define "best interests," it noted that "there are established principles in case law" that would inform the meaning of "best interests" on a case-by-case basis.[19] In discussing the meaning of "best interests" in the context of the Special Entity's representatives (who are also required to act in the best interests of the Special Entity under the Business Conduct Proposal), the CFTC cited, among other standards, the requirements for ERISA fiduciaries (including the prudent man standard and the exclusive benefit rule).[20] If the term "best interests" is used consistently and the same standard applies for swap dealers, then it would be logically impossible for a swap dealer who complies with such a "best interests" standard under the Business Conduct Proposal to argue that it is not an ERISA fiduciary.

- To meet its requirement to make "reasonable efforts" to obtain information necessary to make a reasonable determination that any swap or trading strategy is

[18] Business Conduct Proposal at 80647.

[19] Business Conduct Proposal at 80650.

[20] Business Conduct Proposal at 80652, note 117.

in the best interests of the Special Entity, the swap dealer would be required to consider:

- 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 swaps;
- Whether the Special Entity has an independent representative that meets the qualifications set forth in section II.A.1 above;[21]
- Whether the Special Entity has the financial capability to withstand potential losses; and
- Any additional information that may be relevant.

- The swap dealer would be able to rely on written representations of the Special Entity to satisfy the "reasonable efforts" requirement, so long as the swap dealer has a reasonable basis to believe that the representations are reliable and the representations are sufficiently detailed for the swap dealer to reasonably conclude that the Special Entity (i) is capable of evaluating independently the risks of the recommendation, (ii) is exercising independent judgment, and (iii) is capable of absorbing potential losses. The swap dealer must also have a reasonable basis to believe that the Special Entity is represented by a qualified independent representative.
- In what can only be described as *Alice in Wonderland* -like reasoning, the CFTC noted that while the swap dealer could rely on written representations to meet its requirement to "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 swap dealer is in the best interests of the Special Entity," the swap dealer could *not* rely on such representations to meet its duty to "to act in the best interests of the Special Entity."[22]

[21] The requirements for independent representatives are set forth in section 23.450(b) ("Requirements for swap dealers and major swap participants acting as counterparties to special entities.").

[22] Business Conduct Proposal at 80651.

III. **Prohibition on Political Contributions by Certain Swap Dealers**.

In addition to requiring a swap dealer to ensure that the independent representative of a municipal entity is subject to restrictions on certain pay-to-play rules, the Business Conduct Proposal also prohibits a swap dealer from entering into swaps with "municipal entities"[23] if the swap dealer makes certain political contributions to officials of such entities. This "pay to play" rule is closely analogous to the one adopted by the SEC under the Investment Advisers Act of 1940.[24]

1. Prohibitions. The Business Conduct Proposal would make it unlawful for a swap dealer to:

- Enter into or offer to enter into a swap with a municipal entity for a two-year period after the swap dealer or a covered associate makes a contribution to an official of the municipal entity.
    - Covered associates would include certain officers and employees of the swap dealer who are either general partners, managing members or executive officers, or employees who solicit municipal entities on behalf of swap dealers and any persons who supervise them. However, the prohibition would not apply to contributions by an individual made more than six months prior to becoming a covered associate of the swap dealer, unless such individual solicits the municipal entity after becoming a covered associate.
- Pay a third party who is not a "regulated person" to solicit municipal entities to enter into a swap.
- Solicit or coordinate contributions to officials of a municipal entity with which the swap dealer is seeking to enter into or has entered into a swap, or payments to a political party of a state or locality with which the swap dealer is seeking to enter or has entered into a swap.

2. De Minimis Exception. The prohibition would not be trigged 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.

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[23] A "municipal entity" is defined to include any State, political subdivision of a State, or municipal corporate instrumentality of a State, including a plan or pool of assets sponsored or established by the State, political subdivision, or municipal corporate instrumentality or any agency, authority, or instrumentality thereof, and any issuer of municipal securities. Proposal at 80654.

[24] *See* Political Contributions by Certain Investment Advisers, 75 Fed. Reg. 41018 (July 14, 2010).

3. Exemptions. The Business Conduct Proposal would provide exemptions for certain contributions by covered associates within the $350/$150 limit that are discovered by the swap dealer within four months of the date of contribution and returned to the contributor within 60 days of the date of discovery. Swap dealers would also be able to apply to the CFTC for individual exemptions from the two-year ban.

IV. **Swaps Traded on DCMs and SEFs**.

1. Exceptions. For swaps traded on a DCM or SEF, the Business Conduct Proposal would provide exceptions to application of the requirements to verify counterparty eligibility and to disclose material information, as well as the requirements applicable to swap dealers that are counterparties to Special Entities.[25] These exceptions would not, however, apply to swaps executed bilaterally on a platform that is not a SEF or DCM, nor would they, as currently drafted in the Business Conduct Proposal, cover request for quote systems (potentially including SEFs) where the swap dealer learns the counterparty's identity only immediately before execution of the swap. Absent these clarifications, the Business Conduct Proposal would effectively prohibit execution of swaps on those platforms or systems.

2. Execution Standards. The Business Conduct Proposal would require swap dealers and other CFTC registrants to execute a swap, if available for trading on a DCM or SEF, on terms that have a "reasonable relationship" to the best terms available. The registrant would also be required to disclose the DCMs and SEFs on which the swap is available for trading and on which markets the swap dealer has trading privileges.

- For the terms to have a reasonable relationship to the best terms available, the terms must be fair and not excessive in light of all relevant circumstances.

- To satisfy this "reasonable relationship" test, registrants would have a duty to exercise reasonable diligence to ascertain which DCM or SEF offers the best terms available for the transaction, including even those markets in which the dealer does not have trading privileges. However, it is unclear how extensive such a survey of DCMs and SEFs must be. For less standard swaps, it may also be difficult to compare the offered terms to the terms of other swaps and it may be difficult to determine "the best terms available" for that particular swap. Moreover, the Business Conduct Proposal does not specify how "reasonably" the offered terms must relate to the best terms available, and this could cause considerable uncertainty for swap dealers attempting to comply with this rule.

[25] In what is perhaps an error, the exception from the obligation to verify counterparty eligibility would not cover swaps traded on a DCM.

- Additionally, the CFTC does not specify whether a registrant that properly surveys DCMs and SEFs will be deemed to have discharged its execution obligation, or whether there are other "relevant circumstances" that must be evaluated and, if so, which circumstances will be deemed relevant. For instance, would a swap dealer's cost of hedging or cost of funds be relevant? This ambiguity is especially likely to be problematic for transactions that are more bespoke and where the terms of transactions available on DCMs and SEFs are not representative.

- The Business Conduct Proposal does not appear to permit a swap dealer to take into account its own appetite for assuming the relevant risk or the relative profitability of other alternatives for the utilization of credit capacity in the case of bilateral swaps when determining the price at which it is willing to enter into a swap.

V. **Liability**.

The vague standards contained throughout the Business Conduct Proposal would expose swap dealers to possible enforcement actions by the CFTC (and potentially the NFA) under circumstances where innocent mistakes or unintentional errors are deemed, in hindsight, to have violated those standards based on interpretations not reasonably foreseeable. Even more troublingly, other provisions of the CEA, as modified by Dodd-Frank, would expose swap dealers to substantial private liability to counterparties for similar conduct.

1. Private Rights of Action. Section 22(b) of the CEA gives participants a private right of action against a registered entity, such as a swap dealer, if the entity fails to enforce any bylaw, rule, regulation, or resolution it is required to enforce or if the entity violates any CFTC rule. In order to recover, a participant must establish that the registered entity acted in bad faith in failing to take action or in violating a rule and that the failure or violation caused the loss. A private right of action can also be maintained against an individual associated with a registered entity, if the individual willfully fails to enforce a required regulation or violates a CFTC rule.

2. Rescission. Dodd-Frank amended Section 22(a) of the CEA to carve back existing limitations on the ability for an ECP to rescind swap transactions and so, as a result, an ECP that is a swap counterparty to a swap dealer could attempt to rescind the swap on the basis of an alleged violation of the business conduct requirements.

VI. **Key Concerns and Open Questions**.

The Business Conduct Proposal raises a number of serious concerns about the legal and administrative feasibility of future swap transactions between swap dealers and ERISA Plans. With respect to all transactions with swap dealers, the Business Conduct Proposal

leaves open numerous questions about the responsibilities of the parties and the allocation of liability when errors occur. That uncertainty, in combination with private rights of action and rescission rights, is likely to chill swap market activity.

- **Dramatic Increase in Required Disclosure, Recordkeeping, and Time Required to Execute a Swap Transaction**. The Business Conduct Proposal requires (i) counterparties to provide to swap dealers extensive representations about the counterparty and its representative and (ii) swap dealers to provide to counterparties detailed disclosure about the swap transaction that is tailored to the characteristics of the counterparties. To comply with such requirements, each party will have to expend significant time and effort, which will delay the consummation of swap transactions.

- **Treatment of Swap Dealer as an ERISA Fiduciary**. The Business Conduct Proposal requires swap dealers to provide the kind of advice that could cause such swap dealers to be treated as ERISA fiduciaries under the DOL Proposal. Of particular concern are the requirements for swap dealers to:

    - Provide scenario analyses;

    - Conduct suitability analyses; and

    - Act in best interests of a Special Entity.

  In order to avoid the disruption of all swap transactions between swap dealers and Special Entities, the DOL should, at a minimum, confirm that compliance with the Business Conduct Proposal in and of itself will not make swap dealers into ERISA fiduciaries. However, even if the DOL confirms that the swap dealer is not a fiduciary under ERISA, there is still a question of whether common law fiduciary duties would attach to non-ERISA counterparties.

- **Swap Dealer's Obligation to Second Guess the Relationship between the Counterparty and the Representative**. Under the Business Conduct Proposal, a swap dealer that is a counterparty to a Special Entity will have to assess the qualifications of the Special Entity's representative as well as the quality of the relationship between the Special Entity and the representative. This duty will impede the prerogative of the Special Entity to choose its advisers without being second-guessed by the swap dealer.

- **Unnecessary New Standard of Independence**. The new independence criteria for qualified representatives creates yet another distinct test of independence, even though there are several other well-established independence tests (such as the QPAM test under ERISA or the affiliate definition under the Securities Act of 1933) already used by market participants. By creating yet another test, the

CFTC only increases the administrative burden of the Business Conduct Proposal without any corresponding benefit.

- **Lack of Clear Guidance on the Prohibition of Front Running**. The Business Conduct Proposal does not appear to carve out trades that may be unrelated to the swap and has no exception for liquid markets or hedging.

- **Possible Further Expansion of the Business Conduct Proposal**. In several cases, the CFTC indicated that it is considering additional ill-advised requirements for swap dealers. In particular, it requested comments on whether swap dealers should be subject to fiduciary duties,[26] whether they should be required to disclose profits,[27] and whether they should have to notify a counterparty of pre-existing positions in a type of swap prior to entering into the same type of swap with the counterparty.[28]

- **Relationship between Parties**. While Dodd-Frank and the CFTC's Business Conduct Proposal require swap dealers to clarify the relationship between the parties, the Business Conduct Proposal consistently muddies the character of that relationship and encourages dependencies on the part of counterparties that are not conducive either to clarity of relationships and responsibilities or to encouraging prudent and independent decision-making by market participants generally.

VII. Next Steps to Consider.

Swap dealers should review the Business Conduct Proposal to determine its potential effects on their business and clients. ERISA Plan sponsors should review the Business Conduct Proposal to determine whether it would significantly impede the ability of counterparties to enter into swaps with ERISA Plans or significantly increase the cost to ERISA Plans of such swap transactions. ERISA Plan sponsors and swap dealers should discuss the proposed changes and contact industry trade associations to ensure that any concerns are adequately expressed to the CFTC.

Swap dealers and ERISA Plan sponsors also should start to sketch out the changes to their businesses that would be required should the Business Conduct Proposal be adopted in its current form. For many swap dealers, such changes would be very significant and would require long lead times to implement.

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[26] Business Conduct Proposal at 80648, 80651.

[27] Business Conduct Proposal at 80651.

[28] Business Conduct Proposal at 80647.

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.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

Appendix A

Variation in Required Conduct for Swap Dealers

Base Requirements | **Additional Requirements**

Counterparty	**Recommendations to any Counterparty**	**Counterparty is a Special Entity**	**Advisor to a Special Entity**
▪ Prohibition on trading ahead of and front running the counterparty. ▪ General requirements to "know your customer," disclose material information about the swap, and, for certain swaps, to provide scenario analyses and daily marks. ▪ Requirement to protect confidential counterparty information and comply with certain fair dealing and execution standards.	▪ Recommendations must be "suitable" to the counterparty's particular needs and financial condition. ▪ The suitability requirement would be met if the counterparty (or its advisor) indicates that it is exercising independent judgment and the swap dealer has a reasonable basis to believe that (i) the counterparty has the capacity to absorb potential losses and (ii) the counterparty (or its advisor) is capable of evaluating the risks.	▪ A swap dealer must have a reasonable basis to believe that the Special Entity has a qualified independent representative. ▪ A swap dealer must disclose to the Special Entity the capacity in which it is acting in connection with the swap.	▪ A swap dealer would be required to act in the "best interests" of the Special Entity and to undertake "reasonable efforts" to obtain information necessary to determine that a recommended swap is in the best interests of the Special Entity.

Counterparty may or may not be a Special Entity | **Counterparty is a Special Entity**

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Federal Register

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Part III

Commodity Futures Trading Commission

17 CFR Parts 23 and 155
Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties; Proposed Rule

COMMODITY FUTURES TRADING COMMISSION

17 CFR Parts 23 and 155

RIN 3038–AD25

Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties

AGENCY: Commodity Futures Trading Commission.

ACTION: Proposed rules.

SUMMARY: The Commodity Futures Trading Commission ("Commission" or "CFTC") is proposing for comment new rules under Section 4s(h) of the Commodity Exchange Act ("CEA") to implement provisions of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act") relating generally to external business conduct standards for swap dealers and major swap participants.

DATES: Written comments must be received on or before February 22, 2011.

ADDRESSES: You may submit comments, identified by RIN number 3038–AD25, by any of the following methods:

• *Agency Web site, via its Comments Online process: http://comments.cftc.gov/.* Follow the instructions for submitting comments through the Web site.

• *Mail:* David A. Stawick, Secretary of the Commission, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581.

• *Hand Delivery/Courier:* Same as mail above.

• *Federal eRulemaking Portal: http://www.regulations.gov.* Follow the instructions for submitting comments.

Please submit your comments using only one method.

All comments must be submitted in English, or if not, accompanied by an English translation. Comments will be posted as received to *http://www.cftc.gov.* You should submit only information that you wish to make available publicly. If you wish the Commission to consider information that you believe is exempt from disclosure under the Freedom of Information Act, a petition for confidential treatment of the exempt information may be submitted according to the procedures established in § 145.9 of the Commission's Regulations.[1]

The Commission reserves the right, but shall have no obligation, to review, pre-screen, filter, redact, refuse or remove any or all of your submission from *http://www.cftc.gov* that it may deem to be inappropriate for publication, such as obscene language. All submissions that have been redacted or removed that contain comments on the merits of the rulemaking will be retained in the public comment file and will be considered as required under the Administrative Procedure Act and other applicable laws, and may be accessible under the Freedom of Information Act.

FOR FURTHER INFORMATION CONTACT: Phyllis J. Cela, Deputy Director and Chief Counsel, Division of Enforcement, or Peter Sanchez, Special Counsel, Division of Clearing and Intermediary Oversight, Commodity Futures Trading Commission, 1155 21st Street, NW., Washington, DC 20581. Telephone number: (202) 418–7642.

SUPPLEMENTARY INFORMATION: The Commission is proposing §§ 23.400–402, 23.410, 23.430–434, 23.440, 23.450–451, and 155.7 under Section 4s(h) of the CEA. The Commission is soliciting comments on all aspects of the proposed rules and will carefully consider any comments received.

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I. Introduction

On July 21, 2010, President Obama signed the Dodd-Frank Act.[3] Title VII of the Dodd-Frank Act amended the CEA[4] to establish a comprehensive new regulatory framework for swaps and certain security-based swaps. The legislation was enacted to reduce risk, increase transparency, and promote

[1] 17 CFR 145.9.

[2] The proposed swap execution standards § 155.7 would apply to any Commission registrant, including a swap dealer or major swap participant, handling an order for a swap that is available for trading on a designated contract market or a swap execution facility.

[3] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010) ("Dodd-Frank Act"). The text of the Dodd-Frank Act may be accessed at *http://www.cftc.gov/LawRegulation/OTCDERIVATIVES/index.htm.*

[4] 7 U.S.C. 1 *et seq.,* as amended by the Dodd-Frank Act. All references to the CEA are to the CEA as amended by the Dodd-Frank Act.

market integrity within the financial system by, among other things: (1) Providing for the registration and comprehensive regulation of swap dealers and major swap participants; (2) imposing clearing and trade execution requirements on standardized derivative products; (3) creating robust recordkeeping and real-time reporting regimes; and (4) enhancing the Commission's rulemaking and enforcement authorities with respect to, among others, all registered entities and intermediaries subject to the Commission's oversight.

Section 731 of the Dodd-Frank Act amends the CEA by adding Section 4s(h). This section provides the Commission with both mandatory and discretionary rulemaking authority to impose business conduct requirements on swap dealers and major swap participants in their dealings with counterparties, including "Special Entities." [5] Such entities are generally defined to include Federal agencies, States and political subdivisions, employee benefit plans as defined under the Employee Retirement Income Security Act of 1974 ("ERISA"), governmental plans as defined under ERISA, and endowments. Congress granted the Commission broad discretionary authority to promulgate business conduct requirements, as appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the CEA.[6]

A. Business Conduct Standards—Dealing With Counterparties Generally

Section 4s(h)(1) grants the Commission authority to promulgate rules applicable to swap dealers and major swap participants related to, among other things: Fraud, manipulation and abusive practices involving swaps; diligent supervision; [7] and adherence to position limits.[8] The proposed rules incorporate the anti-fraud provision for swap dealers and major swap participants contained in Section 4s(h)(4), and also would prohibit swap dealers and major swap participants from disclosing confidential counterparty information, or front running or trading ahead of counterparty transactions. The Commission also proposes to adopt certain counterparty-specific supervisory and compliance duties including a "know your counterparty" requirement and policies and procedures to enforce these business conduct rules and to prevent evasion of the requirements of the CEA and Commission Regulations.[9]

Section 4s(h)(3) directs the Commission to promulgate rules that would require swap dealers and major swap participants to: Verify the eligibility of their counterparties; disclose to their counterparties material information about swaps, including material risks, characteristics, incentives and conflicts of interest; and provide counterparties with information concerning the daily mark for swaps. The Commission also is directed to establish a duty for swap dealers and major swap participants to communicate in a fair and balanced manner based on principles of fair dealing and good faith.

In addition, using its discretionary authority under 4s(h)(3)(D), the Commission is proposing to require that swap dealers and major swap participants comply with certain disclosure requirements based on certain clearing provisions of the Dodd-Frank Act and the CEA.[10]

The Commission proposes to use its rulemaking authority under Section 4s(h) to promulgate several requirements adapted from analogous standards and practices applicable to certain financial market professionals. In drafting the proposed rules, the Commission considered existing requirements for market intermediaries under the CEA, Commission Regulations and the Federal securities laws, as well as self-regulatory organization ("SRO") rules.[11] The Commission also considered standards adopted by prudential regulators, industry recommendations concerning "best practices" and requirements applicable under foreign regulatory regimes.[12] To the extent practicable, the Commission has modeled the proposed rules on these existing rules and standards. Among the proposed requirements that are based on these analogous rules and standards are: An institutional suitability requirement for swap dealers and major swap participants when making recommendations to counterparties; swap execution standards that would apply to all Commission registrants, including swap dealers, for swaps available for trading on a designated contract market ("DCM") or swap execution facility ("SEF"); and, as part of a swap dealer's or major swap participant's duty to disclose the material risks and characteristics of the swap, a duty to provide a scenario analysis of potential exposure for high-risk complex bilateral swaps, and on an "opt-in" basis scenario analysis for bilateral swaps not available for trading on a DCM or SEF.[13] The Commission also is proposing that both swap dealers and independent representatives of Special Entities, including those that are registered with the Commission as

[5] Congress enacted a virtually identical provision in Dodd-Frank Act Section 764 which adds Section 15F(h) to the Securities Exchange Act of 1934 ("Exchange Act") (15 U.S.C. 78a *et seq.*). All references to the Exchange Act are to the Exchange Act, as amended by the Dodd-Frank Act. Section 712(a)(1) of the Dodd-Frank Act requires that the Commission consult with the Securities and Exchange Commission and prudential regulators in promulgating rules pursuant to Section 4s(h).

