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COMMODITY FUTURES TRADING COMMISSION

17 CFR Parts 4 and 23

RIN 3038-AD25

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

AGENCY: Commodity Futures Trading Commission.

ACTION: Final rules.

SUMMARY: The Commodity Futures Trading Commission ("Commission" or "CFTC") is adopting final rules to implement Section 4s(h) of the Commodity Exchange Act ("CEA") pursuant to Section 731 of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"). These rules prescribe external business conduct standards for swap dealers and major swap participants.

DATES: Effective Date: These final rules will become effective on [**INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER**].

Compliance Date: Swap dealers and major swap participants must comply with the rules in subpart H of part 23 on the later of 180 days after the effective date of these rules or the date on which swap dealers or major swap participants are required to apply for registration pursuant to Commission rule 3.10.

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SUPPLEMENTARY INFORMATION: The Commission is adopting final rules §§ 23.400-402, 23.410, 23.430-434, 23.440, and 23.450-451 under Section 4s(h) of the CEA and § 4.6(a)(3) under Section 1a(12) of the CEA.

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I. Introduction

On July 21, 2010, President Obama signed the Dodd-Frank Act.[1] Title VII of the Dodd-Frank Act amended the CEA[2] to establish a comprehensive new regulatory framework for swaps.[3] The legislation was enacted to reduce risk, increase transparency and promote 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.

On December 22, 2010, the Commission published in the Federal Register proposed subpart H of part 23 of the Commission's Regulations to implement new Section 4s(h) of the CEA pursuant to Section 731 of the Dodd-Frank Act (the "proposed rules" or "proposing release").[4] There was a 60-day period for the public to comment on the proposing release, which ended on February 22, 2011. On May 4, 2011, the Commission published in the Federal Register a notice to re-open the public comment period for an additional 30 days, which ended on June 3, 2011.[5]

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[1] See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).
[2] 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 except where otherwise noted.
[3] Title VII of the Dodd-Frank Act also amended the federal securities laws to establish a similar comprehensive new regulatory framework for security-based swaps.
[4] Proposed Rules for Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties, 75 FR 80638, Dec. 22, 2010 ("proposing release").
[5] Reopening and Extension of Comment Periods for Rulemakings Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR 25274, May 4, 2011 ("Extension of Comment Periods"). As reflected

The Commission has determined to adopt the proposed rules with a few exceptions and with certain modifications, discussed below, to address the comments the Commission received. One rule that the Commission has determined not to adopt at this time is proposed § 155.7, which would have required Commission registrants to comply with swap execution standards.[6] Should the Commission determine to consider execution standards at a later date, it would re-propose such rules.

Section 731 of the Dodd-Frank Act amends the CEA by adding Section 4s(h).[7] Section 4s(h) provides the Commission with both mandatory and discretionary rulemaking authority to impose business conduct standards on swap dealers and major swap participants in their dealings with counterparties, including Special Entities.[8] The proposing release included rules mandated by Section 4s(h) as well as discretionary rules that the Commission determined were appropriate in the public interest, for the protection of investors and in furtherance of the purposes of the CEA.[9]

In compliance with Sections 712(a)(1) and 752(a)[10] of the Dodd-Frank Act, Commission

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in the public comment file, the Commission continued to receive comments and meet with commenters after the comment period officially closed.

[6] Proposing release, 75 FR at 80648-49 and 80662.

[7] 7 U.S.C. 6s(h).

[8] Section 4s(h)(2)(C) defines Special Entity as: "(i) a Federal Agency; (ii) a State, State agency, city, county, municipality, or other political subdivision of a State; (iii) an employee benefit plan, as defined in section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002); (iv) any governmental plan, as defined in section 3 of the Employee Retirement Income Security Act of 1974; or (v) any endowment, including an endowment that is an organization described in section 501(c)(3) of the Internal Revenue Code of 1986."

