



Commodity Futures Trading Commission

Office of Public Affairs

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Q & A – External Business Conduct Standards for Swap Dealers and Major Swap Participants Dealings with Counterparties Proposed Rulemaking

What is the goal of the proposed rulemaking?

The proposed rules implement the Dodd-Frank Act's external business conduct requirements for swap dealers ("SDs") and major swap participants ("MSPs") in their dealings with counterparties, including "Special Entities."

Do the proposed rules change the ways in which swap dealers and major swap participants will deal with their counterparties?

Based on the Dodd-Frank Act, the proposed rules would establish due diligence and disclosure obligations, as well as outright prohibitions against certain practices. Generally, these new duties are adapted from industry "best practices" recommendations, self regulatory organization approaches to business conduct standards, and certain existing CFTC requirements for market professionals. The proposed due diligence and disclosure obligations, generally, would not apply to transactions initiated by a counterparty on a designated contract market or swap execution facility where the SD/MSP does not know the identity of the counterparty.

What are the prohibited practices for swap dealers and major swap participants?

The proposed rules adopt the antifraud prohibition applicable to SDs and MSPs in new Section 4s(h)(4) of the Commodity Exchange Act ("CEA"). The rules also would prohibit SDs and MSPs from disclosing material confidential counterparty information and trading ahead or front running counterparty swap transactions. SDs/MSPs would remain subject to all other applicable provisions of the CEA and the Commission's regulations.

What general duties will swap dealers and major swap participants have towards their counterparties under the proposed rules?

Verification of Eligibility. SDs/MSPs would have to verify that a counterparty is an eligible contract participant ("ECP") as defined in Section 1a(18) of the Act and whether the counterparty is a Special Entity.

Disclosures of Material Information. SDs/MSPs would have to disclose to a counterparty (other than an SD/MSP, security-based swap dealer or major security-based swap participant) information concerning the swap in a manner reasonably designed to allow the counterparty to assess the material risks and characteristics of the swap and the material incentives and conflicts of interest that the SD/MSP may have in connection with the swap.

Scenario analysis. For high-risk complex bilateral swaps, SDs/MSPs would have 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. The characteristics of high-risk complex swaps would include one or more of the following criteria: the degree and nature of any leverage; the potential for periods of significantly reduced liquidity; and the lack of price transparency. For bilateral swaps not available for trading on a designated contract market or swap execution facility that are not high-risk complex swaps, counterparties would be able to "opt-in" to obtain a scenario analysis for such swap.

Clearing. SDs/MSPs would have to inform any counterparty of the counterparty’s right to select a derivatives clearing organization (“DCO”) for cleared swaps, and for swaps not subject to the mandatory clearing requirement under Section 2(h) of the Act, the counterparty’s right to elect to clear and to select the DCO.

Daily mark. For cleared swaps, the SD/MSP would have to notify the counterparty of its right to receive a daily mark from the DCO, and for uncleared swaps, provide the counterparty on each business day during the term of the swap a daily mark that is the mid-market value of the swap.

Other duties. SDs/MSPs would have to communicate in a fair and balanced manner based on principles of fair dealing and good faith, have a reasonable basis to believe that any swap or trading strategy involving swaps recommended to a counterparty is suitable for the counterparty, and abide by execution standards with respect to swaps available for trading on a designated contract market or swap execution facility. The proposed execution standards rule would apply to all Commission registrants, not just SDs/MSPs.

Are there any situations in which the general obligations above would not apply?

Yes. For example, the requirement to disclose material information about the risks, characteristics, incentives and conflicts of interest regarding a swap would not apply when the counterparty is another SD/MSP or a security-based swap dealer or major security-based swap participant. In addition, the general verification of eligibility and disclosure duties would not apply when the transaction is initiated by a counterparty on a swap execution facility or designated contract market and the SD/MSP does not know the counterparty’s identity.

Will swap dealers and major swap participants be able to rely on standard form disclosures to satisfy some of their obligations?

Proposed rule 23.402(f) would provide flexibility to SDs/MSPs and their counterparties to agree to a reliable means for making disclosures of material information. Proposed rule 23.402(g) also would allow SDs/MSPs to use, where appropriate, standardized formats to make certain required disclosures of material information, and to include such standardized disclosures in a master or other written agreement between the parties. While standardized disclosures may be appropriate to meet certain disclosure obligations concerning 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 for any particular customized swap.

Will swap dealers and major swap participants be able to satisfy any of their obligations by relying on their counterparties’ representations?

Yes. For example, with respect to the verification of counterparty eligibility, SDs/MSPs would be permitted to rely on reasonable representations of a potential counterparty to establish its eligibility as an ECP. In addition, to fulfill its obligations to determine whether the proposed swap was suitable for the counterparty, SDs/MSPs could rely on a counterparty’s representations, absent red flags, that the counterparty was capable of independently evaluating relevant risks, the counterparty affirmed it was exercising independent judgment, and the counterparty could absorb potential losses related to the recommended swap.

What is a Special Entity?

Under the proposed rules, Special Entity would have the same definition as in new Section 4s(h)(2) of the CEA: 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 the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002) (“ERISA”); 4) a governmental plan, as defined in 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.

What additional duties will a swap dealer or major swap participant have to satisfy when their counterparty is a Special Entity?

As provided, generally, in new Section 4s(h)(5) of the CEA, the proposed rule would require that any SD/MSP that offers to or enters into a swap with a Special Entity 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 SD/MSP; 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 the appropriateness and pricing of any swaps, in accordance with any guidelines provided by the Special Entity; 7) in the case of employee benefit plans subject to ERISA, is a fiduciary as defined in Section 3 of that Act; and 8) in the case of a municipal entity as defined in proposed rule 23.460, is subject to restrictions on certain political contributions.

SDs/MSPs also would have to disclose the capacity in which they are acting when entering into a swap with a Special Entity.

What will it mean to act as an advisor to a Special Entity?

For purposes of the proposed rules, the term “acts as an advisor to a Special Entity” would include where an SD recommends a swap or swap trading strategy to a Special Entity. The term would not include where an SD provides: general transaction, financial, or market information, or terms in response to a competitive bid request from the Special Entity.

What duties will a swap dealer have to satisfy when it is acting as an advisor to a Special Entity?

Based on new Section 4s(h)(4) of the CEA, the proposed rule would require SDs “acting as an advisor to a Special Entity” to act in the “best interests” of the Special Entity and to make “reasonable efforts” to ensure that any recommendation made to the Special Entity is in the Special Entity’s “best interests.” SDs/MSPs would be able, as provided, to rely on the Special Entity’s representations to meet its “reasonable efforts” requirement. The Commission has not proposed to define “best interests” but would expect, based on case law, that SDs would act in good faith and make full and fair disclosure of all material facts and conflicts of interest, and employ reasonable care that any recommendation given to a Special Entity is designed to further the purposes of the Special Entity.

Will swap dealers be able to act as an advisor to a Special Entity and then enter into the same swap for which it provided the advice?

The proposed rules are intended to permit existing business relationships between SDs and Special Entities to continue, albeit subject to the new, higher statutory standards of care. The proposed rules are not intended to preclude, *per se*, an SD 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 rules.

What other general obligations will swap dealers and major swap participants have to satisfy under these proposed rules?

The Commission proposes to prohibit SDs/MSPs dealing with municipal entities from making certain political contributions to certain officials of those municipal entities. There will be exceptions for *de minimis* contributions and newly covered associates, and SDs/MSPs will be able to apply to the Commission for an exemption on an individual basis.