[6] *See* Section 4s(h)(3)(D) ("Business conduct requirements adopted by the Commission shall establish such other standards and requirements as the Commission may determine are appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this Act"); *see also* Sections 4s(h)(1)(D), 4s(h)(5)(B) and 4s(h)(6).

[7] *See also* Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants, 75 FR 71397, Nov. 23, 2010 (proposed § 23.602 imposing additional diligent supervision requirements on swap dealers and major swap participants).

[8] *Id.* (proposed § 23.601 imposing requirements for swap dealers and major swap participants related to monitoring position limits).

[9] Dodd-Frank Act Sections 722(d) (amending CEA Section 2(i)), 723(a)(3) (amending CEA Sections 2(h)(4)(A) and 2(h)(7)(F)) and 741(b)(11) (amending CEA Section 6(e)) amend the CEA by prohibiting a swap dealer or major swap participant from "knowingly or recklessly" evading certain provisions of the CEA.

[10] *See* Sections 2(h)(7)(A) and (B) of the CEA.

[11] In this regard, the Commission has looked to the requirements imposed by the National Futures Association ("NFA"), CME Group, Inc. ("CME"), IntercontinentalExchange, Inc. ("ICE"), Financial Industry Regulatory Authority, Inc. ("FINRA") and the Municipal Securities Rulemaking Board ("MSRB"). SRO rules, in particular, provide a useful model because historically the Commission has relied on SROs to regulate conduct that is unethical or otherwise undesirable, but may not be fraudulent. *See, e.g.,* NFA Compliance Rule 2–4, Just and Equitable Principles of Trade.

[12] *See, e.g.,* International Organization of Securities Commissions, "Operational and Financial Risk Management Control Mechanisms for Over-the-Counter Derivatives Activities of Regulated Securities Firms" (Jul. 1994); Derivatives Policy Group, "Framework for Voluntary Oversight" (Mar. 1995) ("DPG Framework"), available at *http://www.riskinstitute.ch/137790.htm;* The Counterparty Risk Management Policy Group, "Improving Counterparty Risk Management Practices" (June 1999) (CRMPG is composed of OTC derivatives dealers including Bank of America, BNP Paribas, Citigroup, Goldman Sachs, HSBC, JP Morgan and Morgan Stanley); The Counterparty Risk Management Policy Group, "Toward Greater Financial Stability: A Private Sector Perspective—The Report of the Counterparty Risk Management Policy Group II" (Jul. 27, 2005); The Counterparty Risk Management Policy Group, "Containing Systemic Risk: The Road to Reform, The Report of the CRMPG III (Aug. 6, 2008) ("CRMPG III Report"), available at *http://www.crmpolicygroup.org/.*

[13] The CRMPG III Report identifies the characteristics of high-risk complex bilateral swaps to be: The degree and nature of leverage, the potential for periods of significantly reduced liquidity, and the lack of price transparency. The CRMPG III Report, at 54–57.

commodity trading advisors ("CTAs"), be subject to certain restrictions with respect to political contributions to certain governmental Special Entities ("pay-to-play").

B. Business Conduct Standards—Dealing With Counterparties That Are Special Entities

Section 4s(h)(4) requires that a swap dealer who "acts as an advisor to a Special Entity" 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. The Commission proposes to incorporate the statutory text in a proposed rule and to specify that certain swaps-related conduct would be included within the meaning of the term "act as an advisor to a Special Entity."

Section 4s(h)(5) authorizes the Commission to establish duties for swap dealers and major swap participants that offer swaps or enter into swaps with Special Entities, including requiring a swap dealer or major swap participant to have a reasonable basis to believe that the Special Entity has a representative, independent of the swap dealer or major swap participant, that meets certain criteria, including having sufficient knowledge to evaluate the transaction and risks, undertaking a duty to act in the "best interests" of the Special Entity, and being subject to pay-to-play restrictions. The statute requires swap dealers and major swap participants to disclose in writing the capacity in which they are acting before initiating a transaction with a Special Entity. The Commission is proposing to establish the duties described in Section 4s(h)(5) for swap dealers and major swap participants dealing with all categories of Special Entities.

The Dodd-Frank Act requires the Commission to promulgate the mandatory rules by July 15, 2011.[14] The Commission requests comment on all aspects of the proposed rules, as well as comment on the specific provisions and issues highlighted in the discussion below.

C. Consultations With Stakeholders

Commission staff held more than two dozen external consultations [15] with stakeholders representing a broad spectrum of views on business conduct standards.[16] Commission staff conducted many of these consultations jointly with Securities and Exchange Commission ("SEC") staff. The consultations included discussions of the general nature of counterparty relationships today, counterparty practices unique to different types of swaps and asset classes, and interpretive recommendations concerning certain provisions of Section 4s(h).

D. Consultation and Coordination With the SEC, Prudential Regulators and Other Domestic and Foreign Regulatory Authorities

In compliance with Sections 712(a)(1) and 752(a) [17] of the Dodd-Frank Act, Commission staff has consulted and coordinated with the SEC, prudential regulators and foreign authorities. Commission staff has worked closely with SEC staff in the development of the proposed rules. The Commission's objective was to establish consistent requirements for CFTC and SEC registrants to the extent practicable given the differences in existing regulatory regimes and approaches. With respect to the prudential regulators, Commission staff consulted and considered certain existing business conduct standards that apply to banks. Commission staff also consulted informally with staff from the Department of Labor ("DOL") and the Internal Revenue Service with respect to certain Special Entity definitions and the intersection of their regulatory requirements with the Dodd-Frank Act business conduct provisions.

In addition, Commission staff consulted with foreign authorities, specifically, European Commission and United Kingdom Financial Services Authority staff. Staff also considered the existing and ongoing work of the International Organization of Securities Commissions ("IOSCO"). Staff consultations with foreign authorities revealed many similarities in the proposed rules and foreign regulatory requirements.[18]

II. Proposed Rules for Swap Dealers and Major Swap Participants Dealing With Counterparties

The proposed business conduct rules dealing with counterparty relationships are contained in subpart H of new part 23 of the Commission's regulations.[19] While the CEA and other provisions of the Commission's rules will govern swap transactions and the business of swap dealers and major swap participants, subpart H will contain the principal regulations governing sales practices and counterparty relationships. A section-by-section description of the proposed rules follows.

A. Proposed §§ 23.400, 23.401 and 23.402—Scope, Definitions and General Provisions

These proposed rules set out the scope, definitions and general provisions that apply, as appropriate, to subpart H of new part 23 of the Commission's regulations. The "scope" provision, under proposed § 23.400, states that the rules in subpart H apply to swap dealers and major swap participants and that the rules do not limit the applicability of other provisions of the CEA, Commission Regulations or other laws.[20] So, for example, in addition to the anti-fraud provision that would apply only to swap dealers and major swap participants in proposed § 23.410, swap dealers and major swap participants will be subject to all other applicable anti-fraud provisions in the CEA and

[14] *See* Dodd-Frank Act Sections 712 and 754.

[15] A list of Commission staff consultations in connection with this proposed rulemaking is posted on the Commission's Web site, available at *http://www.cftc.gov/LawRegulation/DoddFrankAct/ExternalMeetings/index.htm.*

[16] The Commission received several written submissions from the public including: National Futures Association, Aug. 25, 2010 ("NFA Letter"); Swap Financial Group, Aug. 9, 2010 ("SFG Letter"); Swap Financial Group, "Briefing for SEC/CFTC Joint Working Group" Aug. 9, 2010 ("SFG Presentation"); Christopher Klem, Ropes & Gray LLP, Sept. 2, 2010 ("Ropes & Gray Letter"); American Benefits Council, Sept. 8, 2010 ("ABC Letter"); American Benefits Council and the Committee on Investment of Employee Benefit Assets, Oct. 19, 2010 ("ABC/CIEBA Letter"); and Securities Industry and Financial Markets Association and International Swaps and Derivatives Association, Oct. 22, 2010 ("SIFMA/ISDA Letter"), available at *http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/OTC_3_BusConductStandardsCP.html.*

[17] Dodd-Frank Act Section 752(a) states in part, "the Commodity Futures Trading Commission, the Securities and Exchange Commission, and the prudential regulators (as that term is defined in section 1a(39) of the [CEA]), as appropriate, shall consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards with respect to the regulation (including fees) of swaps * * *."

[18] *See generally* European Union Markets in Financial Instruments Directive ("MiFID"), Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments, available at *http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2004L0039:20070921:EN:PDF;* European Union Market Abuse Directive ("Market Abuse Directive"), Directive 2006/6/EC of the European Parliament and of the Council of 28 January 2003 on market abuse, available at *http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2003:096:0016:0016:EN:PDF.*

[19] The proposed swap execution § 155.7 would be promulgated in part 155. All the other proposed rules would appear in subpart H of new part 23.

[20] In addition to its obligations under the proposed rules, to the extent a swap dealer or major swap participant is required to be a member of a registered futures association it would be required to comply as well with the business conduct and other requirements of NFA and any other applicable SROs.

Commission Regulations, as appropriate.[21] The scope section also provides that, where appropriate, the rules also apply to swaps offered but not entered into. For example, the fair and balanced communications and fair dealing requirements in proposed § 23.433 apply to swap dealers and major swap participants with respect to both counterparties and prospective counterparties.

The proposed rules under subpart H will have most applicability when swap dealers and major swap participants have a pre-trade relationship with their counterparty, where that relationship includes discussions and negotiations that would allow a swap dealer or major swap participant to make appropriate disclosures and conduct due diligence. Indeed, when a swap is initiated on a DCM or SEF and the swap dealer or major swap participant does not know the counterparty's identity prior to execution, disclosure and due diligence obligations, such as the duties to verify counterparty eligibility under proposed § 23.430, to disclose material information under proposed § 23.431, and the duty to verify that a Special Entity has a qualified representative under proposed § 23.450, would not apply because there would be no basis on which to make those disclosures or opportunity to engage in discussions. However, when a swap dealer or major swap participant does not know the counterparty's identity pre-execution, but does become aware of the counterparty's identity post-execution of a bilateral swap, the swap dealer or major swap participant would still have certain specific duties such as the one to provide a daily mark in proposed § 23.431(c)(2), (3).

The Commission also proposes to define several terms for purposes of subpart H in proposed § 23.401. The term "counterparty" would include "prospective counterparty" as appropriate in the rules. The terms swap dealer and major swap participant would include anyone acting for or on behalf of such persons, including associated persons as defined in Section 1a(4) of the CEA. Proposed § 23.401 adopts the definition of Special Entity in Section 4s(h)(2). Additional terms are defined in the proposed rules relating to Special Entities.

The "general provisions" for subpart H that are specified in proposed § 23.402 include a requirement that swap dealers and major swap participants have policies and procedures reasonably designed to ensure compliance with the business conduct rules in subpart H and, in particular, to prevent a swap dealer or major swap participant from evading any provision of the CEA or Commission Regulations. For example, for a swap that is subject to mandatory clearing, a swap dealer or major swap participant should only be offering to enter into such a swap on an uncleared basis with a counterparty who has qualified for a valid end-user exception to the mandatory clearing of swaps.[22] The Commission expects that these policies and procedures would be part of a swap dealer's or major swap participant's overall system of supervision, compliance and risk management.[23]

Section 4s(h)(1)(B) gives the Commission the authority to prescribe rules relating to diligent supervision by swap dealers and major swap participants. In a separate release containing internal business conduct rules, the Commission has proposed comprehensive supervision and risk management program duties on swap dealers and major swap participants contained in new subpart J of part 23 of the Commission's Regulations.[24] Proposed § 23.402(b) would require swap dealers and major swap participants to diligently supervise their dealings with counterparties as required under subpart H in accordance with the diligent supervision requirements of subpart J.

Proposed § 23.402(c) would establish a "know your counterparty" requirement on swap dealers and major swap participants.[25] The proposed requirement would include the use of reasonable due diligence to know and retain a record of the essential facts concerning the counterparty, including information necessary to comply with the law, to service the counterparty, to implement a counterparty's special instructions, and to evaluate the counterparty's swaps experience and objectives. The proposed rule also would assist swap dealers and major swap participants in avoiding violations of Section 4c(a)(7) of the CEA which makes it "unlawful for any person to enter into a swap knowing, or acting in reckless disregard of the fact, that its counterparty will use the swap as part of a device, scheme, or artifice to defraud any third party."

Proposed § 23.402(d) would require swap dealers and major swap participants to keep a record showing the true name and address of each counterparty, as well as a counterparty's address and the same information for any other person guaranteeing the counterparty's performance or controlling the counterparty's positions. This proposed rule is based on existing § 1.37(a)(1) [26] of the Commission's Regulations which applies to futures commission merchants, introducing brokers and members of a designated contract market.

Another general provision, under proposed § 23.402(e), states that swap dealers and major swap participants that seek to rely on the representations of their counterparties to satisfy any requirements in the proposed rules must have a reasonable basis to believe that the representations are reliable under the circumstances. In addition, the representations must be sufficiently detailed to enable the swap dealer or major swap participant to reasonably conclude that the particular requirement is satisfied. Proposed § 23.402(e) would allow the parties to a swap to agree that such representations can be included in a master agreement [27] or other written agreement between the parties and that the representations can be deemed applicable or renewed, as appropriate, to subsequent swaps between the parties. For example, particular counterparty representations about its sophistication or financial wherewithal relevant to the institutional suitability obligation imposed on swap dealers and major swap participants in proposed § 23.434 may be contained in a master agreement, if agreed by the parties, and may be applied to subsequent swaps between the parties if the representations continue to be accurate

[21] *See, e.g.,* Section 4b of the CEA.

[22] Separately, the Commission is proposing rules detailing when a counterparty may elect to use the exception to mandatory clearing under section 2(h)(7)(A)(iii) of the CEA.

[23] Separately, the Commission is proposing rules detailing the supervision, compliance and risk management obligations for swap dealers and major swap participants. *See* 75 FR 71397, Nov. 23, 2010.

[24] *See* proposed §§ 23.600 and 23.602, 75 FR 71397, Nov. 23, 2010.

[25] This rule is based in part on NFA Compliance Rule 2–30, Customer Information and Risk Disclosure, which NFA has interpreted to impose "know your customer" duties, and has been a key component of NFA's customer protection regime. *See* NFA Interpretive Notice 9013.

[26] 17 CFR 1.37(a)(1).

[27] The Commission understands that swaps are generally governed by a master agreement and confirmation setting forth the relationship of the counterparties and the particulars of the transaction. Master agreements, which have typically been standard form agreements prepared by industry associations like the International Swaps and Derivatives Association ("ISDA"), include basic representations and covenants that are subject to negotiation by the parties and are supplemented with modifications to account for their specific interests. Master agreements contain terms that govern all succeeding swaps between the counterparties, and generally include provisions applicable to all swaps including: Payment netting, events of default, cross-default provisions, early termination events and closeout netting.

and relevant with respect to the subsequent swaps.

Proposed § 23.402(f) would provide flexibility to swap dealers, major swap participants and their counterparties to agree to a reliable means for making disclosures of material information. Furthermore, proposed § 23.402(g) would also allow swap dealers and major swap participants to use, where appropriate, standardized formats to make certain required disclosures of material information to their counterparties, and to include such standardized disclosures in a master or other written agreement between the parties, if agreed to by the parties. While standardized disclosures may be appropriate to meet certain disclosure obligations relating to the risks, characteristics, incentives and conflicts of interest related to a particular swap, it is unlikely that they would be adequate to meet all such disclosure duties. Swap dealers and major swap participants are cautioned to consider their disclosure obligations under the CEA and proposed rules with respect to each swap that they offer or enter into with a counterparty.

Finally, proposed § 23.402(h) would require swap dealers and major swap participants to create and retain a written record of their compliance with the requirements in subpart H. Such requirements would be part of the overall recordkeeping obligations imposed on swap dealers and major swap participants in the CEA and part 23 supbart F of the Commission's Regulations, would be maintained in accordance with § 1.31 [28] of the Commission's Regulations, and would be accessible to applicable prudential regulators.

Request for Comment: The Commission requests comment generally on all of the proposed rules regarding scope, general provisions and definitions, and specifically on the following specific issues:

- Should the Commission adopt any of the guidance from SRO rules relating to know your customer requirements? Is other guidance necessary in this area?
- Are there additional terms that should be defined by the Commission? If so, how should such terms be defined and why?
- Do any proposed requirements conflict with any requirement imposed by an SRO such that it would be impracticable or impossible for a swap dealer or major swap participant that is a member of an SRO to meet both obligations? If so, which ones and why?
- Should the Commission specify any particular restrictions or prohibitions to further protect against evasion?

B. Proposed § 23.410—Prohibition on Fraud, Manipulation and Other Abusive Practices

Section 4s(h)(1) grants the Commission discretionary authority to promulgate rules applicable to swap dealers and major swap participants related to, among other things: Fraud, manipulation and abusive practices.[29] To implement this provision the Commission proposes to adopt the anti-fraud provision in Section 4s(h)(4)(A) as § 23.410, which prohibits fraudulent, deceptive and manipulative practices by swap dealers and major swap participants.[30] While the heading of Section 4s(h)(4) states "Special Requirements for Swap Dealers Acting as Advisors," the anti-fraud provision that follows in Section 4s(h)(4)(A) is not so limited. The proposed rule follows the statutory text and applies to swap dealers and major swap participants acting in any capacity, *e.g.,* as an advisor, counterparty or other market participant in relation to counterparties generally. The first two paragraphs of the rule focus on Special Entities and prohibit swap dealers and major swap participants from (1) employing any device, scheme or artifice to defraud any Special Entity; and (2) engaging in any transaction, practice, or course of business that operates as a fraud or deceit on any Special Entity. The third paragraph is not limited to Special Entities and prohibits swap dealers and major swap participants from engaging in any act, practice, or course of business that is fraudulent, deceptive or manipulative.[31]

The Commission also proposes §§ 23.410(b) and 23.410(c), which would prohibit swap dealers and major swap participants from disclosing confidential counterparty information and front running or trading ahead of counterparty swap transactions.[32] These rules are based on trading standards applicable to futures commission merchants and introducing brokers that prohibit trading ahead of a customer and protect the confidentiality of customer orders.[33] Such abuses are considered fraudulent practices.[34] Viewed together, proposed §§ 23. 410(b) and 23.410(c) build on the code of ethics requirements and informational barriers in proposed subpart J which add substantial protections for counterparties from abuse of their confidential information and business opportunities.

Request for Comment: The Commission requests comment generally on all of the proposed rules regarding fraud, manipulation, and abusive practices, and on the following specific issues:

- Should a swap dealer or major swap participant be required to disclose to a counterparty its pre-existing positions in a type of swap prior to entering into the same type of swap with the counterparty?
- Should the prohibitions on trading ahead of a counterparty transaction and disclosure of confidential counterparty information be limited in any way not already provided in the proposed rule? For example, if a counterparty discusses a potential swap but does not immediately enter into it with the swap

[28] 17 CFR 1.31.