[9] 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 [the CEA.]"); see also Sections 4s(h)(1)(D), 4s(h)(5)(B) and 4s(h)(6). The proposed and final rules are informed by existing requirements for market intermediaries under the CEA and Commission Regulations, the federal securities laws, self-regulatory organization ("SRO") rules, prudential regulator standards for banks, industry "best practices" and requirements applicable under foreign regulatory regimes. See proposing release, 75 FR at 80639 for further discussion of the sources the Commission considered in drafting the proposing release.

[10] Section 712(a)(1) of the Dodd-Frank Act requires that the Commission consult with SEC and prudential regulators in promulgating rules pursuant to Section 4s(h). Section 752(a) of the Dodd-Frank Act states in part, that the Commission, SEC, and the prudential regulators "shall consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards with respect to the regulation (including fees) of swaps . . . ."

staff consulted and coordinated with the Securities and Exchange Commission ("SEC"),[11] prudential regulators and foreign authorities. Commission staff also consulted informally with staff from the Department of Labor ("DOL") and the Internal Revenue Service ("IRS") with respect to certain Special Entity definitions and the intersection of their regulatory requirements with the Dodd-Frank Act business conduct standards provisions. This ongoing consultation and coordination effort is described more fully in Section II of this adopting release.

In addition, Commission staff consulted with foreign authorities, specifically European Commission and United Kingdom Financial Services Authority staff. Commission staff also considered the existing and ongoing work of the International Organization of Securities Commissions ("IOSCO"). Staff consultations with foreign authorities revealed similarities in the proposed rules and foreign regulatory requirements.[12]

The Commission received more than 120 written submissions on the proposing release from a range of commenters.[13] Commission staff also met with representatives from at least 33 of the commenters and other members of the public. Commenters included members of Congress, dealers, advisors, large asset managers, consumer advocacy groups and pension beneficiaries, end-users, trade or professional organizations and Special Entities such as State and municipal governmental entities, ERISA pension plan sponsors and administrators, government pension

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[11] See proposing release, 75 FR at 80640 for further discussion of the Commission's consultation and coordination with the SEC before issuing the proposing release.

[12] See proposing release, 75 FR at 80640 for further discussion of the Commission's consultation with foreign authorities. 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; see also 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; Proposal for a Directive of the European Parliament and of the Council on markets in financial instruments repealing Directive 2004/39/EC, COM (2011) 656 final (Oct. 20, 2011) ("MiFID II Proposal").

[13] Subsequent to the issuance of the proposing release, the Commission received written submissions from the public, available in the comment file on www.cftc.gov, including, but not limited to those listed in the table in Appendix 1 to this adopting release.

plan administrators and endowments. These comments and meetings were in addition to seven written submissions received by the Commission and at least 33 meetings held by Commission staff with commenters and other members of the public prior to the publication of the proposing release.[14] The proposed rules included a scope provision,[15] definitions,[16] general compliance provisions,[17] rules that would apply to dealings with all counterparties[18] and rules that would apply to dealings with Special Entities.[19] While the comments touched on all aspects of the proposing release, many of them concerned the proposed requirements for swap dealers and major swap participants in their dealings with Special Entities.

The Commission has reviewed and considered the comments and, in Sections III and IV below, has endeavored to address both the primary themes running throughout the comment letters and the significant points made by individual commenters. The final rules, like the statute and proposed rules, are principles based and generally follow the framework of the proposed rules.[20] The text has been clarified in a number of respects to take into account the comments received by the Commission and to harmonize with the SEC's and DOL's regulatory approaches.

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[14] Prior to the publication of the proposing release, the Commission received several written submissions from the public, available in the comment file on www.cftc.gov, including, but not limited to: American Benefits Council letter, dated Sept. 8, 2010; American Benefits Council and the Committee on the Investment of Employee Benefit Assets letter, dated Oct. 19, 2010; National Futures Association letter, dated Aug. 25, 2010 ("NFA Aug. 25, 2010 Letter"); New York City Bar Association letter, dated Nov. 29, 2010; Ropes & Gray letter, dated Sept. 2, 2010; Securities Industry and Financial Markets Association and International Swaps and Derivatives Association letter, dated Oct. 22, 2010 ("SIFMA/ISDA Oct. 22, 2010 Letter"); Swap Financial Group letter, dated Aug. 9, 2010; Swap Financial Group presentation entitled "Briefing for SEC/CFTC Joint Working Group," dated Aug. 9, 2010; and Morgan Stanley letter, dated Dec. 3, 2010.