[29] On October 26, 2010, the Commission proposed rules to implement new anti-manipulation authority in Section 753 of the Dodd-Frank Act. The proposed rules expand and codify the Commission's authority to prohibit manipulation. 75 FR 67657, Nov. 3, 2010. The same day, the Commission issued an advance notice of proposed rulemaking seeking comment on Section 747 of the Dodd-Frank Act, which amends Section 4c(a) of the CEA to expressly prohibit certain trading practices deemed disruptive of fair and equitable trading. 75 FR 67301, Nov. 2, 2010.

[30] In addition to the proposed anti-fraud rule, swap dealers and major swap participants will be subject to all other applicable provisions of the CEA and Commission Regulations, including those dealing with fraud and manipulation (*e.g.,* Sections 4b, 6(c)(1), (3) and 9(a)(2) of the CEA).

[31] This language mirrors the language in Section 206(4) of the Investment Advisers Act of 1940 ("Advisers Act") (15 U.S.C. 80b–1 *et seq.*), which does not require scienter to prove liability. *See SEC* v. *Steadman,* 967 F.2d 636, 647 (D.C. Cir. 1992) ("[S]ection 206(4) uses the more neutral 'act, practice, or course or business' language. This is similar to section 17(a)(3)'s 'transaction, practice, or course of business,' which 'quite plainly focuses upon the effect of particular conduct * * * rather than upon the culpability of the person responsible.' Accordingly, scienter is not required under section 206(4), and the SEC did not have to prove it in order to establish the appellants' liability * * *.") (citations omitted).

[32] Senator Lincoln noted in a colloquy that the Commission should adopt rules to ensure that swap dealers maintain the confidentiality of hedging and portfolio information provided by Special Entities, and prohibit swap dealers from using information received from a Special Entity to engage in trades that would take advantage of the Special Entity's positions or strategies. 156 Cong. Rec. S5923 (daily ed. Jul. 15, 2010) (statement of Sen. Lincoln). In consultations with stakeholders, Commission staff has learned that these concerns apply more generally to all counterparties, rather than exclusively to Special Entities. Thus, the Commission proposes that the business conduct rules include prohibitions on these types of activities in all transactions between swap dealers or major swap participants and their counterparties.

[33] *See, e.g.,* 17 CFR 155.3–4; *cf.* Market Abuse Directive, at Para. 19, Art. 1(1) (prohibiting the misuse of confidential customer information and front running). The proposed rule would make clear that the confidentiality requirements do not apply when disclosure is made upon request of the Commission, Department of Justice or an applicable prudential regulator.

[34] *See, e.g., United States* v. *Dial,* 757 F.2d 163, 168 (7th Cir. 1985).

dealer or major swap participant, should there be a limit on the time during which the swap dealer or major swap participant must refrain from trading on or otherwise disclosing the counterparty's information?

• Are there other specific fraudulent, manipulative or abusive practices by swap dealers and major swap participants that should be prohibited in these proposed rules? If so, how would they assist in protecting swap markets and counterparties? Are there gaps in the existing requirements that should be filled here?

C. Proposed § 23.430—Verification of Counterparty Eligibility

The Dodd-Frank Act makes it unlawful for any person, other than an eligible contract participant ("ECP"),[35] to enter into a swap unless it is executed on or subject to the rules of a designated contract market.[36] Section 4s(h)(3)(A) also requires the Commission to establish a duty for a swap dealer or major swap participant to verify that any counterparty meets the eligibility standards for an ECP. Proposed § 23.430 would require swap dealers and major swap participants to verify that a counterparty meets the definition of an ECP prior to offering or entering into a swap. The proposed rule also would require a swap dealer or major swap participant to determine whether the counterparty is a Special Entity as defined in Section 4s(h)(2) and proposed § 23.401.

The Commission contemplates that, in the absence of "red flags," and as provided in proposed § 23.402(e), a swap dealer or major swap participant would be permitted to rely on reasonable written representations of a potential counterparty to establish its eligibility as an ECP.[37] In addition, under proposed § 23.402(g), such written representations could be expressed in a master agreement or other written agreement and, if agreed by the parties, could be deemed to be renewed with each subsequent swap transaction, absent any facts or circumstances to the contrary.[38]

Finally, as set forth in proposed § 23.430(c), a swap dealer or major swap participant would not be required to verify the ECP or Special Entity status of the counterparty for any swap initiated on a SEF where the swap dealer or major swap participant does not know the identity of the counterparty.[39]

Request for Comment: The Commission requests comment generally on all of the proposed rules regarding verification of counterparties as ECPs and Special Entities, and on the following specific issues:

• Should there be an ongoing, affirmative duty to verify eligibility? If so, how would it be met? Would the swap dealer or major swap participant's duty change in any way if the ECP status of the counterparty changes after the swap has been entered into?

• Are there particular "red flags" that should indicate a need for a swap dealer or major swap participant to obtain additional information about the status of the counterparty as an ECP or Special Entity?

D. Proposed § 23.431—Disclosure of Material Risks, Characteristics, Material Incentives and Conflicts of Interest Regarding a Swap

Section 4(s)(h)(3)(B) requires swap dealers and major swap participants to disclose to their counterparties material information about the risks, characteristics, incentives and conflicts of interest regarding a swap. The requirements do not apply if both counterparties are any of the following: Swap dealer, major swap participant, security-based swap dealer or major security-based swap participant. Proposed § 23.431 would implement the statutory disclosure requirements and provide specificity with respect to certain material information that must be disclosed under the rule. Information is material if there is a substantial likelihood that a reasonable counterparty would consider it important in making a swap related decision.[40]

1. Timing and Manner of Disclosures

The Dodd-Frank Act does not address the timing and form of the required disclosures. Proposed § 23.431(a) would require that the disclosures be made before entering into a swap and in a manner reasonably designed to allow the counterparty to assess the disclosures. To satisfy its obligation, the swap dealer or major swap participant would also be required to make such disclosures at a time prior to entering into the swap that was reasonably sufficient to allow the counterparty to assess the disclosures. Swap dealers and major swap participants would have flexibility to make these disclosures using reliable means agreed to by the parties, as provided in proposed § 23.402(f).[41]

Standardized disclosure of some required information may be appropriate if the information is applicable to multiple swaps of a particular type and class.[42] As discussed below, the Commission believes that most bespoke transactions, however, will require some combination of standardized and particularized disclosures.

2. Disclosure of Material Risks

The proposed rule tracks the statutory obligations under Section 4s(h)(3)(B)(i) and would require the swap dealer or major swap participant to disclose information to enable a counterparty to assess the material risks of a particular swap. The Commission anticipates that swap dealers and major swap participants typically will rely on a combination of general and more particularized disclosures to satisfy this requirement. The Commission understands that there are certain types of risks that are associated with swaps generally, including market,[43] credit,[44] operational,[45] and liquidity risks.[46] Required risk disclosure would include sufficient information to enable a

[35] "Eligible contract participant" is a defined term in Section 1a(18) of the CEA.

[36] *See* Section 2(e) of the CEA.

[37] This position is consistent with industry comment. *See, e.g.,* NFA Letter, at 2 (recommending the Commission adopt a rule modeled after NFA Compliance Rule 2–23, which permits NFA members to rely on information provided by the customer to satisfy the member's know-your-customer obligations).

[38] Certain industry comments support this approach. *See, e.g.,* NFA Letter, at 2; SIFMA/ISDA Letter, at 12.

[39] This rule tracks the statutory language in Section 4s(h)(7).

[40] *Cf. CFTC* v. *R.J. Fitzgerald & Co.,* 310 F.3d 1321, 1328–29 (11th Cir. 2002) ("A representation or omission is "material" if a reasonable investor would consider it important in deciding whether to make an investment.") (citing *Affiliated Ute Citizens of Utah* v. *United States,* 406 U.S. 128, 153–54 (1972)).

[41] Additionally, under proposed § 23.402(h), swap dealers and major swap participants would be required to maintain a record of their compliance with the proposed rules.

[42] *Cf.* SIFMA/ISDA Letter, at 12 (recommending the use of standard disclosure templates that could be adopted on an industry-wide basis, with disclosure requirements satisfied by a registrant on a relationship (rather than a transaction-by-transaction) basis in cases where prior disclosures apply to and adequately address the relevant transaction).

[43] Market risk refers to the risk to a counterparty's financial condition resulting from adverse movements in the level or volatility of market prices.

[44] Credit risk refers to the risk that a party to a swap will fail to perform on an obligation under the swap.

[45] Operational risk refers to the risk that deficiencies in information systems or internal controls, including human error, will result in unexpected loss.

[46] Liquidity risk is the risk that a counterparty may not be able to, or cannot easily, unwind or offset a particular position at or near the previous market price because of inadequate market depth, unique trade terms or remaining party characteristics or because of disruptions in the marketplace.

counterparty to assess its potential exposure during the term of the swap and at expiration or upon early termination. Consistent with industry "best practices," information regarding specific material risks must identify the material factors that influence the day-to-day changes in valuation, as well as the factors or events that might lead to significant losses.[47] Appropriate disclosures should consider the effect of future economic factors and other material events that could cause the swap to experience such losses. Disclosures should also identify, to the extent possible, the sensitivities of the swap to those factors and conditions, as well as the approximate magnitude of the gains or losses the swap will likely experience.

Swap dealers and major swap participants also should consider the unique risks associated with particular types of swaps, asset classes and trading venues, and tailor their disclosures accordingly.

Request for Comment: The Commission requests comment generally on all of the proposed rules regarding material risk disclosures for swaps and on the following specific issues:

- Are there specific material risks that the Commission should require a swap dealer or major swap participant to disclose to a counterparty? Are there specific risks that should be disclosed with respect to particular types of swaps, asset classes and trading venues?
- NFA and SIFMA/ISDA submitted letters that have suggested that the Commission develop a standard form risk disclosure statement for certain generic-type disclosures, similar to those used today for futures, options and retail foreign currency transactions.[48] Should the Commission undertake such an effort? Should the Commission encourage the industry or SROs to develop such disclosures, in addition, or instead? If it would be beneficial to have such forms, why has the industry not developed such a standard form to date? Would standard form disclosure be inconsistent with the requirement that disclosures be based on the facts and circumstances presented by each swap and counterparty?
- Are there other ways for the Commission to describe the risk disclosure duty required by the CEA that would provide additional guidance or clarify the obligation?
- Should the rule distinguish explicitly risk disclosure requirements for SEF or DCM traded swaps versus bilateral swaps?

3. Scenario Analysis for High-Risk Complex Bilateral Swaps and Counterparty "Opt-In" for Bilateral Swaps Not Available for Trading on a Designated Contract Market or Swap Execution Facility

The Commission is proposing that swap dealers and major swap participants be required to provide scenario analyses when they offer to enter into high-risk complex bilateral swaps to allow the counterparty to assess its potential exposure in connection with the swap.[49] In addition, the rule would allow counterparties to elect to receive scenario analysis when offered bilateral swaps that are not available for trading on a DCM or SEF. The elective aspect of the rule reflects the expectation that there may be circumstances where scenario analysis may be helpful for certain counterparties, even for swaps that are not high-risk complex. Proposed § 23.431(a)(1) is modeled on the CRMPG III industry best practices recommendation for high-risk complex financial instruments.[50]

a. High-Risk Complex Bilateral Swap: Characteristics

The rule's mandatory scenario analysis delivery requirement would apply only when "high-risk complex bilateral swaps" are offered or recommended. Like the industry "best practice" recommendation, the term "high-risk complex bilateral swap" is not defined in the proposed rule; rather, certain flexible characteristics are identified to avoid over inclusive and under inclusive concerns. The characteristics are: The degree and nature of leverage,[51] the potential for periods of significantly reduced liquidity, and the lack of price transparency.[52] The proposed rule would require swap dealers and major swap participants to establish reasonable policies and procedures to identify high-risk complex bilateral swaps, and in connection with such swaps, provide the additional risk disclosure specified in proposed § 23.431(a)(1).

b. Market Risk Disclosures: Scenario Analysis

Scenario analysis, as required by the proposed rule, would be an expression of potential losses to the fair value of the swap in market conditions ranging from normal to severe in terms of stress.[53] Such analyses would be designed to illustrate certain potential economic outcomes that might occur and the effect of these outcomes on the value of the swap. The proposed rule would require that these outcomes or scenarios be developed by the swap dealer or major swap participant in consultation with the counterparty. In addition, the proposed rule would require that all material assumptions underlying a given scenario and its impact on swap valuation be disclosed.[54] In requiring such disclosures, however, the Commission does not propose to require swap dealers or major swap participants to disclose proprietary information about any pricing models.

The Commission does not propose to define the parameters of the scenario analysis in order to provide flexibility to the parties to design the analyses in accordance with the characteristics of the bespoke swap at issue, as well as any criteria developed in consultations with the counterparty. Further, the proposed rule would require swap dealers and major swap participants to consider relevant internal risk analyses including any new product reviews when designing the analyses.[55] As for the format, the proposed rule would require both narrative and tabular expressions of the analyses.

To ensure fair and balanced communications and to avoid misleading counterparties, swap dealers and major swap participants also would

[47] *See* CRMPG III Report, at 60.

[48] *See* NFA Letter, at 2; SIFMA/ISDA Letter, at 12.

[49] Scenario analysis is in addition to required disclosures for swaps which do not qualify as high-risk complex. Such required disclosures include a clear explanation of the economics of the instrument.

[50] CRMPG III Report, at 60–61.

[51] The leverage characteristic is particularly relevant when the swap includes an embedded option, including one in which the counterparty is "short" or selling volatility. Such features can significantly increase counterparty risk exposure in ways that are not transparent.

[52] CRMPG III Report states that:

The aforementioned characteristics are neither an exhaustive list nor should they be assumed to provide a strict definition of high-risk complex instruments, which the Policy Group believes should be avoided. Instead, market participants should establish procedures for determining, based on the key characteristics discussed above, whether an instrument is to be considered high-risk and complex and thus require the special treatment outlined in this section. CRMPG III Report, at 56.

[53] These value changes originate from changes or shocks to the underlying risk factors affecting the given swap, such as interest rates, foreign currency exchange rates, commodity prices and asset volatilities.

[54] Material assumptions include: (1) The assumptions of the valuation model and any parameters applied and (2) a general discussion of the economic state that the scenario is intended to illustrate.

[55] The Commission has proposed that swap dealers and major swap participants adopt policies and procedures regarding a new product policy as part of the risk management system. *See* proposed § 23.600(c)(3), 75 FR 71397, Nov. 23, 2010.

be required to state the limitations of the scenario analysis, including cautions about the predictive value of the scenario analysis, and any limitations on the analysis based on the assumptions used to prepare it. The Commission's proposed rule is aligned with longstanding industry best practice recommendations,[56] and indeed, several large swap dealers told Commission staff that they provide scenario analysis upon request and without separate charge to counterparties today.

Request for Comment: The Commission requests comment generally on all of the proposed rules regarding required scenario analysis for high-risk complex bilateral swaps and opt-in scenario analysis for swaps not available for trading on a DCM or SEF and on the following specific issues:

- Regarding high-risk complex bilateral swaps, should other characteristics be added to the rule? Should any of the proposed high-risk complex bilateral swap characteristics be deleted or modified?
- Instead of high-risk complex bilateral swaps, should the Commission require scenario analysis for all swaps that are: (1) Not accepted or listed for clearing on a derivatives clearing organization ("DCO"), or alternatively, (2) uncleared? What are the costs/benefits of changing the requirement to option one or option two?
- Regarding scenario analysis, should a swap dealer/major swap participant be required to provide such analysis for any swap upon reasonable request by any counterparty? Would there be a charge to counterparties that elect to "opt-in"? How much on average would it cost? If the cost varies by swap type or asset class, provide an average cost by category. What are the costs and benefits to swap dealers and major swap participants and counterparties associated with scenario analysis?
- Are there certain types of counterparties for which a scenario analysis should always be provided? If so, which ones and why?
- Should swap dealers and major swap participants be able to avoid their duty to provide scenario analysis if a counterparty opts out of receiving it?
- Should a Value at Risk ("VaR") type analysis be part of the mandatory scenario analysis?
- In the event that a swap dealer or major swap participant elects to disclose a VaR type analysis, should any minimum parameters apply? For instance, should there be any required confidence levels such as 95 percent or 99 percent? Should there be any minimum standards regarding the type of VaR model chosen? Should there be a required time horizon such as the time between payments, the expected time to liquidate the position, or something else?

4. Material Characteristics

The proposed rule would require swap dealers and major swap participants to include in their disclosures of material characteristics, the material economic terms of the swap, the material terms relating to the operation of the swap and the material rights and obligations of the parties during the term of the swap. Under the proposed rule, the Commission intends that the material characteristics would include the material terms of the swap that would be included in any "confirmation" of any swap sent by the swap dealer or major swap participant to the counterparty upon execution.

5. Material Incentives and Conflicts of Interest

The proposed rule tracks the statutory language under Section 4s(h)(3)(B)(ii) and would require a swap dealer or major swap participant to disclose to any counterparty the material incentives and conflicts of interest that the swap dealer or major swap participant may have in connection with the particular swap. Several stakeholders recommended that the Commission require added transparency concerning the components that make up the price of a transaction. In response, the Commission proposes that swap dealers and major swap participants be required to include with the price of a swap the mid-market value of the swap as defined in proposed § 23.431(c)(2). In addition, swap dealers and major swap participants would be required to disclose any compensation or benefit that they receive from any third party in connection with the swap. In connection with any recommended swap, swap dealers and major swap participants would be expected to disclose whether their compensation related to the recommended swap would be greater than for another instrument with similar economic terms offered by the swap dealer or major swap participant. With respect to conflicts of interest, the Commission expects such disclosure to include the inherent conflicts in a counterparty relationship, particularly when the swap dealer or major swap participant recommends the transaction. The Commission also expects that a swap dealer or major swap participant that engages in business with the counterparty in more than one capacity should consider whether acting in multiple capacities creates material incentives or conflict of interests that require disclosure.[57]

Request for Comment: The Commission requests comment generally on all of the proposed rules regarding material incentives and conflicts of interest and on the following specific issues:

- Should the Commission impose more specific requirements concerning the content of the required disclosures generally?
- Should the Commission require swap dealers and major swap participants to disclose their profit? If so, how should a swap dealer or major swap participant be required to compute profitability for purposes of the rule?

6. Daily Mark

Section 4s(h)(3)(B) directs the Commission to adopt rules that require: (1) For cleared swaps, upon request of the counterparty, receipt of the daily mark from the appropriate DCO; and (2) for uncleared swaps, receipt of the daily mark of the swap from the swap dealer or major swap participant. The term "daily mark" is not defined in the statute, and the Commission understands that the term "mark" is used colloquially to refer to various types of valuation information.

a. Cleared Swaps

For a cleared swap, proposed § 23.431(c)(1) would require the swap dealer or major swap participant to notify a counterparty of their right to receive, upon request, the daily mark from the appropriate DCO.

b. Uncleared Swaps

For uncleared swaps, proposed § 23.431(c)(2) and (3) would require a swap dealer or major swap participant to provide a daily mark to its counterparty on each business day during the term of the swap as of the close of business, or such other time as the parties agree in writing. The Commission is proposing to define daily mark for uncleared swaps as the mid-market value of the swap,[58] which shall

[56] *See* DPG Framework, at Part V(II)(G); *but see* SIFMA/ISDA Letter, at 13–14.

[57] This may exist, for example, when the swap dealer or major swap participant acts both as an underwriter in a bond offering and as a counterparty to the swaps used to hedge such financing. In these circumstances, the swap dealer's or major swap participant's duties to the counterparty would vary depending on the capacities in which it is operating and should be disclosed.

[58] *Cf.* SIFMA and ISDA assert that "[b]y market convention and often by contract, parties generally agree to utilize a mid-market level for margin

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not include amounts for profit, credit reserve, hedging, funding, liquidity or any other costs or adjustments.[59] Based on staff consultations, the consensus was that mid-market value is a transparent measure that would assist counterparties in calculating valuations for their own internal risk management purposes. Further, the Commission is proposing that swap dealers and major swap participants disclose both the methodology and assumptions used to prepare the daily mark, and any material changes to the methodology or assumptions during the term of the swap. The Commission understands that the daily mark for certain bespoke swaps may be generated using proprietary models. The proposed rule does not require the swap dealer or major swap participant to disclose proprietary information relating to its model.