[15] See proposed § 23.400.

[16] See proposed § 23.401.

[17] See proposed § 23.402.

[18] See proposed §§ 23.410, 23.430, 23.431, 23.432, 23.433, and 23.434.

[19] See proposed §§ 23.440, 23.450 and 23.451.

[20] The requirements under Section 4s(h), generally, do not distinguish between swap dealers and major swap participants. However, the Commission has considered the nature of the business done by swap dealers and major swap participants and determined that certain of the final rules will not apply to major swap participants. In particular, major swap participants will not be subject to the institutional suitability, "know your counterparty" and scenario analysis requirements, or to a pay-to-play restriction. This is discussed further in the sections below addressing those rules.

The Commission discusses each of the final rules in separate sections below, which address the changes from the proposed rules, if any, and the content of the final rules.[21] The discussions address comments concerning costs and benefits, as well as alternative approaches proposed by commenters. The Commission also provides guidance, where appropriate, to assist swap dealers and major swap participants in complying with their new duties. The Commission also states that it does not view the business conduct standards statutory provisions or rules in subpart H of part 23 to impose a fiduciary duty on a swap dealer or major swap participant with respect to any other party.

II. Regulatory Intersections

A. Securities and Exchange Commission Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants

In addition to CEA Section 4s(h), which was added by Section 731 of the Dodd-Frank Act, Section 764 of the Dodd-Frank Act added virtually identical business conduct standards provisions in Section 15F(h) of the Securities Exchange Act of 1934 ("Exchange Act").[22] Section 15F(h)[23] of the Exchange Act provides the SEC with rulemaking authority to impose business conduct standards on security-based swap dealers ("SBS Dealers") and major security-based swap participants ("Major SBS Participants" and collectively "SBS Entities") in their dealings

[21] The Commission is not adopting a diligent supervision rule in this rulemaking, finding that such a rule would be duplicative of the proposed diligent supervision rule in a separate rulemaking. See Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants, 75 FR 71397, Nov. 23, 2010 ("Governing the Duties of Swap Dealers") (proposed § 23.602 imposing additional diligent supervision requirements on swap dealers and major swap participants). The final rules also do not include a free standing prohibition against front running or trading ahead of counterparty transactions as proposed in § 23.410(c) because the Commission has determined that such trading, depending on the facts and circumstances, would violate the Commission's prohibitions against fraudulent, deceptive or manipulative practices, including Sections 4b, 4s(h)(4)(A) and 6(c)(1) of the Act and Regulations §§ 23.410 and 180.1.

[22] 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.

[23] 15 U.S.C. 78o-10(h).

with counterparties, including Special Entities. Furthermore, Section 712(a)(1) of the Dodd-Frank Act requires that the Commission and SEC consult with one another in promulgating certain rules including business conduct standards.[24]

On July 18, 2011, the SEC published in the Federal Register proposed rules for Business Conduct Standards for SBS Entities ("SEC's proposed rules").[25] The comment period for the SEC's proposed rules closed on August 29, 2011. Following publication of the SEC's proposed rules, commenters requested that the Commission work with the SEC to harmonize the rules for swap dealers, major swap participants, and SBS Entities.[26]

Commission staff worked closely with SEC staff in the development of the Commission's proposed rules,[27] the SEC's proposed rules, and these final rules. Additionally, the Commission and SEC staffs held thirteen joint external consultations on business conduct standards with interested parties following the publication of the SEC's proposed rules.[28] 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. At this time, the SEC's business conduct standards rules for SBS Entities remain at the proposal stage; however, the Commission believes it has appropriately harmonized its final rules with the SEC's proposed rules, to the extent practicable, and will continue to work with the SEC as it approaches finalization of the SEC's proposed rules.