Lastly, the Commission proposes that swap dealers and major swap participants provide appropriate clarifying statements relating to the daily mark. Such disclosures may include, as appropriate, that the daily mark may not necessarily be: (1) A price at which the swap dealer or major swap participant would agree to replace or terminate the swap; (2) the basis for a variation margin call;[60] nor (3) the value of the swap that is marked on the books of the swap dealer or major swap participant.[61]

Industry representatives have asked whether swap dealers and major swap participants may satisfy their obligations to provide daily marks for uncleared swaps by making the relevant information available to counterparties through password protected access to a webpage containing the relevant information.[62] Proposed § 23.402(f) would permit swap dealers and major swap participants to provide daily marks by any reliable means agreed to in writing by the counterparty.

Request for Comment: The Commission requests comments generally on the daily mark and on the following specific issues:

- Should the Commission define the daily mark for uncleared swaps as proposed, on a different basis, or should it be subject to negotiation by the parties? If so, why?
- In addition to the daily mark as defined in the proposed rule, should the Commission require that swap dealers or major swap participants provide executable quotes to counterparties upon request? Should this be left to negotiations between the parties?

E. Proposed § 23.432—Clearing

For swaps where clearing is mandatory,[63] proposed § 23.432(a) would require that a swap dealer or major swap participant notify the counterparty that the counterparty has the sole right to select the DCO that will clear the swap. For swaps that are not required to be cleared, under proposed § 23.432(b), a swap dealer or major swap participant must notify a counterparty that the counterparty may elect to require the swap to be cleared and that it has the sole right to select the DCO for clearing the swap.[64] Neither of these notification provisions would apply where the counterparty is a registered swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant.

Request for Comment: The Commission requests comment generally on all of the proposed rules regarding clearing, and on the following specific issues:

- Are there additional disclosures that a swap dealer or major swap participant should be required to make with respect to clearing of swaps?

F. Proposed § 23.433—Communications—Fair Dealing

The Dodd-Frank Act requires that the Commission establish a duty for swap dealers and major swap participants to communicate in a fair and balanced manner based on principles of fair dealing and good faith. Proposed § 23.433 would establish such a duty and, consistent with statutory language, would apply broadly to all swap dealer and major swap participant communications with counterparties. These principles are well established in the futures and securities markets, particularly through SRO rules.[65] For example, the duty to communicate in a fair and balanced manner is one of the primary requirements of the NFA customer communication rule[66] and is designed to ensure a balanced treatment of potential benefits and risks. In determining whether a communication with a counterparty is fair and balanced, the Commission expects that a swap dealer or major swap participant would consider factors such as whether the communication: (1) Provides a sound basis for evaluating the facts with respect to any swap;[67] (2) avoids making exaggerated or unwarranted claims, opinions or forecasts;[68] and (3) balances any statement that refers to the potential opportunities or advantages presented by a swap with statements of corresponding risks. The Commission also would expect that to deal fairly would require the swap dealer or major swap participant to treat counterparties in such a way so as not to advantage one counterparty or group of counterparties over another. Additionally, communications would be subject to the specific anti-fraud provisions of the CEA and Commission Regulations, as well as applicable SRO rules, if swap dealers and major swap participants are required to be SRO members.

Request for Comment: The Commission requests comment generally on all of the proposed rules regarding fair and balanced communications, and on the following specific issues:

- Should the Commission specify in its final rule any additional

purposes. Counterparties understand that this level does not represent a valuation at which a transaction may be entered into or terminated and accordingly may differ from actual market prices. We recommend that the Commissions endorse this use of mid-market levels for margin purposes as a uniform market practice." SIFMA/ISDA Letter, at 17.

[59] For a discussion of mid-market value and costs, *see* ISDA Research Notes, The Value of a New Swap, Issue 3 (2010), available at *http://www.isda.org/researchnotes/pdf/NewSwapRN.pdf.*

[60] *But see* SIFMA/ISDA Letter at 17 (asserting that mid-market level is market convention for margin purposes and not a quote for entering into a transaction or terminating the swap).

[61] *See also* Trading & Capital-Markets Activities Manual, section 2150.1 (Bd. of Gov. Fed. Reserve Sys. Jan. 2009) ("Trading & Capital-Markets Activities Manual") ("When providing a quote to a counterparty, institutions should be careful that the counterparty does not confuse indicative quotes with firm prices. Firms receiving dealer quotes should be aware that these values may not be the same as those used by the dealer for its internal purposes and may not represent other 'market' or model-based valuations."), available at *http://www.federalreserve.gov/boarddocs/supmanual/trading/200901/0901trading.pdf.*

[62] SIFMA/ISDA Letter, at 17; NFA Letter, at 3.

[63] *See* Section 2(h) of the CEA.

[64] With respect to these proposed disclosure requirements, the Commission notes that, as between the parties, the counterparty is entitled to choose whether and where to clear, but that no DCM or SEF must make clearing available through any DCO. In other words, it would be up to the parties to take the swap to a DCM or SEF that provides for clearing through the counterparty's preferred DCO.

[65] *See, e.g.,* 17 CFR 170.5 ("A futures association must establish and maintain a program for * * * the adoption of rules * * * to promote fair dealing with the public."); NFA Compliance Rule 2–29—Communications with the Public and Promotional Material; NFA Interpretative Notice 9041—Obligations to Customers and Other Market Participants.

[66] *See, e.g.,* NFA Compliance Rule 2–29(b)(2), (5); *see also* NFA Interpretive Notice 9043—NFA Compliance rule 2–29: Use of Past or Projected Performance; Disclosing Conflicts of Interest for Security Futures Products (performance must be presented in a balanced manner).

[67] *See, e.g.,* NFA Interpretive Notice 9041, Obligations to Customers and Other Market Participants ("Members * * * and their Associates should provide a sound basis for evaluating the facts regarding any particular security futures product * * *").

[68] *See, e.g.,* NFA Compliance Rule 2–29(b)(4)–(5).

requirements necessary to satisfy the duty? If so, what?

- Should the Commission specify additional considerations in the rule to guide compliance with the rule? Should the Commission adopt interpretive guidance, instead or in addition?

G. Proposed § 23.434—Recommendations to Counterparties—Institutional Suitability

To determine whether the Commission should use its discretionary authority under new Section 4s(h), the Commission considered requirements for professionals in other markets and in other jurisdictions. One common requirement is a suitability obligation which is imposed when a market professional recommends a product to a customer, including institutional or sophisticated customers. For example, federally regulated banks acting as broker-dealers for government securities have an institutional suitability obligation when making recommendations to institutional customers.[69] Securities broker-dealers are also subject to a suitability obligation when recommending any securities to an institutional customer.[70] Municipal securities dealers have a suitability obligation for any municipal security offered to a "sophisticated municipal market professional." [71] And, in the European Union, investment services firms have a suitability obligation with respect to financial instruments recommended to "professional clients" under MiFID.[72]

In light of its broad application in other markets and jurisdictions, the Commission proposes an institutional suitability obligation for any recommendation a swap dealer or major swap participant makes to a counterparty in connection with a swap or swap trading strategy. The Commission recognizes that futures market professionals have not been subject to an explicit "suitability" obligation.[73] Instead, such professionals have been required to meet a variety of related requirements, including NFA "know your customer" duties,[74] mandatory standard form risk disclosure,[75] NFA's fair and balanced communication rules and just and equitable principles,[76] and general anti-fraud provisions.[77] These requirements developed to address the risks and characteristics of standardized exchange-traded futures and options contracts. Because the definition of swap includes a variety of different types of financial instruments and those instruments can be customized to have a wide range of risk/reward profiles, the Commission believes that standard risk disclosure, alone, may not be sufficient to ensure that counterparties understand their potential exposure. The Commission also has considered that many swap dealers and major swap participants already are, or will be, subject to institutional suitability obligations by virtue of their status as banks, broker-dealers or security-based swap dealers. Thus, to promote regulatory consistency [78] and to take account of the nature of swaps, the Commission proposes to adopt an institutional suitability obligation for swap dealers and major swap participants, modeled, in part, on existing obligations for banks and broker-dealers dealing with institutional clients.

Proposed § 23.434 would require a swap dealer or major swap participant to have reasonable grounds to believe that any recommendation for a swap or trading strategy involving swaps is suitable for its counterparty.[79] A suitability determination would be based upon information the swap dealer or major swap participant obtains regarding the counterparty's financial situation and needs, objectives, tax status, ability to evaluate the recommendation, liquidity needs, risk tolerance, ability to absorb potential losses related to the recommended swap or trading strategy, and any other information known by the swap dealer or major swap participant.

A swap dealer or major swap participant could rely on counterparty representations to satisfy its suitability obligations if: (1) It had a reasonable basis to believe that the counterparty was capable of independently evaluating relevant risks with regard to the particular swap or trading strategy; (2) the counterparty had affirmatively indicated that it was exercising independent judgment in evaluating any recommendations; [80] and (3) the swap dealer or major swap participant had a reasonable basis to believe that the counterparty had the capacity to absorb potential losses related to the recommended swap or swap trading strategy. To the extent that a swap dealer or major swap participant cannot rely on a counterparty's representations as contemplated by proposed § 23.434, it would need to undertake a suitability analysis as set forth in the rule.

Whether a swap dealer or major swap participant has made a recommendation and thus triggered its suitability obligation would depend on the facts and circumstances of the particular case. A recommendation would include any communication by which a swap dealer or major swap participant provides information to a counterparty about a particular swap or trading strategy that is tailored to the needs or characteristics of the counterparty, but would not include information that is general transaction, financial, or market information, swap terms in response to a competitive bid request from the counterparty.[81] In implementing the proposed institutional suitability rule, the Commission intends to consult relevant precedents and interpretive guidance under Federal securities and banking requirements in the United States.[82]

The Commission notes that swap dealers and major swap participants are likely to be acting as CTAs [83] when they

[69] *See, e.g.,* 12 CFR 13.4; Trading & Capital-Markets Activities Manual, Section 2150.

[70] *See* NASD Rule 2310, Recommendations to Customers (Suitability); *see also* proposed FINRA Rule 2111 (Suitability), 75 FR 53562, Aug. 26, 2010.

[71] *See* Municipal Securities Rulemaking Board Rule G–19, Suitability of Recommendations and Transactions; Discretionary Accounts.

[72] MiFID Art. 19(3). "Professional clients" under MiFID include certain financial institutions, insurance companies, pension funds, and other entities. *See* MiFID Art. 19(4), Annex II.

[73] The proposed institutional suitability obligation would apply only to swap dealers and major swap participants, and only when they make swap recommendations, not futures.

[74] NFA Compliance Rule 2–30, Customer Information and Risk Disclosure; NFA Interpretive Notice 901—NFA Compliance Rule 2–30: Customer Information and Risk Disclosure.

[75] 17 CFR 1.55.

[76] NFA Compliance Rules 2–29, 2–36, Requirements for Forex Transactions.

[77] *See, e.g.,* Section 4b of the CEA and §§ 32.9, 33.10 of the Commission's Regulations (17 CFR 32.9, 33.10).

[78] *See, e.g.,* 12 CFR 13.4; Trading & Capital-Markets Activities Manual, section 2150.

[79] The rule would not apply to recommendations made to counterparties that are swap dealers, major swap participants, security-based swap dealers or major security-based swap participants.

[80] A counterparty may indicate that it is exercising independent judgment on one or more particular swaps or types of swaps, or in terms of all swaps.

[81] NASD Notice to Members 01–23 (April 2001); FINRA Proposed Suitability Rule, 75 FR 52562, 52564–69, Aug. 26, 2010.

[82] *See, e.g.,* 12 CFR 13.4, 208.25(d), 368.4. In 1997, the Federal banking agencies offered the following guidance regarding recommendations in the context of government securities sales practices: "While the agencies do not believe it is appropriate to define the term 'recommendation,' they note that they would not view the provision of general market information, including market observations, forecasts about interest rates, and price quotations, as making a recommendation under the rule, absent other conduct." 62 FR 13276, 13280, Mar. 19, 1997.

[83] Section 1a(12) of the CEA defines a commodity trading advisor, in relevant part, as any person who, for compensation or profit, trades, or advises (either directly or through publications, writings, or

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make recommendations, particularly recommendations tailored to the needs of their counterparty. As such, they would be subject to any additional duties that might be applicable to CTAs under the CEA and Commission Regulations, including registration requirements and Section 4*o* of the CEA, the anti-fraud provision that applies to CTAs and commodity pool operators.[84]

Request for Comment: The Commission requests comments generally on the proposed rules regarding recommendations and the following specific issues:

- Should the Commission adopt a suitability obligation for swaps in the absence of such an explicit requirement for exchange traded futures and options? Have securities-style suitability obligations for institutional customers had demonstrable benefits for such customers? If so, provide examples.
- Are there additional factors that swap dealers or major swap participants should consider in determining whether a particular swap is suitable for a particular counterparty?
- Should the Commission specify additional considerations in the rule to guide compliance with the rule? Should the Commission adopt interpretive guidance, similar to that provided by the prudential regulators in connection with sales of government securities instead or in addition?
- Should swap dealers be subject to an explicit fiduciary duty when making a recommendation to a counterparty?

H. Proposed § 155.7—Execution Standards

The Commission is proposing a swap execution standard rule that would apply to swaps available for trading on a DCM or SEF to ensure fair dealing and protect against fraud and other abusive practices. The proposed execution standard rule would require Commission registrants, with respect to any swap that is available for trading on a DCM or SEF, to execute the swap on terms that have a "reasonable relationship" to the best terms available.[85] In addition, the registrant would be required, prior to execution of the order, to disclose the DCMs and SEFs on which the swap is available for trading, and on which markets the registrant has trading privileges. The swap execution standards would apply to all Commission registrants executing customer orders for swaps made available for trading on a DCM or SEF, whether execution occurs on or through a DCM, SEF or bilaterally.[86] The Commission notes that bilateral execution of swaps available for trading on a DCM or a SEF would only occur pursuant to the "end user" exemption provided under Section 2(h)(7)(A) of the CEA.

In determining what constitutes a "reasonable relationship," the Commission registrant should consider whether the terms offered to the customer are fair and consistent with principles of fair dealing,[87] good faith, and, when acting as an agent for the customer, the duty of loyalty.[88] To have a reasonable relationship to the best terms available, the terms must be fair and not excessive in light of all other relevant circumstances. Additionally, whether the terms of any swap executed on behalf of a customer satisfy the "reasonable relationship" duty would be analyzed in connection with the specific anti-fraud provisions of the CEA and Commission Regulations and would be considered in connection with the course of dealing between the registrant and the customer.

To satisfy its reasonable relationship obligation, a Commission registrant would be expected to exercise reasonable diligence to ascertain which DCM or SEF offers the best terms available for the transaction. To meet their reasonable diligence duty, Commission registrants would have to survey a sufficient number of DCMs or SEFs to be able to make a reasonable determination as to whether the terms they offer their clients bear a reasonable relationship to the best terms available. Such a survey would not necessarily be confined to markets on which the registrant has trading privileges and would include reviewing available bids and offers, requests for quotes, and real time reporting of trades executed within a reasonable period of time prior to execution of the order. In proposing this execution standard, the Commission notes that in separate rulemakings the Commission is proposing rules requiring DCMs and SEFs to provide market participants with open access to their trading platforms and that current pre-trade price and quote information will be available to all persons with access to DCMs and SEFs. Post-trade data also will be available to registrants on a real-time reporting basis. The Commission's proposed rule lists a number of factors that the Commission would consider in determining compliance with the rule which include an evaluation of the characteristics unique to the customer's swap order as well as the prevailing market conditions.

As swaps trading transitions to and develops on DCMs and SEFs, technology and other innovations are

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electronic media) as to the value of, or the advisability of trading in, a commodity for future delivery, or swap. Section 1a(12)(B) of the CEA excludes from the definition of commodity trading advisor a variety of persons, but only if a person's commodity advice is solely incidental to the conduct of its principal business or profession. The excluded persons include (i) banks and trust companies and their employees, (ii) news reporters, news columnists, and news editors of print or electronic media, (iii) lawyers, accountants, and teachers, (iv) floor brokers and futures commission merchants, (v) publishers and producers of any print or electronic data of general and regular dissemination, including their employees, (vi) fiduciaries of defined benefit plans subject to ERISA, (vii) contract markets, and (viii) other persons that the CFTC, by rule, regulation, or order, may exclude as "not within the intent of" the definition. The revised definition does not exclude swap dealers whose advice is solely incidental to their swap dealer activities. Therefore, any "advisory" activities by a swap dealer could bring it within the statutory definition of a commodity trading advisor.

[84] Depending on the nature of the relationship, swap dealers might also have common law fiduciary duties to their counterparties. *Cf. Commodity Trend Serv., Inc.* v. *CFTC,* 233 F.3d 981, 990 (7th Cir. 2000).

[85] The term "reasonable relationship" has been used in evaluating execution standards over several decades in the securities industry. In an early securities law case, the Second Circuit stated that "[i]n its interpretation of Sec. 17(a) of the Securities Act, the Commission has consistently held that a dealer cannot charge prices not reasonably related to the prevailing market price without disclosing that fact." *Charles Hughes & Co.* v. *SEC,* 139 F.2d 434, 437 (2d Cir. 1943). The SEC issued a release in 1987, "Notice to broker-dealers concerning disclosure requirements for mark-ups on zero-coupon securities," which stated that the "duty of fair dealing includes the implied representation that the price a firm charges bears a reasonable relationship to the prevailing market price." 52 FR 15575, 15576, Apr. 21, 1987 (citing *Charles Hughes,* 139 F.2d at 437). In IM–2440–1 the former NASD stated that "It shall be deemed a violation of Rule 2110 [recommendations] and Rule 2440 [fair prices and commissions] for a member to enter into any transaction with a customer in any security at any price not reasonably related to the current market price of the security or to charge a commission which is not reasonable." Although Rule 2440 and IM–2440–1 related to OTC transactions, FINRA expanded the principle to include fees charged in exchange-traded transactions. *See* FINRA Regulatory Notice 08–36.

[86] The duty under the proposed rule would apply whether the Commission registrant was acting as agent or principal in the transaction. This is consistent with existing duties for broker-dealers under the Federal securities laws. *See Newton* v. *Merrill, Lynch, Pierce, Fenner & Smith, Inc.,* 135 F.3d 266, 270 n. 1 (3d Cir. 1988) ("[T]he best execution duty 'does not dissolve when the broker/dealer acts in its capacity as a principal.'") (citations omitted). *Accord E.F. Hutton & Co.,* Release No. 34–25887, 49 S.E.C. 829, 832 (1988); NASD Rule 2320(e).

[87] *Supra* at footnote 85. The "duty of fair dealing includes the implied representation that the price a firm charges bears a reasonable relationship to the prevailing market price." 52 FR 15575, 15576, Apr. 21, 1987.

[88] *See Newton,* 135 F.3d at 270 ("The duty of best execution * * * has its roots in the common law agency obligations of undivided loyalty and reasonable care that an agent owes to his principal.")

likely to affect how Commission registrants determine whether the terms they offer their customers are reasonably related to the "best terms available" for purposes of satisfying the proposed execution standards. For example, registrants' survey obligations may be satisfied by consulting, where available, information aggregators that facilitate the collection of information about current trading activity across markets. The proposed rule is intended to be sufficiently flexible to take account of such innovations and developments which should further the quality of executions.

Request for Comment: The Commission requests comments generally on the proposed rules regarding the swap execution standard and the following specific issues:

• For the purpose of meeting the duty to use reasonable diligence to determine whether the terms it offers are reasonably related to the best terms available for execution of a swap that is available for trading on a DCM or SEF, should the Commission prescribe a certain percentage of DCMs or SEFs that must be reviewed/considered by the Commission registrant? If so, what percentage is appropriate?

• Should the Commission define what it means for the terms of execution to have a "reasonable relationship to the best terms available"? If so, how should the Commission define the phrase?

• Should the Commission require any additional disclosures to the customer, including for example, the best terms available for execution of the swap order and the difference between the best terms and the terms on which the swap was executed?

III. Proposed Rules for Swap Dealers and Major Swap Participants Dealing With Special Entities

In Section 4s(h), Congress created a separate category of swap counterparty called Special Entities, and imposed heightened duties and requirements for swap dealers that act as advisors to them, and for swap dealers and major swap participants that are their counterparties.

A. Definition of "Special Entity" Under Section 4s(h)(2)(C)

Section 4s(h)(2)(C) defines a "Special Entity" as: (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; [89] (iv) any governmental plan, as defined in Section 3 of ERISA; [90] or (v) any endowment, including an endowment that is an organization described in Section 501(c)(3) of the Internal Revenue Code of 1986.[91]

The Commission has received a number of letters from stakeholders identifying a variety of ambiguities in the definition of Special Entity in Section 4s(h)(2)(C) and suggesting clarifications. For example, under Section 4s(h)(2)(C)(iii), the term Special Entity includes employee benefit plans as defined in Section 3 of ERISA.[92] Industry representatives have raised issues concerning whether the definition requires "looking through" investment vehicles to determine whether the vehicle is a Special Entity, including master trusts holding the assets of one or more pension plans of a single employer, and collective investment vehicles in which Special Entities invest.[93]

Stakeholders similarly have raised issues with respect to whether plans defined in but not subject to ERISA (unless they are covered by another applicable prong of the Special Entity definition) are Special Entities,[94] and whether only those plans subject to the fiduciary responsibility provisions of ERISA should be included within the Special Entity definition.[95]

Under Section 4s(h)(2)(C)(v), the term Special Entity includes any endowment, including an endowment that is an organization described in Section 501(c)(3) of the Internal Revenue Code of 1986.[96] Non-profit organizations that enter into swaps have asked whether they will be treated as Special Entities if their endowment is pledged as collateral or is used to make payments on those swaps or whether the definition of endowment is limited to those endowments that are the named counterparty to the swap.[97] Others have suggested that the phrase "any endowment" be limited to endowments that are non-profit organizations described in Section 501(c) of the Internal Revenue Code or are established for the benefit of such an organization.

Given the range of issues surrounding the definition of Special Entity, the Commission is not proposing to clarify the definition at this time but, instead, is seeking comment on whether clarification is necessary.

Request for Comment: The Commission requests comments on the definition of Special Entity in general and on the following specific issues:

• Should the definition of State, State agency, city, county, municipality, or other political subdivision of a State be clarified in any way?

• Should the definition "employee benefit plans, as defined in Section 3 of ERISA" be clarified in any way?

• Should the definition "employee benefit plans, as defined in Section 3 of ERISA" be limited to plans subject to regulation under ERISA?

• Should the Commission "look through" an entity to determine whether it is a Special Entity for the purposes of these rules? If so, why? If not, why not? If so, should the Commission clarify that master trusts, or similar entities, that hold assets of more than one pension plan from the same plan sponsor are within the definition of Special Entity?

• Should the Commission clarify in any way the definition of governmental plan under Section 4s(h)(C)(iv)?

• Should the Commission clarify the definition of endowment to include or exclude charitable organizations that enter into swaps but whose endowments have contractual obligations regarding that swap?

• Should the Commission clarify the definition of endowment to include or exclude foreign endowments? If so, why? If not, why not?

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[89] 29 U.S.C. 1002. The term "Special Entities" includes employee benefit plans defined in section 3 of ERISA. This class of employee benefit plans is broader than the category of plans that are "subject to" ERISA for purposes of Section 4s(h)(5)(A)(i)(VII). Employee benefit plans not "subject to" regulation under ERISA include: (1) Governmental plans; (2) church plans; (3) plans maintained solely for the purpose of complying with applicable workmen's compensation laws or unemployment compensation or disability insurance laws; (4) plans maintained outside the U.S. primarily for the benefit of persons substantially all of whom are nonresident aliens; or (5) unfunded excess benefit plans. *See* 29 U.S.C. 1003(b).

[90] Section 3(32) of ERISA defines "governmental plan" as a "plan established or maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing." 29 U.S.C. 1002(32).

[91] The term "endowment" is not defined in the Dodd-Frank Act or in the CEA.

[92] 29 U.S.C. 1002.

[93] *See, e.g.,* SIFMA/ISDA Letter, at 5 (investment vehicle which 25 percent or more of its equity interest is owned by benefit plan investors and is subject to DOL plan assets rules (29 CFR 2510.3–101) for purposes of ERISA).

[94] *See, e.g.,* SIFMA/ISDA Letter, at 2.

[95] SIFMA/ISDA Letter, at 5 ("This would exclude such plans as (i) unfunded plans for highly compensated employees; (ii) foreign pension plans (including foreign-based governmental plans); (iii) church plans that have elected not to subject themselves to ERISA; (iv) Section 403(b) plans that accept only employee contributions; and (v) Section 401(a), 403(b) and 457 plans sponsored by governmental entities.") (citations omitted).

[96] 26 U.S.C. 501(c)(3). Section 501(c)(3) lists tax exempt organizations including: "Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes * * *."

[97] SIFMA/ISDA Letter, at 6; SFG Presentation, at 8.

B. Proposed § 23.440—Requirements for Swap Dealers Acting as Advisors to Special Entities

Section 4s(h)(4) provides that a swap dealer that "acts as an advisor to a Special Entity" 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. These terms are not defined in the statute. The Commission's proposed rules incorporate the statutory language and clarify that "acts as an advisor to a Special Entity" includes to make a swap recommendation to a Special Entity.

1. Act as an Advisor to a Special Entity

With respect to what it means to "act as an advisor to a Special Entity," the Commission proposes to clarify that a swap dealer that makes a recommendation to a Special Entity falls within the definition. The Commission also proposes to clarify that a swap dealer that merely provides to a Special Entity general transaction, financial, or market information or that provides swap terms as part of a response to a competitive bid request from the Special Entity does not fall within the definition. The proposed definition does not address what it means to act as an advisor in connection with any other dealings between a swap dealer and a Special Entity.

2. Best Interests

The proposed rule would not define the term "best interests." There are established principles in case law under the CEA, with respect to the duties of advisors which will inform the meaning of the term on a case-by-case basis. The Commission believes that those best interest principles, in the context of a recommended swap or swap trading strategy, would impose affirmative duties to act in good faith and make full and fair disclosure of all material facts and conflicts of interest, and to employ reasonable care that any recommendation given to a Special Entity is designed to further the purposes of the Special Entity.[98] The Commission's proposal is guided by the statutory language in Sections 4s(h)(4) and (5) and Congressional intent that swap dealers could act both as an advisor to a Special Entity when recommending a swap and then as a counterparty by entering into the same swap with the Special Entity, where the Special Entity has a representative independent of the swap dealer on which it can rely.[99] The proposed rules are intended to allow existing business relationships to continue, albeit subject to the new, higher statutory standards of care.[100] Thus, the proposed rule is not intended to preclude, *per se,* a swap dealer from both recommending a swap to a Special Entity and entering into that swap with the same Special Entity where the parties abide by the requirements of Sections 4s(h)(4) and (5) and the Commission's proposed regulations.[101]

3. Reasonable Efforts

Section 4s(h)(4)(C) requires swap dealers to undertake "reasonable efforts" to obtain information necessary to determine that a recommended swap is in the best interests of the Special Entity. Such information includes the financial and tax status of the Special Entity and the financing objectives of the Special Entity. The statute grants the Commission discretionary authority to prescribe additional types of information. The Commission proposes to add: (1) The authority of the Special Entity to enter into a swap; (2) future funding needs of the Special Entity; (3) the experience of the Special Entity with respect to entering into swaps, generally, and swaps of the type and complexity being recommended; (4) whether the Special Entity has a representative as provided in proposed § 23.450 and Section 4s(h)(5) that is capable of evaluating the recommended swap in light of the needs and circumstances of the Special Entity; and (5) whether the Special Entity has the financial capability to withstand changes in market conditions during the term of the swap. The Commission believes that this non-exclusive list would assist a swap dealer in meeting its duty to act in the "best interests" of a Special Entity in recommending a swap or swap trading strategy.

4. Reasonable Reliance To Satisfy the "Reasonable Efforts" Obligation

Proposed § 23.440(c) would allow a swap dealer to rely on the Special Entity's representations to satisfy its "reasonable efforts" obligations. The Commission understands from stakeholders, including a number of Special Entities, that Special Entities are sometimes reluctant to provide complete information to swap dealers about their investment portfolio or other information that might be relevant to the appropriateness of a particular recommendation. To address this circumstance, the Commission proposes to allow a swap dealer to meet its "reasonable efforts" duty by relying on representations of the Special Entity[102] and any other information known by the swap dealer. In such circumstances, the swap dealer would be expected to make clear to the Special Entity that the recommendation is based on the limited information known to the swap dealer, and that the recommendation might be different if the swap dealer had more complete information as provided in Section 4s(h)(4)(C) and proposed § 23.440(b)(2).[103]

To rely, the swap dealer must have a reasonable basis to believe that the representations of the Special Entity are reliable based on the facts and

[98] There is similar language in *SEC* v. *Capital Gains Research Bureau, Inc.,* 375 U.S. 180, 191–94 (1963) in which the Supreme Court construed Advisers Act Section 206 (15 U.S.C. 80b–6) as creating an enforcement mechanism for violations of fiduciary duties under the common law. The fiduciary duty imposes upon investment advisers the "affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts,' as well as an affirmative obligation to 'employ reasonable care to avoid misleading' " their clients.

[99] Senator Blanche Lincoln stated in a floor colloquy that:

[N]othing in [CEA Section 4s(h)] prohibits a swap dealer from entering into transactions with Special Entities. Indeed, we believe it will be quite common that swap dealers will both provide advice and offer to enter into or enter into a swap with a special entity. However, unlike the status quo, in this case, the swap dealer would be subject to both the acting as advisor and business conduct requirements under subsections (h)(4) and (h)(5).

156 Cong. Rec. S5923 (daily ed. Jul. 15, 2010) (statement of Sen. Lincoln). However, swap dealers have an obligation to ensure that any Special Entity counterparty is represented by a sophisticated representative, independent of the swap dealer, when the swap dealer is acting both as an advisor and as counterparty to the Special Entity. (Section 4s(h)(5)).

[100] The Commission anticipates that swap dealers and Special Entities will continue to rely on representations to inform the nature of their relationships, including, for example, representations that the Special Entity: (1) Is not relying on the swap dealer; (2) has an independent representative that, by virtue of their relationship, is legally obligated to act in the best interests of the Special Entity; and (3) is relying on the independent representative's advice in evaluating any recommendation from a swap dealer. The parties' agreement, however, does not bind the Commission or override the protections granted to market participants under the CEA. *Cf.* Complaint at ¶ 18, *SEC* v. *Barclays Bank,* 07–CV–04427 (S.D.N.Y. May 30, 2007) (so-called "Big Boy" letters may not insulate parties from enforcement actions brought by the SEC for insider trading); *SEC* v. *Barclays Bank,* SEC Litig. Release No. 20132 (May 30, 2007) (Barclays Bank settles insider trading charges).

[101] The Commission staff has consulted with DOL staff, who has advised that any determination of status under the Dodd-Frank Act is separate and distinct from the determination of whether an entity is a fiduciary under ERISA.

[102] Certain Special Entity trade associations supported this approach. *See* ABC Letter, at 6–7; ABC/CIEBA Letter, at 3.

[103] In the absence of sufficient representations from the Special Entity, and if a swap dealer's reasonable efforts produce incomplete information, the swap dealer would be required to assess whether it is able to make a swap recommendation that is in the best interests of the Special Entity as required by proposed § 23.440.

circumstances of the particular swap and the Special Entity. The representations themselves must be detailed and include information regarding the Special Entity's ability to: evaluate the recommended transaction; exercise independent judgment; and absorb potential losses associated with the swap. The Special Entity also would have to have a representative that meets the criteria in Section 4s(h)(5) and proposed § 23.450. This mechanism would not relieve a swap dealer of its duty to act in the "best interests" of the Special Entity.

Request for Comment: The Commission requests comment generally on all of the proposed rules regarding swap dealers that act as advisors to Special Entities, and on the following specific issues:

• Is the proposed clarification of the term "acts as an advisor to a Special Entity" appropriate? Should the Commission further define the term?

• Should the Commission define "best interests" in this context, and if so, what should the definition be?

• Because a swap dealer has an inherent conflict of interest when it acts as both an advisor and a counterparty to Special Entity, are there additional disclosures that a swap dealer should have to make that could mitigate the conflicts of interest?

• When acting as both an advisor and a counterparty to a Special Entity, should a swap dealer have to disclose any positions it holds from which it may profit should the swap in question move against the Special Entity?

• Should swap dealers have to disclose to a Special Entity the profit it expects to make on swaps it enters into with the Special Entity.

• Should swap dealers be subject to an explicit fiduciary duty when acting as an advisor to a Special Entity?

• Would the proposed rule preclude swap dealers from continuing their current practice of both recommending and entering into swaps with Special Entities? If so, why?

• Should the Commission prescribe additional information that would be relevant to a swap dealer's "reasonable efforts" and "best interests" duties under the proposed rule?

C. Proposed § 23.450—Requirements for Swap Dealers and Major Swap Participants Acting as Counterparties to Special Entities

Section 4s(h)(5) requires that swap dealers and major swap participants [104] that offer swaps to or enter into swaps with Special Entities comply with any duty established by the Commission that requires them to have a reasonable basis to believe that the Special Entity has an independent representative that meets certain criteria.[105] The Commission interprets the statute as imposing this duty on swap dealers and major swap participants when they are counterparties to any Special Entity.[106] In making this determination the Commission considered staff's consultations with staff at other Federal regulators, stakeholders, letters from the public,[107] as well as legislative history.[108] To meet their duties under the proposed rule, swap dealers and major swap participants would be able to rely on reasonable, detailed representations of the Special Entity concerning the qualifications of the independent representative.[109]

1. Qualifications of the Independent Representative

The proposed rule would require swap dealers and major swap participants to have a reasonable basis to believe that a Special Entity has a representative that satisfies the enumerated criteria.[110] The proposed rule provides that relevant considerations would include: (1) The nature of the Special Entity-representative relationship; (2) the representative's capability of making hedging or trading decisions; (3) use of consultants or, with respect to employee benefit plans subject to ERISA, use of a Qualified Professional Asset Manager [111] or In-House Asset Manager; [112] (4) the representative's general level of experience in the financial markets and particular experience with the type of product under consideration; (5) the representative's ability to understand the economic features of the swap; (6) the representative's ability to evaluate how market developments would affect the swap; and (7) the complexity of the swap.

2. Statutory Disqualification

To guide swap dealers and major swap participants, the proposed rule defines "statutory disqualification" as grounds for refusal to register or to revoke, condition or restrict the registration of any registrant or applicant for registration as set forth in Sections 8a(2) and 8a(3) of the CEA.

3. Independent

Proposed § 23.450(b) would require that a swap dealer or major swap participant "have a reasonable basis to believe a Special Entity has a

[104] Although the title of Section 4s(h)(5) refers only to swap dealers, the specific requirements in Section 4s(h)(5)(A) are imposed on both swap dealers and major swap participants that offer to or enter into a swap with a Special Entity. Accordingly, the Commission proposes to apply the counterparty requirements to major swap participants as well as to swap dealers.

[105] Pursuant to Section 4s(h)(7), the duty would not apply to transactions initiated on a DCM or SEF where the swap dealer or major swap participant does not know the counterparty to the transaction.

[106] The statutory language is ambiguous as to whether the duty is intended to apply with respect to all types of Special Entity counterparties, or just a sub-group. The ambiguities arise, in part, from the reference to subclauses (I) and (II) of Section 1a(18)(A)(vii) of the CEA, which include certain governmental entities and multinational or supranational government entities. Yet, multinational and supranational government entities do not fall within the definition of Special Entity in Section 4s(h)(2)(C), and State agencies, which are defined as Special Entities, are not included in Section 1a(18)(A)(vii)(I) and (II) but are included in (III).

[107] *See, e.g.,* Ropes & Gray Letter, at 1; ABC/CIEBA Statement letter, at 2; SIFMA/ISDA Letter, at 11.

[108] *See* H.R. Rep. No. 111–517, at 869 (June 29, 2010) (Conf. Rep.) ("When acting as counterparties to a pension fund, endowment fund, or state or local government, dealers are to have a reasonable basis to believe that the fund or governmental entity has an independent representative advising them.").

[109] *See, e.g.,* ABC Letter, at 4; ABC/CIEBA Letter, at 2; SIFMA/ISDA Letter, at 11. Stakeholders have asserted that, even if Congress did intend for Section 4s(h)(5)(A) to apply to non-governmental Special Entities, it did not intend for it to apply to ERISA plans. Stakeholders further assert that, even if Section 4s(h)(5)(A) applies to ERISA plans, swap dealers and major swap participants should only be expected to verify that the independent representative satisfies the criteria of Section 4s(h)(5)(A)(i)(VII)—that the independent representative is a fiduciary as defined in Section 3 of ERISA (29 U.S.C. 1002)—and not the criteria of Section 4s(h)(5)(A)(i)(I)–(VI). They contend that verification of the duty under Section 4s(h)(5)(A)(i)(VII) is the equivalent of verification of Section 4s(h)(5)(A)(i)(I)–(VI) and that to require verification of all the criteria would lead to regulatory conflicts under ERISA and the CEA.

[110] The criteria for an independent representative based generally on the statute and under proposed § 23.450 would be: (1) Sufficient knowledge to evaluate the transaction and risks; (2) not subject to a statutory disqualification; (3) independent of the swap dealer or major swap participant; (4) undertakes a duty to act in the best interests of the Special Entity it represents; (5) makes appropriate and timely disclosures to the Special Entity; (6) evaluates, consistent with any guidelines provided by the Special Entity, fair pricing and the appropriateness of the swap; (7) in the case of employee benefit plans subject to the ERISA, is a fiduciary as defined in Section 3 of ERISA (29 U.S.C. 1002); and 8) in the case of a municipal entity as defined in proposed § 23.451, whether the representative is subject to restrictions on certain political contributions imposed by the Commission, the SEC or a self-regulatory organization subject to the jurisdiction of the Commission or the SEC. Criterion 8 is not in the statutory text under Section 4s(h)(5)(A)(i)(I)–(VII). The Commission is proposing this criterion using its discretionary authority under Section 4s(h)(5)(B).

[111] *See* DOL Prohibited Transaction Exemption ("PTE") 84–14, 70 FR 49305, Aug. 23, 2005.

[112] *See* DOL PTE 96–23, 61 FR 15975, Apr. 10, 1996; Proposed Amendment to PTE 96–23, 75 FR 33642, June 14, 2010.

representative that * * * is independent of the swap dealer or major swap participant * * *" [113] This formulation of the duty is intended to clarify that "independent" as it relates to a representative of a Special Entity means independent of the swap dealer or major swap participant,[114] not independent of the Special Entity.[115]

As to what it means for the representative to be independent of the swap dealer or major swap participant, the Commission's proposed rule provides that a representative would be deemed to be independent if: (1) It is not (with a one-year look back) an associated person of the swap dealer or major swap participant within the meaning of Section 1a(4) of the CEA; (2) there is no "principal" relationship between the representative and the swap dealer or major swap participant within the meaning of § 3.1(a)[116] of the Commission's Regulations; and (3) the representative does not have a material business relationship with the swap dealer or major swap participant. However, if the representative received any compensation from the swap dealer or major swap participant within one year of an offer to enter into a swap, the swap dealer or major swap participant would have to ensure that the Special Entity is informed of the compensation and that the Special Entity agrees in writing, in consultation with the representative, that the compensation does not constitute a material business relationship between the representative and the swap dealer or major swap participant. The proposed rule defines a material business relationship as any relationship with a swap dealer or major swap participant, whether compensatory or otherwise, that reasonably could affect the independent judgment or decision making of the representative.

4. Best Interests

The Commission is not proposing to define what "best interests" means in this context. As the Commission explained regarding proposed § 23.440, the scope of the duty will be related to the nature of the relationship between the independent representative and the Special Entity. There are established principles in case law which will inform the meaning of the term on a case-by-case basis.[117]

We would expect that, at a minimum, the swap dealer or major swap participant would have a reasonable basis for believing that the representative could assess: (1) How the proposed swap fits within the Special Entity's investment policy; (2) what role the particular swap plays in the Special Entity's portfolio; and (3) the Special Entity's potential exposure to losses. The swap dealer or major swap participant would also need to have a reasonable basis for believing that the representative has sufficient information to understand and assess the appropriateness of the swap prior to the Special Entity's entering into the transaction.[118]

5. Makes Appropriate and Timely Disclosures

The proposed rule refines the criterion under Section 4s(h)(5)(A)(i)(V), "appropriate disclosures," to mean "appropriate and timely disclosures." A swap dealer or major swap participant would have to have a reasonable basis to believe that a representative makes appropriate and timely disclosures to the Special Entity for the representative to meet the requirements of the proposed rule.

6. Evaluates Fair Pricing and the Appropriateness of the Swap

The Commission has received a number of questions regarding the statutory criterion in Section 4s(h)(5)(A)(i)(VI) which states that the representative will provide "written representations to the Special Entity regarding fair pricing and the appropriateness of the transaction." [119] The Commission's proposed rule refines the statutory language to say that the representative "evaluates, consistent with any guidelines provided by the Special Entity, fair pricing and the appropriateness of the swap." The Commission proposes to allow swap dealers and major swap participants to rely on appropriate legal arrangements between Special Entities and their independent representatives in applying this criterion. For example, where a pension plan has a plan fiduciary that by contract has discretionary authority to carry out the investment guidelines of the plan, the swap dealer would be able to rely, absent red flags, on the Special Entity's representations regarding the legal obligations of the fiduciary. Evidence of the legal relationship between the plan and its fiduciary would enable the swap dealer or major swap participant to conclude that the fiduciary is evaluating fair pricing and the appropriateness of all transactions prior to entering into such transactions on behalf of the plan. To comply with this criterion, the swap dealer or major swap participant should also have a reasonable basis to believe that the

[113] Section 4s(h)(5)(A)(i) provides in relevant part: "reasonable basis to believe that the counterparty that is a Special Entity has an independent representative that * * * (III) is independent of the swap dealer or major swap participant * * *" By including the word "independent" twice, an ambiguity was created as to whether the representative had to be independent of both the swap dealer or major swap participant and the Special Entity. The legislative history indicates that was not the intent of Congress. Thus, the proposed rule drops the first "independent" to clarify that the representative of a Special Entity only needs to be independent of the swap dealer or major swap participant.

[114] *See, e.g.,* ABC Letter, at 6; ABC/CIEBA Letter, at 3; Ropes & Gray Letter, at 2; SIFMA/ISDA Letter, at 12; NFA Letter, at 6.

[115] *See* 156 Cong. Rec. S5903 (daily ed. Jul. 15, 2010) (statements of Sens. Lincoln and Harkin):

Mrs. LINCOLN Our intention in imposing the independent representative requirement was to ensure that there was always someone independent of the swap dealer or the security-based swap dealer reviewing and approving swap or security-based swap transactions. However, we did not intend to require that the special entity hire an investment manager independent of the special entity. Is that your understanding, Senator Harkin?

Mr. HARKIN. Yes, that is correct. We certainly understand that many special entities have internal managers that may meet the independent representative requirement. For example, many public electric and gas systems have employees whose job is to handle the day-to-day hedging operations of the system, and we intended to allow them to continue to rely on those in-house managers to evaluate and approve swap and security-based swap transactions, provided that the manager remained independent of the swap dealer or the security-based swap dealer and meet the other conditions of the provision. Similarly, the named fiduciary or in-house asset manager-INHAM-for a pension plan may continue to approve swap and security-based swap transactions.

[116] 17 CFR 3.1(a).

[117] Under the CEA, a commodity trading advisor will have a fiduciary duty towards its customer when it offers personalized advice. *See Savage* v. *CFTC,* 548 F.2d 192, 194 (7th Cir. 1977); *Commodity Trend Serv.,* 233 F.3d at 990 ("the party in [*Savage*] offered personalized advice and so would be considered a fiduciary under the common law") (citing *Capital Gains,* 375 U.S. at 194). Under the Advisers Act, an adviser is a fiduciary whose duty is to serve the best interests of its clients, which includes an obligation not to subrogate clients' interests to its own. An adviser must deal fairly with clients and prospective clients, seek to avoid conflicts with its clients and, at a minimum, make full disclosure of any material conflict or potential conflict. "Amendments to Form ADV," Release No. IA–3060 (Aug. 12, 2010) (citing *Capital Gains,* 375 U.S. at 191–94). Under ERISA, "a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and * * * for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan" (29 U.S.C. 1104(a)(1)(A)) and act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims * * *" (29 U.S.C. 1104(a)(1)(B)).

[118] The description of the duties under Section 4s(h)(5)(A)(i)(IV) is drawn from a description of ERISA fiduciary obligations in connection with the use of derivatives in the management of a portfolio of assets of a pension plan that is subject to ERISA. *See* Letter of Olena Berg, DOL, to Honorable Eugene A. Ludwig, Comptroller of the Currency (March 21, 1996), available at, *http://www.dol.gov/ebsa/programs/ori/advisory96/driv4ltr.htm.*

[119] *See, e.g.,* ABC Letter, at 8; SFG Letter, at 1.

independent representative is documenting its decisions about appropriateness and pricing of all swap transactions and that such documentation is being retained in accordance with any regulatory requirements that might apply to the independent representative.[120] This approach would apply to in-house independent representatives as well.

7. ERISA Fiduciary

The proposed rule tracks the statutory language that in the case of employee benefit plans subject to ERISA, the independent representative is a fiduciary as defined in Section 3 of that Act.[121] Certain ERISA plans, fiduciaries and their trade associations, have urged the Commission to interpret the statute to mean that the independent representative of a plan subject to ERISA would not have to satisfy the additional criteria in Section 4s(h)(5)(A)(i)(I)–(VI), because such criteria would be duplicative of or inconsistent with ERISA requirements.[122] After consultations with DOL staff, the Commission is inclined, at this time, to treat ERISA fiduciaries like other independent representatives of Special Entities with respect to the criteria in Section 4s(h)(5)(A)(i)(I)–(VI). The Commission would expect that such ERISA fiduciaries and plans would be able to provide adequate representations to swap dealers and major swap participants to meet the additional criteria without incurring significant costs. The Commission seeks further comment from interested parties as to this approach, particularly with respect to whether the additional criteria, as proposed in the rule, are inconsistent in any way with the requirements under ERISA.

8. Restrictions on Political Contributions by Independent Representative of a Municipal Entity

As part of the process of determining the qualifications of an independent representative of a Special Entity that is a municipal entity,[123] the Commission proposes [124] to require swap dealers and major swap participants to ensure that the independent representative is subject to restrictions on certain political contributions, known as "pay-to-play" rules.[125] The requirement would not apply to in-house independent representatives of a municipal entity.[126]

9. Unqualified Independent Representative

Some stakeholders have expressed concern that the independent representative requirement places undue influence in the hands of the swap dealer or major swap participant by allowing it to use Section 4s(h)(5)(A)(i) to control who qualifies as an independent representative.[127] Thus, the proposed rule also provides that, if a swap dealer or major swap participant were to determine that the independent representative of a Special Entity did not meet the criteria established in this provision, the swap dealer or major swap participant would be required to make a written record of the basis for such determination and submit such determination to its Chief Compliance Officer for review to ensure that the swap dealer or major swap participant had a substantial, unbiased basis for the determination.

10. Disclosure of Capacity

Section 4s(h)(5)(A)(ii) requires swap dealers and major swap participants to disclose in writing to Special Entities the capacity in which they are acting before initiation of a swap transaction. The Commission proposes to adopt the statutory standard in a rule, and to require that, if a swap dealer or major swap participant were to engage in business with the Special Entity in more than one capacity, the swap dealer or major swap participant would have to disclose the material differences between the capacities. This would apply, for example, when the swap dealer acts both as an advisor and as a counterparty to the Special Entity, or when firms act both as underwriters in a bond offering and as counterparties in swaps used to hedge such financing. In these circumstances, the swap dealers' or major swap participants' duties to the Special Entities would vary depending on the capacities in which they are operating.

11. Inapplicability

Proposed § 23.450 would not apply with respect to a swap that is initiated on a DCM or SEF where the swap dealer or major swap participant does not know the Special Entity's identity.

Request for Comment: The Commission requests comment generally on all of the proposed rules regarding swap dealers and major swap participants that act as counterparties to Special Entities, and on the following specific issues:

- Should the rule clarify the statutory language to give more guidance to the criteria in Section 4s(h)(5)(A)(i)(I)–(VI)? If, yes, how?
- Are there any specific qualifications that should be considered in forming a reasonable basis regarding whether the independent representative has sufficient knowledge to evaluate the transaction and risks?
- Should the criterion in Section 4s(h)(5)(A)(i)(VII) be the only criterion that applies to employee benefit plans subject to ERISA? Why or why not? Are the criteria in Section 4s(h)(5)(A)(i)(I)–(VI) inconsistent with a fiduciary's duties under ERISA? Do the criteria in Section 4s(h)(5)(A)(i)(I)–(VI) add any protections for plans subject to ERISA that are not otherwise provided under ERISA?
- To resolve the ambiguity in the statutory text referenced in footnote 106, should the rule be limited to certain types of Special Entities? Why or why not? Which types should be included or excluded from coverage under the proposed rule?
- Should the rule define what it means for the independent representative to be independent of the swap dealer or major swap participant? If yes, should independence be measured in relation to ownership and control, material business relationships, or another measure? Should any "independence" test apply to employees of the independent representative, as well as to the representative, itself?
- Should the Commission specify a de minimis threshold below wh ich an independent representative will not be deemed to have a material business relationship with the swap dealer or major swap participant? If so, what would be an appropriate threshold?

D. Proposed § 23.451—Political Contributions by Certain Swap Dealers and Major Swap Participants

Using its discretionary rulemaking authority under Section 4s(h) to impose business conduct requirements in the

[120] For example, CTAs are required to maintain books and records for 5 years pursuant to § 1.31 of the Commission's regulations. (17 CFR 1.31).

[121] 29 U.S.C. 1002.

[122] *See, e.g.,* ABC Letter, at 4–5; ABC/CIEBA Letter, at 2–5.

[123] Proposed § 23.451.

[124] The Commission proposes this requirement pursuant to its discretionary authority in Section 4s(h) of the CEA, including in particular Section 4s(h)(5)(B).

[125] *See, e.g.,* SEC Rule 206(4)–5 under the Advisers Act (17 CFR 275.206(4)–5); MSRB Rule G–37: Political Contributions and Prohibitions on Municipal Securities Business. The Commission proposes to impose comparable requirements on swap dealers and major swap participants that act as advisors or counterparties to Special Entities. *See* proposed § 23.432. In a separate release, the Commission will also propose comparable requirements on registered commodity trading advisors when they advise municipal entities.

[126] The definition of "municipal advisor" in Section 15B of the Exchange Act (15 U.S.C. 78o–4) excludes employees of a municipal entity.

[127] *E.g.,* ABC Letter, at 8.

public interest,[128] the Commission is proposing to prohibit swap dealers and major swap participants from entering into swaps with "municipal entities" if they make certain political contributions to officials of such entities.[129] The proposed rule is intended to complement existing pay-to-play prohibitions imposed by Federal securities regulators to deter undue influence and other fraudulent practices that harm the public. The Commission's proposed rule would promote consistency in the business conduct standards that apply to financial market professionals dealing with municipal entities.

The existing restrictions on pay-to-play practices are contained in SEC Rule 206(4)–5 under the Investment Advisers Act of 1940,[130] which prohibits certain political contributions by investment advisers providing or seeking to provide investment advisory services to public pension plans and other government investors,[131] and under the Municipal Securities Rule Making Board ("MSRB") Rules G–37 and G–38,[132] which impose pay-to-play restrictions on municipal securities dealers and broker-dealers engaging or seeking to engage in the municipal securities business. The proposed rule is intended to deter swap dealers and major swap participants from engaging in pay-to-play practices.

1. Prohibitions

Proposed § 23.451, generally, would make it unlawful for a swap dealer or major swap participant to offer to enter or to enter into a swap with a municipal entity for a two-year period after the swap dealer or major swap participant or any of its covered associates makes a contribution to an official of the municipal entity. The proposed rule also would prohibit a swap dealer or major swap participant from paying a third-party to solicit municipal entities to enter into a swap, unless the third-party is a "regulated person" that is itself subject to a pay-to-play restriction under applicable law.[133] The proposed rule also would ban a swap dealer or major swap participant from soliciting or coordinating contributions to an official of a municipal entity with which the swap dealer or major swap participant is seeking to enter into, or has entered into a swap, or payments to a political party of a state or locality with which the swap dealer or major swap participant is seeking to enter into, or has entered into a swap. These proposed prohibitions are similar to those contained in SEC Advisers Act Rule 206(4)–5 and MSRB Rules G–37 and G–38.

The proposed rule also includes a provision that would make it unlawful for a swap dealer or major swap participant to do indirectly or through another person or means anything that would, if done directly, result in a violation of the prohibitions contained in the proposed rule.

a. Two-Year "Time Out"

The proposed rule would prohibit swap dealers and major swap participants from offering to enter into or entering into a swap with a municipal entity within two years after a contribution to an official of such municipal entity was made by the swap dealer or major swap participant or any of its covered associates. The two-year time out is consistent with the time out provisions contained in SEC Advisers Act Rule 206(4)–5 and MSRB Rule G–37.

b. Covered Associates

Political contributions made to influence the firm selection process are typically made not by the firm itself, but by officers and employees of the firm who have a stake in the business relationship with the municipal client. For this reason, contributions by such persons, which the rule defines as "covered associates," would trigger the two-year time out. A "covered associate" of a swap dealer or major swap participant is defined as (i) any general partner, managing member or executive officer, or other individual with a similar status or function; (ii) any employee who solicits a municipal entity for the swap dealer or major swap participant and any person who supervises, directly or indirectly, such employee; and (iii) any political action committee controlled by the swap dealer or major swap participant or any of its covered associates. This definition mirrors a similar provision in SEC Advisers Act Rule 206(4)–5.

Because the proposed rule attributes to a firm contributions made by a person even prior to becoming a covered associate of the firm, swap dealers and major swap participants must "look back" in time to determine whether the time out applies when an employee becomes a covered associate. For example, if the contribution was made less than two years (or six months, as applicable) before an individual becomes a covered associate, the proposed rule would prohibit the firm from entering into a swap with the relevant municipal entity until the two-year time out period has expired.

2. Exceptions

a. De Minimis Contributions

The proposed rule would permit an individual that is a covered associate to make aggregate contributions up to $350 per election, without being subject to the two-year time out period for any one official for whom the individual is entitled to vote, and up to $150, per election, to an official for whom the individual is not entitled to vote. The Commission believes this two-tiered de minimis approach is reasonable because of the more remote interest an individual is likely to have in contributing to a person for whom such individual is not entitled to vote. This provision is similar to the one contained in SEC Advisers Act Rule 206(4)–5.

b. New Covered Associates

The prohibitions of the proposed rule would not apply to contributions by an individual made more than six months prior to becoming a covered associate of the swap dealer or major swap participant, unless such individual solicits the municipal entity after becoming a covered associate.

c. Exchange and SEF Transactions

The prohibitions of the proposed rule would not apply to a swap that is initiated on a DCM or SEF, for which the swap dealer or major swap participant does not know the identity of the counterparty.

[128] Section 4s(h)(5)(B).

[129] *See* proposed § 23.451(a)(3). The proposed definition of "municipal entity" is based on Exchange Act Section 15B(e)(8) (15 U.S.C. 78o–4(e)(8)) and means any State, political subdivision of a State, or municipal corporate instrumentality of a State, including—

(A) Any agency, authority, or instrumentality of the State, political subdivision, or municipal corporate instrumentality;

(B) Any plan, program, or pool of assets sponsored or established by the State, political subdivision, or municipal corporate instrumentality or any agency, authority, or instrumentality thereof; and

(C) Any other issuer of municipal securities.

[130] 17 CFR 275.206(4)–5 ("SEC Advisers Act Rule 206(4)–5").

[131] *See* "Political Contributions by Certain Investment Advisers," Release No. IA–3043 (Jul. 1, 2010), 75 FR 41018, Jul. 14, 2010 (adopting a rule that prohibits certain political contributions by investment advisers providing or seeking to provide investment advisory services to public pension plans and other government investors).

[132] *See* MSRB Rule G–37, Political Contributions and Prohibitions on Municipal Securities Business; MSRB Rule G–38, Solicitation of Municipal Securities Business.

[133] The Commission is proposing to define "regulated person," for purposes of the rule, to mean generally a person that is subject to rules of the SEC, the MSRB, a self-regulatory organization, or the Commission prohibiting it from engaging in specified activities if certain political contributions have been made, or its officers or employees.

3. Exemptions

A swap dealer or major swap participant would be exempt from the prohibitions of the proposed rule where the contribution that was made by a covered associate did not exceed $150 or $350, as applicable, was discovered by the swap dealer or major swap participant within four months of the date of contribution, and was returned to the contributor within 60 calendar days of the date of discovery. This automatic exemption mirrors similar provisions contained in SEC Advisers Act Rule 206(4)–5 and MSRB Rule G–37.

In addition, the Commission proposes a provision under which a swap dealer or major swap participant may apply to the Commission for an exemption from the two-year ban. In determining whether to grant the exemption, the Commission would consider, among other factors: (i) Whether the exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes of the CEA; (ii) whether the swap dealer or major swap participant, before the contribution resulting in a prohibition was made, had adopted and implemented policies and procedures reasonably designed to prevent violations of the proposed rule, prior to or at the time of the contribution, had any actual knowledge of the contribution, and, after learning of the contribution, has taken all available steps to cause the contributor to obtain return of the contribution and such other remedial or preventative measures as may be appropriate under the circumstances; (iii) whether, at the time of the contribution, the contributor was a covered associate or otherwise an employee of the swap dealer or major swap participant, or was seeking such employment; (iv) the timing and amount of the contribution; (v) the nature of the election (*e.g.,* Federal, State or local); and (vi) the contributor's intent or motive in making the contribution, as evidenced by the facts and circumstances surrounding the contribution.[134] This exemption is similar to automatic exemption provisions contained in SEC Rule 206(4)–5 and MSRB Rule G–37.

Request for Comment: The Commission requests comments generally on the proposed rules regarding restrictions on certain political contributions by swap dealers and major swap participants and the following specific issues:

• Is the term "municipal entity" appropriately defined? If not, should the Commission refer to "a State, State agency, city, county, municipality, or other political subdivision of a State, or any governmental plan, as defined in Section 3 of [ERISA] (29 U.S.C. 1002)" within the meaning of Section 4s(h)(2)(C)? Should the Commission use the definition of "government entity" from SEC Advisers Act Rule 206(4)–5? [135] Should the Commission instead follow the approach of MSRB Rule G–37? [136]

• Should the proposed rule apply not to all swap dealers and major swap participants, but instead to only swap dealers? If so, why?

IV. Request for Comment

A. Generally

The Commission requests comment on all aspects of the proposed rules. In addition, the Commission seeks comment on the following specific issues:

• Should any proposed requirements be modified or deemed satisfied with respect to swaps that are traded and/or cleared on a registered entity? If so, which requirements should be modified or deemed satisfied, and why?

• Should the Commission use its discretionary authority, where applicable, to distinguish among swap dealers depending on their size and the nature of their business? If so, under what circumstances and how?

• Should any additional business conduct requirements be imposed on swap dealers and/or major swap participants? If so, which requirements should be imposed, and why?

• Should the Commission delay the effective date of any of the proposed requirements to allow additional time to comply with the requirements? If so, which requirements, and what is the compliance burden that should merit a delay?

B. Consistency With SEC Approach

The SEC is proposing rules related to business conduct standards for swap dealers and major swap participants as required under Section 764 of the Dodd-Frank Act. Understanding that the Commission and the SEC regulate different products and markets and thus, appropriately may be proposing alternative regulatory requirements, we request comments generally on the impact of any differences between the Commission and SEC approaches to business conduct regulation in this area.

• Do the regulatory approaches proposed by the Commission and the SEC result in duplicative or inconsistent business conduct standards for market participants subject to both regulatory regimes? Do the approaches result in gaps or different levels of regulation between those regimes? If so, in what ways do commenters believe that such duplication, inconsistencies, or gaps should be minimized?

• Do commenters believe there are ways that would make the approaches more consistent?

V. Related Matters

A. Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA)[137] requires that agencies consider whether the rules they propose will have a significant economic impact on a substantial number of small entities and, if so, provide a regulatory flexibility analysis respecting the impact.[138] The business conduct rules proposed by the Commission generally will affect swap dealers and major swap participants. Prior to Dodd-Frank, the Commission did not have jurisdiction over swaps, swap dealers and major swap participants. Thus, the Commission has not previously addressed the question of whether swap dealers and major swap participants are, in fact, "small entities" for purposes of the RFA.

However, the Commission has previously established certain definitions for small entities to be used by the Commission in evaluating the impact of its regulations on small entities in accordance with the RFA.[139] For example, the Commission has previously determined that futures commission merchants ("FCMs") are not small entities for the purpose of the

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[134] Proposed § 23.451(d).

[135] As used in SEC Advisers Act Rule 206(4)–5(f)(5) (17 CFR 275.206(4)–5(f)(5)), the term "government entity" means any State or political subdivision of a State, including:

(i) Any agency, authority, or instrumentality of the State or political subdivision;

(ii) A pool of assets sponsored or established by the State or political subdivision or any agency, authority or instrumentality thereof, including, but not limited to a "defined benefit plan" as defined in section 414(j) of the Internal Revenue Code (26 U.S.C. 414(j)), or a State general fund;

(iii) A plan or program of a government entity; and

(iv) Officers, agents, or employees of the State or political subdivision or any agency, authority or instrumentality thereof, acting in their official capacity.

[136] MSRB Rule G–37(g)(ii) references "the governmental issuer specified in section 3(a)(29) of the [Exchange] Act" which includes "a State or any political subdivision thereof, or any agency or instrumentality of a State or any political subdivision thereof, or any municipal corporate instrumentality of one more States * * *" (15 U.S.C. 78c(29)).

[137] 5 U.S.C. 601 *et seq.*

[138] *Id.*

[139] 47 FR 18618, Apr. 30, 1982.

RFA[140] based upon, among other things, the requirements that FCMs meet certain minimum financial requirements that enhance the protection of customers' segregated funds and protect the financial condition of FCMs generally. The analogy to FCMs is appropriate in that we anticipate that swap dealers and major swap participants may have to register as FCMs depending on the nature of their business. Moreover, swap dealers and major swap participants will be subject to minimum capital and margin requirements, and are expected to comprise the largest global financial firms. Entities that engage in a *de minimis* quantity of swap dealing in connection with transactions with or on behalf of customers are exempt from the definition of swap dealers and major swap participants. Accordingly, the Commission is hereby determining that swap dealers and major swap participants not be considered to be "small entities" for essentially the same reasons that FCMs have previously been determined not to be small entities.

Similarly, the Commission has also previously determined that large traders are not "small entities" for RFA purposes.[141] The Commission considered the size of a trader's position to be the only appropriate test for purposes of large trader reporting.[142] Major swap participants maintain substantial positions in swaps, creating substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets. Accordingly, the Commission is hereby determining that major swap participants not be considered "small entities" for essentially the same reasons that large traders have previously been determined not to be small entities. Therefore, the Chairman, on behalf of the Commission, hereby certifies pursuant to 5 U.S.C. 605(b) that the proposed rules will not have a significant economic impact on a substantial number of small entities.

B. Paperwork Reduction Act

The Paperwork Reduction Act ("PRA") provides that an agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number from the Office of Management and Budget ("OMB"). [143]

[140] *Id.* at 18619.

[141] *Id.* at 18620.

[142] *Id.*

[143] 44 U.S.C. 3501 *et seq.*

This rulemaking contains collections of information, notably the proposed rules that will require swap dealers and major swap participants to make records, document processes, and make disclosures to counterparties with whom they propose to enter into swaps. OMB has not yet assigned a control number to the new collections. OMB has not yet assigned a control number to the new collection.

The collections of information contained herein overlap the requirements that are being proposed by the Commission in other rulemakings implementing the Dodd-Frank Act. The Commission is seeking or will seek control numbers from OMB for these collections in association with the other rulemakings. The other proposed rulemakings are being issued contemporaneously within the CFTC's Business Conduct Standard–Internal related rulemakings[144] implementing the Dodd-Frank Act. The Commission invites public comment on the accuracy of its estimate that no additional recordkeeping or information collection requirements or changes to existing collection requirements would result from the rules proposed herein.

C. Cost-Benefit Analysis

Section 15(a) of the CEA requires the Commission to consider the costs and benefits of its actions before issuing a rulemaking under the CEA. By its terms, Section 15(a) does not require the Commission to quantify the costs and benefits of an order or to determine whether the benefits of the order outweigh its costs; rather, it requires that the Commission "consider" the costs and benefits of its actions. Section 15(a) further specifies that the costs and benefits shall be evaluated in light of five broad areas of market and public concern: (1) Protection of market participants and the public; (2) efficiency, competitiveness and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. The Commission may in its discretion give greater weight to any one of the five enumerated areas and could in its discretion determine that, notwithstanding its costs, a particular order is necessary or appropriate to protect the public interest or to effectuate any of the provisions or accomplish any of the purposes of the CEA.

[144] The Business Conduct Standard-Internal Rulemakings are: Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants, 75 FR 71397, Nov. 23, 2010; Designation of a Chief Compliance Officer, Required Compliance Policies, and Annual Report of a Futures Commission Merchant, Swap Dealer, Major Swap Participant, 75 FR 70881, Nov. 19, 2010; and Implementation of Conflict-of-Interest Standards by Swap Dealers and Major Swap Participants, 75 FR 71391, Nov. 23, 2010. In addition, the Commission will be issuing proposed rules regarding recordkeeping, reporting and daily trading records for swap transactions consistent with § 1.31 of the Commission's Regulations. (17 CFR § 1.31).

Summary of proposed requirements. The proposed regulations would implement Section 4s(h) which requires the Commission to promulgate rules to establish business conduct standards for swap dealers and major swap participants governing their relationships with counterparties including special requirements with respect to Special Entities. Among other things, the statute mandates that the Commission adopt rules requiring swap dealers and major swap participants to verify that counterparties meet eligibility criteria, disclose material information about the contemplated swaps to counterparties, including material risks, characteristics, incentives and conflicts of interest; and an ongoing duty to provide counterparties a daily mark for swaps. The Commission also is directed to establish a duty for swap dealers and major swap participants to communicate in a fair and balanced manner based on principles of fair dealing and good faith.

Costs. The Commission's proposed rules implement new Section 4s(h) and enhance transparency, protect counterparties from fraud and abuse, bolster confidence in markets, reduce risk, and allow regulators to better monitor and manage our financial system. With respect to efficiency, the Commission has determined that adhering to the new requirements under the proposed rules will not be unduly burdensome for swap dealers and major swap participants. Indeed, the proposed rules, in part, reflect existing regulatory requirements in other markets as well as current industry practices in the swaps market.[145] In addition, the Commission has determined that the cost to market participants and the public if these rules are not adopted could be substantial. Significantly, without these rules to promote transparency and fair dealing, the financial integrity and stability of the swaps markets could be undermined.

Benefits. With respect to benefits, the Commission has determined that the proposed regulations would require a swap dealer or major swap participant to transact with market participants according to the principles of fair

[145] *See, e.g.,* Trading & Capital-Markets Activities Manual, Section 2150; CRMPG III Report.

dealing and good faith in a manner intended to heighten the protection of market participants and the public. The additional protections for Special Entities reduces the overall risk to institutions critical to the public interest and the stability of the financial system by providing tools and safeguards to market participants in order to accurately assess risk, make informed decisions, and avoid crises. The proposed rules, if adopted, will result in greater certainty, reduced risk, increased transparency and market integrity in the swap market. Therefore, the Commission believes it is prudent to issue these business conduct requirements for swap dealers and major swap participants.

The Commission invites public comment on its cost-benefit considerations. Commenters are also are invited to submit any data or other information that they may have quantifying or qualifying the costs and benefits of the proposed regulations with their comment letters.

List of Subjects in 17 CFR Part 23

Antitrust, Commodity futures, Business conduct standards, Conflict of Interests, Counterparties, Information, Major swap participants, Registration, Reporting and recordkeeping, Special entities, Swap dealers, Swaps.

List of Subjects in 17 CFR Part 155

Brokers, Commodity futures, Consumer protection, Reporting and recordkeeping requirements, Swaps.

For the reasons presented above, the Commodity Futures Trading Commission proposes to amend part 23 (as proposed to be added by FR Doc 2010–29024, published on November 23, 2010, 75 FR 71379) and part 155 of Title 17 of the Code of Federal Regulations as follows:

PART 23—SWAP DEALERS AND MAJOR SWAP PARTICIPANTS

Authority and Issuance

1. The authority citation for part 23 shall be revised to read as follows:

Authority: 7 U.S.C. 1a, 2, 6, 6a, 6b, 6c, 6p, 6s, 9, 9a, 12a, 13b, 13c, 16a, 18, 19, 21 as amended by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat. 1376 (Jul. 21, 2010).

2. Add subpart H to read as follows:

Subpart H—Business Conduct Standards for Swap Dealers and Major Swap Participants Dealing With Counterparties, Including Special Entities

Sec.
23.400 Scope.
23.401 Definitions.
23.402 General provisions.
23.403–23.409 [Reserved]
23.410 Prohibition on fraud, manipulation and other abusive practices.
23.411–23.429 [Reserved]
23.430 Verification of counterparty eligibility.
23.431 Disclosures of material information.
23.432 Clearing.
23.433 Communications—fair dealing.
23.434 Recommendations to counterparties—institutional suitability.
23.435–23.439 [Reserved]
23.440 Requirements for swap dealers acting as advisors to special entities.
23.441–23.449 [Reserved]
23.450 Requirements for swap dealers and major swap participants acting as counterparties to special entities.
23.451 Political contributions by certain swap dealers and major swap participants.

§ 23.400 Scope.

(a) *Scope.* The sections of this subpart shall apply to swap dealers and major swap participants. These rules are not intended to limit, or restrict the applicability of other provisions of the Act, and rules and regulations thereunder, or other applicable laws, rules and regulations. The provisions of this subpart shall apply in connection with transactions in swaps as well as in connection with swaps that are offered but not entered into.

§ 23.401 Definitions.

Counterparty. The term "counterparty," as appropriate in this subpart, includes any person who is a prospective counterparty to a swap.

Major swap participant. The term "major swap participant" means any person defined in Section 1a(33) of the Act and § 1.33(bbb) of this chapter and, as appropriate in this subpart, any person acting for or on behalf of a major swap participant, including an associated person defined in Section 1a(4) of the Act.

Special Entity. The term Special Entity means:

(1) A Federal agency;

(2) A State, State agency, city, county, municipality, or other political subdivision of a State or;

(3) Any employee benefit plan, as defined in Section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002);

(4) Any governmental plan, as defined in Section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002); or

(5) Any endowment, including an endowment that is an organization described in Section 501(c)(3) of the Internal Revenue Code of 1986 (26 U.S.C. 501(c)(3)).

Swap dealer. The term "swap dealer" means any person defined in Section 1a(49) of the Act and § 1.3(aaa) of this chapter and, as appropriate in this subpart, any person acting for or on behalf of a swap dealer, including an associated person defined in Section 1a(4) of the Act.

§ 23.402 General provisions.

(a) *Policies and Procedures to Ensure Compliance and Prevent Evasion of the Requirements of this Subpart.*

(1) Swap dealers and major swap participants shall have policies and procedures reasonably designed to:

(i) Ensure compliance with the requirements of this subpart; and

(ii) Prevent a swap dealer or major swap participant from evading or participating in or facilitating an evasion of any provision of the Act or any regulation promulgated thereunder.

(2) Swap dealers and major swap participants shall implement and monitor compliance with such policies and procedures as part of their supervision and risk management requirements specified in subpart J of this part.

(b) *Diligent Supervision.* Swap dealers and major swap participants shall diligently supervise their compliance with the requirements of this subpart in accordance with the diligent supervision requirements of subpart J of this part.

(c) *Know your counterparty.* Each swap dealer or major swap participant shall use reasonable due diligence to know and retain a record of the essential facts concerning each counterparty and the authority of any person acting for such counterparty, including facts necessary to:

(1) Comply with applicable laws, regulations and rules;

(2) Effectively service the counterparty;

(3) Implement any special instructions from the counterparty; and

(4) Evaluate the previous swaps experience, financial wherewithal and flexibility, trading objectives and purposes of the counterparty.

(d) *True name and owner.* Each swap dealer or major swap participant shall keep a record which shall show the true name and address of each counterparty, the principal occupation or business of such counterparty as well as the name and address of any other person

guaranteeing the performance of such counterparty and any person exercising any control with respect to the positions of such counterparty.

(e) *Reasonable Reliance on Representations.* A swap dealer or major swap participant that seeks to rely on the written representations of a counterparty with respect to any requirements under this subpart must have a reasonable basis to believe that the representations are reliable taking into consideration the facts and circumstances of the particular relationship, assessed in the context of the particular transaction. The representations shall include information sufficiently detailed for the swap dealer or major swap participant reasonably to conclude that the relevant requirement is satisfied. If agreed to by the counterparties, such representations may be contained in a master or other written agreement between the counterparties and may satisfy the relevant requirements of this subpart for subsequent swaps offered to or entered into with a counterparty, unless the representations are inadequate to meet the requirements of this subpart with respect to any subsequent swap.

(f) *Manner of disclosure.* A swap dealer or major swap participant may provide the information required by this subpart by any reliable means agreed to in writing by the counterparty.

(g) *Disclosures in a standard format.* If agreed to by a counterparty, the disclosure of material information that is applicable to multiple swaps between a swap dealer or major swap participant and a counterparty, may be made in a standard format, including in a master or other written agreement between the counterparties.

(h) *Record Retention.* Swap dealers and major swap participants shall create a record of their compliance with the requirements in this subpart and shall retain such records in accordance with subpart F of this part and § 1.31 of this chapter and make them available to applicable prudential regulators, upon request.

§§ 23.403–23.409 [Reserved]

§ 23.410 Prohibition on fraud, manipulation and other abusive practices.

(a) It shall be unlawful for a swap dealer or major swap participant–

(1) To employ any device, scheme, or artifice to defraud any Special Entity or prospective customer who is a Special Entity;

(2) To engage in any transaction, practice, or course of business that operates as a fraud or deceit on any Special Entity or prospective customer who is a Special Entity; or

(3) To engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative.

(b) *Confidential treatment of counterparty information.* It shall be unlawful for any swap dealer or major swap participant to disclose to any other person any material confidential information obtained from a counterparty, unless such disclosure is necessary for the effective execution of any swap for or with the counterparty or to hedge any exposure created by such swap, and the counterparty specifically consents to such disclosure, or such disclosure is made upon request of the Commission, Department of Justice or an applicable prudential regulator.

(c) *Trading ahead and front running prohibited.* It shall be unlawful for any swap dealer or major swap participant knowingly to enter into a transaction for its own benefit ahead of:

(1) Any executable order for a swap received from a counterparty, or

(2) Any swap that is the subject of negotiation with a counterparty, unless the counterparty specifically consents to the prior execution of such swap transaction.

§§ 23.411–23.429 [Reserved]

§ 23.430 Verification of counterparty eligibility.

(a) *Eligibility.* A swap dealer or major swap participant shall verify that a counterparty meets the eligibility standards for an eligible contract participant, as defined in Section 1a(18) of the Act and § 1.3(m) of this chapter, before offering to enter into or entering into a swap with that counterparty.

(b) *Special Entity.* In verifying the eligibility of a counterparty pursuant to paragraph (a) of this section, a swap dealer or major swap participant shall also verify whether the counterparty is a Special Entity.

(c) This section shall not apply with respect to a transaction that is:

(1) Initiated on a swap execution facility; and

(2) One in which the swap dealer or major swap participant does not know the identity of the counterparty to the transaction.

§ 23.431 Disclosures of material information.

(a) At a reasonably sufficient time prior to entering into a swap, a swap dealer or major swap participant shall disclose to any counterparty to the swap (other than a swap dealer, major swap participant, security-based swap dealer or major security-based swap participant) material information concerning the swap in a manner reasonably designed to allow the counterparty to assess–

(1) The material risks of the particular swap, which may include, market, credit, liquidity, foreign currency, legal, operational, and any other applicable risks. In addition to the disclosures of material risks required in paragraph (a) of this section:

(i) Prior to entering into a bilateral swap that is not available for trading on a designated contract market or swap execution facility, swap dealers and major swap participants shall notify the counterparty that it can request a scenario analysis as provided in paragraph (a)(1) of this section. Swap dealers and major swap participants shall, upon request of such counterparty, provide such scenario analysis.

(ii) For a high-risk complex bilateral swap with a counterparty, a swap dealer or major swap participant shall provide a scenario analysis designed in consultation with the counterparty to allow the counterparty to assess its potential exposure in connection with the swap. The scenario analysis shall be done over a range of assumptions, including severe downside stress scenarios that would result in a significant loss.

(iii) For the purposes of paragraph (a)(1)(ii) of this section, a swap dealer or major swap participant shall use reasonable policies and procedures to determine whether a bilateral swap is a high-risk complex swap based on the material characteristics of the swap including, but not limited to, one or more of the following criteria:

(A) The degree and nature of leverage;

(B) The potential for periods of significantly reduced liquidity; and

(C) The lack of price transparency.

(iv) The scenario analysis required by paragraphs (a)(1)(i) and (a)(1)(ii) of this section shall be provided by the swap dealer or major swap participant in both tabular and narrative formats. The swap dealer or major swap participant shall disclose all material assumptions and explain the calculation methodologies used to perform the required analysis; provided that, the swap dealer or major swap participant is not required to disclose confidential, proprietary information about any model it may use to value the swap.

(v) In designing the scenario analysis required by paragraphs (a)(1)(i) and (a)(1)(ii) of this section, a swap dealer or major swap participant shall consider any relevant analyses that it undertakes for its own risk management purposes, including analyses performed as part of its "New Product Policy" specified in § 23.600(c)(3);

(2) The material characteristics of the particular swap, which shall include 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; and

(3) The material incentives and conflicts of interest that the swap dealer or major swap participant may have in connection with the particular swap, which shall include:

(i) With respect to disclosure of the price of a swap, the price of the swap and the mid-market value of the swap as defined in paragraph (c)(2) of this section; and

(ii) Any compensation or other incentive from any source other than the counterparty that the swap dealer or major swap participant may receive in connection with the swap.

(b) Paragraph (a) of this section shall not apply with respect to a transaction that is:

(1) Initiated on a designated contract market or a swap execution facility; and

(2) One in which the swap dealer or major swap participant does not know the identity of the counterparty to the transaction.

(c) *Daily mark.* A swap dealer or major swap participant shall:

(1) For cleared swaps, notify a counterparty of the counterparty's right to receive, upon request, the daily mark from the appropriate derivatives clearing organization; and

(2) For uncleared swaps, provide the counterparty with a daily mark which shall be the mid-market value of the swap. The mid-market value of the swap shall not include amounts for profit, credit reserve, hedging, funding, liquidity or any other costs or adjustments. The daily mark shall be provided to the counterparty on each business day during the term of the swap as of the close of business, or such other time as the parties agree in writing.

(3) For uncleared swaps, disclose to the counterparty:

(i) The methodology and assumptions used to prepare the daily mark and any material changes during the term of the swap, provided that, the swap dealer or major swap participant is not required to disclose to the counterparty confidential, proprietary information about any model it may use to prepare the daily mark.

(ii) Additional information concerning the daily mark to ensure a fair and balanced communication, including, as appropriate:

(A) The daily mark may not necessarily be a price at which either the counterparty or the swap dealer or major swap participant would agree to replace or terminate the swap;

(B) Depending upon the agreement of the parties, calls for margin may be based on considerations other than the daily mark provided to the counterparty; and

(C) The daily mark may not necessarily be the value of the swap that is marked on the books of the swap dealer or major swap participant.

§ 23.432 Clearing.

(a) *For swaps required to be cleared—right to select derivatives clearing organization.* A swap dealer or major swap participant shall notify any counterparty (other than a registered swap dealer, securities-based swap dealer, major swap participant or major securities-based swap participant) that enters into a swap or is offered to enter into a swap that is subject to mandatory clearing under Section 2(h) of the Act, that the counterparty has the sole right to select the derivatives clearing organization at which the swap will be cleared.

(b) *For swaps not required to be cleared—right to clearing.* A swap dealer or major swap participant shall notify any counterparty (other than a registered swap dealer, securities-based swap dealer, major swap participant or major securities-based swap participant) that enters into a swap that is not subject to the mandatory clearing requirements under Section 2(h) of the Act that the counterparty:

(1) May elect to require clearing of the swap, and

(2) Shall have the sole right to select the derivatives clearing organization at which the swap will be cleared.

§ 23.433 Communications—fair dealing.

With respect to any communication between a swap dealer or major swap participant and any counterparty, the swap dealer or major swap participant shall communicate in a fair and balanced manner based on principles of fair dealing and good faith.

§ 23.434 Recommendations to counterparties—institutional suitability.

(a) A swap dealer or major swap participant shall have a reasonable basis to believe that any swap or trading strategy involving swaps recommended to a counterparty is suitable for the counterparty based on information obtained through reasonable due diligence concerning the counterparty's financial situation and needs, objectives, tax status, ability to evaluate the recommendation, liquidity needs, risk tolerance, ability to absorb potential losses related to the recommended swap or trading strategy, and any other information known by the swap dealer or major swap participant.

(b)(1) A swap dealer or major swap participant will fulfill its obligations under paragraph (a) of this section if:

(i) The swap dealer has a reasonable basis to believe that the counterparty is capable of evaluating, independently, the risks related to a particular swap or trading strategy involving swaps recommended to the counterparty;

(ii) The counterparty affirmatively indicates that it is exercising independent judgment in evaluating the recommendations; and

(iii) The swap dealer has a reasonable basis to believe that the counterparty has the capacity to absorb potential losses related to the recommended swap or trading strategy involving swaps.

(2) Provided that, where a counterparty has delegated discretionary authority to another person, such as a registered commodity trading advisor, the factors contained in paragraphs (b)(1)(i) and (b)(1)(ii) of this section shall be applied to such person.

(c) This section shall not apply:

(1) To any recommendations made to another swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant; or

(2) Where a swap dealer or major swap participant provides:

(i) Information that is general transaction, financial, or market information; or

(ii) Swap terms in response to a competitive bid request from the counterparty.

§§ 23.435–23.439 [Reserved]

§ 23.440 Requirements for swap dealers acting as advisors to special entities.

(a) For purposes of this section the term "acts as an advisor to a Special Entity" shall include where a swap dealer recommends a swap or trading strategy that involves the use of swaps to a Special Entity. The term shall not include where a swap dealer provides:

(1) Information to a Special Entity that is general transaction, financial, or market information or

(2) Swap terms in response to a competitive bid request from the Special Entity.

(b) A swap dealer that acts as an advisor to a Special Entity regarding a swap shall comply with the following requirements:

(1) *Duty.* Any swap dealer that acts as an advisor to a Special Entity shall have a duty to act in the best interests of the Special Entity.

(2) *Reasonable Efforts.* Any swap dealer that acts as an advisor to a

Special Entity shall 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 swap dealer is in the best interests of the Special Entity. This information shall include information relating to:

(i) The authority of the Special Entity to enter into a swap;

(ii) The financial status of the Special Entity, as well as future funding needs;

(iii) The tax status of the Special Entity;

(iv) The investment or financing objectives of the Special Entity (including review of any written derivatives, financing and investment policies, plans or similar documents);

(v) The experience of the Special Entity with respect to entering into swaps, generally, and swaps of the type and complexity being recommended;

(vi) Whether the Special Entity has an independent representative that meets the criteria enumerated in § 23.450(b);

(vii) Whether the Special Entity has the financial capability to withstand potential market-related changes in the value of the swap during the term of the swap; and

(viii) Such other information as is relevant to the particular facts and circumstances of the Special Entity, market conditions and the type of swap recommended.

(c) *Reasonable reliance on representations of the Special Entity.* The swap dealer may rely on written representations of the Special Entity to satisfy its requirement in paragraph (b) of this section to make "reasonable efforts" to obtain necessary information, provided that:

(1) The swap dealer has a reasonable basis to believe that the representations are reliable taking into consideration the facts and circumstances of a particular swap dealer-Special Entity relationship, assessed in the context of a particular transaction; and

(2) The representations include information sufficiently detailed for the swap dealer to reasonably conclude that the Special Entity is:

(i) Capable of evaluating independently the material risks inherent in the recommendation;

(ii) Exercising independent judgment in evaluating the recommendation; and

(iii) Capable of absorbing potential losses related to the recommended swap; and

(3) The swap dealer has a reasonable basis to believe that the Special Entity has a representative that meets the criteria enumerated in § 23.450(b).

§§ 23.441–23.449 [Reserved]

§ 23.450 Requirements for swap dealers and major swap participants acting as counterparties to special entities.

(a) *Definitions.* For purposes of this section:

(1) The term "material business relationship" means any relationship with a swap dealer or major swap participant, whether compensatory or otherwise, that reasonably could affect the independent judgment or decision making of the representative, provided however, that material business relationship does not include payment of fees by the swap dealer or major swap participant to the representative at the written direction of the Special Entity for services provided by the representative in connection with the swap executed between the Special Entity and the swap dealer or major swap participant. The term "material business relationship" shall be subject to a one-year look back; and

(2) The term "principal relationship" means where a swap dealer or major swap participant is a principal of the representative of a Special Entity or the representative of a Special Entity is a principal of the swap dealer or major swap participant, as the term "principal" is defined in § 3.1(a) of this chapter;

(3) The term "statutory disqualification" means grounds for refusal to register or to revoke, condition or restrict the registration of any registrant or applicant for registration as set forth in Sections 8a(2) and 8a(3) of the Act.

(b) Any swap dealer or major swap participant that offers to or enters into a swap with a Special Entity shall have a reasonable basis to believe that the Special Entity has a representative that:

(1) Has sufficient knowledge to evaluate the transaction and risks;

(2) Is not subject to a statutory disqualification;

(3) Is independent of the swap dealer or major swap participant;

(4) Undertakes a duty to act in the best interests of the Special Entity it represents;

(5) Makes appropriate and timely disclosures to the Special Entity;

(6) Evaluates, consistent with any guidelines provided by the Special Entity, fair pricing and the appropriateness of the swap;

(7) In the case of employee benefit plans subject to the Employee Retirement Income Security Act of 1974, is a fiduciary as defined in Section 3 of that Act (29 U.S.C. 1002); and

(8) In the case of a municipal entity as defined in § 23.451, is subject to restrictions on certain political contributions imposed by the Commission, the Securities and Exchange Commission or a self-regulatory organization subject to the jurisdiction of the Commission or the Securities and Exchange Commission, provided that, this paragraph shall not apply if the representative is an employee of the Special Entity.

(c) For purposes of paragraph (b)(3) of this section, a representative of a Special Entity will be deemed to be independent of the swap dealer or major swap participant if:

(1) The representative is not and, within one year, was not an associated person of the swap dealer or major swap participant, within the meaning of Section 1a(4) of the Act;

(2) There is no principal relationship between the representative of the Special Entity and the swap dealer or major swap participant; and

(3) The representative does not have a material business relationship with the swap dealer or major swap participant, provided however, that if the representative received any compensation from the swap dealer or major swap participant, the swap dealer or major swap participant must ensure that the Special Entity is informed of the compensation and the Special Entity agrees in writing, in consultation with the representative, that the compensation does not constitute a material business relationship.

(d) *Reasonable reliance on representations of the Special Entity.* A swap dealer may rely on written representations of a Special Entity to satisfy its obligation to have a reasonable basis to believe that the Special Entity has a representative that satisfies the criteria in paragraph (b) of this section provided that:

(1) The swap dealer has a reasonable basis to believe that the representations are reliable taking into consideration the facts and circumstances of a particular Special Entity-representative relationship, assessed in the context of a particular transaction;

(2) The representations include information sufficiently detailed for the swap dealer reasonably to conclude that the representative satisfies the criteria in paragraph (b) of this section. Relevant considerations would include:

(i) The nature of the relationship between the Special Entity and the representative and the duties of the representative, including the obligation of the representative to act in the best interests of the Special Entity;

(ii) The representative's capability to make hedging or trading decisions, and the resources available to the

representative to make informed decisions;

(iii) The use by the representative of one or more consultants;

(iv) The general level of experience of the representative in financial markets and specific experience with the type of instruments, including the specific asset class, under consideration;

(v) The representative's ability to understand the economic features of the swap involved;

(vi) The representative's ability to evaluate how market developments would affect the swap; and

(vii) The complexity of the swap or swaps involved.

(e) *Unqualified representative.* If a swap dealer or major swap participant determines that the representative of a Special Entity does not meet the criteria established in this section, the swap dealer or major swap participant shall make a written record of the basis for such determination and submit such determination to its Chief Compliance Officer for review to ensure that the swap dealer or major swap participant has a substantial, unbiased basis for the determination.

(f) Before the initiation of a swap, a swap dealer or major swap participant shall disclose to the Special Entity in writing:

(1) The capacity in which it is acting in connection with the swap; and

(2) If the swap dealer or major swap participant engages in business with the Special Entity in more than one capacity, the swap dealer or major swap participant shall disclose the material differences between such capacities in connection with the swap and any other financial transaction or service involving the Special Entity.

(g) This section shall not apply with respect to a transaction that is:

(1) Initiated on a designated contract market or swap execution facility; and

(2) One in which the swap dealer or major swap participant does not know the identity of the counterparty to the transaction.

§ 23.451 Political contributions by certain swap dealers and major swap participants.

(a) *Definitions.* For the purposes of this section:

(1) The term "*contribution*" means any gift, subscription, loan, advance, or deposit of money or anything of value made:

(i) For the purpose of influencing any election for state or local office;

(ii) For payment of debt incurred in connection with any such election; or

(iii) For transition or inaugural expenses incurred by the successful candidate for state or local office.

(2) The term "*covered associate*" means:

(i) Any general partner, managing member or executive officer, or other person with a similar status or function;

(ii) Any employee who solicits a municipal entity for the swap dealer or major swap participant and any person who supervises, directly or indirectly, such employee; and

(iii) Any political action committee controlled by the swap dealer or major swap participant or by any person described in paragraphs (a)(2)(i) and (a)(2)(ii) of this section.

(3) The term "*municipal entity*" means any State, political subdivision of a State, or municipal corporate instrumentality of a State, including—

(i) Any agency, authority, or instrumentality of the State, political subdivision, or municipal corporate instrumentality;

(ii) Any plan, program, or pool of assets sponsored or established by the State, political subdivision, or municipal corporate instrumentality or any agency, authority, or instrumentality thereof; and any other issuer of municipal securities.

(4) The term "*official*" of a municipal entity means any person (including any election committee for such person) who was, at the time of the contribution, an incumbent, candidate or successful candidate for elective office of a municipal entity, if the office:

(i) Is directly or indirectly responsible for, or can influence the outcome of, the selection of a swap dealer or major swap participant by a municipal entity; or

(ii) Has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the selection of a swap dealer or major swap participant by a municipal entity.

(5) The term "*payment*" means any gift, subscription, loan, advance, or deposit of money or anything of value.

(6) The term "*regulated person*" means:

(i) A person that is subject to restrictions on certain political contributions imposed by the Commission, the Securities and Exchange Commission or a self-regulatory agency subject to the jurisdiction of the Commission or the Securities and Exchange Commission;

(ii) A general partner, managing member or executive officer of such person, or other individual with a similar status or function; or

(iii) An employee of such person who solicits a municipal entity for the swap dealer or major swap participant and any person who supervises, directly or indirectly, such employee.

(7) The term "*solicit*" means a direct or indirect communication by any person with a municipal entity for the purpose of obtaining or retaining an engagement related to a swap.

(b) *Prohibitions and Exceptions.*

(1) As a means reasonably designed to prevent fraud, no swap dealer or major swap participant shall offer to enter into or enter into a swap or a trading strategy involving a swap with a municipal entity within two years after any contribution to an official of such municipal entity was made by the swap dealer or major swap participant, or by any covered associate of the swap dealer or major swap participant, provided however, that:

(2) This prohibition does not apply:

(i) If the only contributions made by the swap dealer or major swap participant to an official of such municipal entity were made by a covered associate:

(A) To officials for whom the covered associate was entitled to vote at the time of the contributions, provided that the contributions in the aggregate do not exceed $350 to any one official per election; or

(B) To officials for whom the covered associate was not entitled to vote at the time of the contributions, provided that the contributions in the aggregate do not exceed $150 to any one official, per election;

(ii) To a swap dealer or major swap participant as a result of a contribution made by a natural person more than six months prior to becoming a covered associate of the swap dealer or major swap participant, provided that this exclusion shall not apply if the natural person, after becoming a covered associate, solicits the municipal entity on behalf of the swap dealer or major swap participant to offer to enter into or to enter into a swap or trading strategy involving; or

(iii) With respect to a swap that is initiated on a designated contract market or swap execution facility if the swap dealer or major swap participant does not know the identity of the counterparty to the transaction at the time of the transaction.

(3) No swap dealer or major swap participant or any covered associate of the swap dealer or major swap participant shall:

(i) Provide or agree to provide, directly or indirectly, payment to any person to solicit a municipal entity to offer to enter into, or to enter into, a swap with that swap dealer or major swap participant unless such person is a regulated person; or

(ii) Coordinate, or solicit any person or political action committee to make, any:

(A) Contribution to an official of a municipal entity with which the swap dealer or major swap participant is offering to enter into, or has entered into, a swap; or

(B) Payment to a political party of a state or locality with which the swap dealer or major swap participant is offering to enter into or has entered into a swap or a trading strategy involving a swap.

(c) *Circumvention of Rule.* No swap dealer or major swap participant shall, directly or indirectly, through or by any other person or means, do any act that would result in a violation of paragraph (b) of this section.

(d) *Requests for Exemption.* The Commission, upon application, may conditionally or unconditionally exempt a swap dealer or major swap participant from the prohibition under paragraph (b) of this section. In determining whether to grant an exemption, the Commission will consider, among other factors:

(1) Whether the exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes of the Act;

(2) Whether the swap dealer or major swap participant:

(i) Before the contribution resulting in the prohibition was made, adopted and implemented policies and procedures reasonably designed to prevent violations of this section;

(ii) Prior to or at the time the contribution which resulted in such prohibition was made, had no actual knowledge of the contribution; and

(iii) After learning of the contribution:

(A) Has taken all available steps to cause the contributor involved in making the contribution which resulted in such prohibition to obtain a return of the contribution; and

(B) Has taken such other remedial or preventive measures as may be appropriate under the circumstances;

(3) Whether, at the time of the contribution, the contributor was a covered associate or otherwise an employee of the swap dealer or major swap participant, or was seeking such employment;

(4) The timing and amount of the contribution which resulted in the prohibition;

(5) The nature of the election (*e.g.,* Federal, State or local); and

(6) The contributor's apparent intent or motive in making the contribution that resulted in the prohibition, as evidenced by the facts and circumstances surrounding the contribution.

(e) *Prohibitions Inapplicable.* (1) The prohibitions under paragraph (b) of this section shall not apply to a contribution made by a covered associate of the swap dealer or major swap participant if:

(i) The swap dealer or major swap participant discovered the contribution within 120 calendar days of the date of such contribution;

(ii) The contribution did not exceed the amounts permitted by paragraphs (b)(2)(i)(A) or (B) of this section; and

(iii) The covered associate obtained a return of the contribution within 60 calendar days of the date of discovery of the contribution by the swap dealer or major swap participant.

(2) A swap dealer or major swap participant may not rely on paragraph (e)(1) of this section more than twice in any 12-month period.

(3) A swap dealer or major swap participant may not rely on paragraph (e)(1) of this section more than once for any covered associate, regardless of the time between contributions.

PART 155—TRADING STANDARDS

Authority and Issuance

3. The authority citation for part 155 shall be revised to read as follows:

Authority: 7 U.S.C. 6b, 6c, 6g, 6j, 6s, and 12a as amended by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376 (Jul. 21, 2010).

4. Add § 155.7 to read as follows:

§ 155.7 Execution standards.

(a) In connection with any customer order to enter into a swap where such swap is available for trading on one or more designated contract markets or swap execution facilities, a Commission registrant shall:

(1) Prior to execution of the swap, disclose to the customer:

(i) The designated contract markets and swap execution facilities on which the swap is available for trading; and

(ii) The designated contract markets and swap execution facilities on which the registrant has trading privileges.

(2) Execute the order on terms that have a reasonable relationship to the best terms available for such swap on designated contract markets or swap execution facilities trading such swap.

(b) As part of the execution requirements in paragraph (a) of this section, the registrant shall use reasonable diligence to ascertain the best terms available. Among the factors that will be considered in determining whether a Commission registrant has used "reasonable diligence" are:

(1) The character of the market for the swap, including price, volatility, speed, certainty of execution, and liquidity;

(2) The size and type of transaction;

(3) The number of markets checked;

(4) Accessibility of quotations; and

(5) The terms and conditions of the order which results in the transaction, as communicated to the Commission registrant.

By the Commission, this 9th day of December 2010.

David A. Stawick,

Secretary.

Appendices to Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties—Commission Voting Summary and Statements of Commissioners

Note: The following appendices will not appear in the Code of Federal Regulations.

Appendix 1—Commission Voting Summary

On this matter, Chairman Gensler and Commissioners Dunn, Sommers, Chilton and O'Malia voted in the affirmative; no Commissioner voted in the negative.

Appendix 2—Statement of Chairman Gary Gensler

I support the proposed rulemaking to establish business conduct standards for swap dealers and major swap participants in their dealings with counterparties. Today's proposal implements important new authorities that Congress granted the Commission to establish and enforce robust sales practices in the swap markets. The proposed rule will level the playing field and bring needed transparency. It will strengthen confidence in the market to benefit hedgers and other market participants.

The proposed rule would prohibit fraud and certain abusive practices. It also would implement requirements for swap dealers and major swap participants to deal fairly with customers, provide balanced communications and disclose conflicts of interest and material incentives before entering into a swap. The rule also would implement the Dodd-Frank heightened duties on swap dealers and major swap participants when they deal with certain entities, such as pension plans, governmental entities and endowments.

The proposed rule is intended to ensure that swaps customers get fair treatment in the execution of their transactions. It would require swap dealers to disclose what access they have to swap execution facilities and designated contract markets. These rules also prohibit a swap dealer from defrauding a customer by executing a transaction on terms that have no "reasonable relationship" to the market. The proposed rule provides flexibility to accommodate developments in

the swaps markets while also protecting customers.

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