B. Department of Labor ERISA Fiduciary Regulations

[24] Section 712(a)(1) of the Dodd-Frank Act requires that the Commission consult with the SEC and prudential regulators in promulgating rules pursuant to Section 4s(h).
[25] SEC proposed rules, Business Conduct Standards for Security-Based Swap Dealers & Major Security-Based Swap Participants, 76 FR 42396, Jul. 18, 2011.
[26] See, e.g., FIA/ISDA/SIFMA Sept. 14 Letter, at passim; CFA/AFR Aug. 29 Letter, at passim.
[27] See proposing release, 75 FR at 80640 (Commission staff and SEC staff jointly held numerous external consultations with stakeholders prior to publication of the proposed rules in the Federal Register).
[28] A list of Commission staff consultations in connection with this final rulemaking is posted on the Commission's website, available at http://www.cftc.gov/.

Special Entities defined in Section 4s(h)(2)(C) of the CEA include "any employee benefit plan, as defined in Section 3"[29] of the Employee Retirement Income Security Act of 1974 ("ERISA"). DOL is the federal agency responsible for administering and enforcing Title I of ERISA.[30]

On October 22, 2010, DOL published in the Federal Register proposed revisions ("DOL's proposed fiduciary rule") to the regulatory definition of "fiduciary" under Section 3(21)(A)(ii) of ERISA.[31] Section 3(21)(A)(ii) states that a person is a fiduciary ("ERISA fiduciary") to an employee benefit plan subject to Title I of ERISA ("ERISA plan") "to the extent it renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so."[32] In 1975, DOL issued a regulation that defines the circumstances under which a person renders "investment advice" to a plan within the meaning of Section 3(21)(A)(ii).[33] The regulation established a 5-part test that must be satisfied for a person to be treated as an ERISA fiduciary by reason of rendering investment advice.[34] DOL's proposed fiduciary rule would have revised the 5-part test and created a counterparty exception or "limitation" for a person acting in its capacity as a purchaser or seller.[35]

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

[30] 29 U.S.C. 1001 et seq.; History of EBSA and ERISA, available at http://www.dol.gov/ebsa/aboutebsa/history.html.

[31] Definition of the Term "Fiduciary," 75 FR 65263, Oct. 22, 2010 ("DOL's proposed fiduciary rule").

[32] 29 U.S.C. 1002(21)(A)(ii).

[33] 29 CFR 2510.3–21(c); see also DOL's proposed fiduciary rule, 75 FR at 65264.

[34] See id., at 65264. The 5-part test states in relevant part:

> For advice to constitute "investment advice," an adviser . . . must— (1) Render advice as to the value of securities or other property, or make recommendations as to the advisability of investing in, purchasing or selling securities or other property (2) On a regular basis (3) Pursuant to a mutual agreement, arrangement or understanding, with the plan or a plan fiduciary, that (4) The advice will serve as a primary basis for investment decisions with respect to plan assets, and that (5) The advice will be individualized based on the particular needs of the plan.

[35] DOL's proposed fiduciary rule provided that, unless the person has expressly represented that it is acting as a fiduciary, it will not be treated as one if it:

The Commission received numerous comments concerning the intersection between ERISA, DOL's proposed fiduciary rule, and existing fiduciary regulation with the business conduct standards under the CEA and the Commission's proposed rules.[36] Many commenters, including ERISA plan sponsors, swap dealers and institutional asset managers, stated that although many ERISA plans currently use swaps as part of their overall hedging or investment strategy, the statutory and regulatory intersections of ERISA and the CEA could prevent ERISA plans from participating in swap markets in the future.[37]

Commenters were primarily concerned that compliance with the business conduct standards under the CEA or the Commission's proposed rules would cause a swap dealer or major swap participant to be an ERISA fiduciary to an ERISA plan and subject to ERISA's prohibited transaction provisions.[38] Thus, if a swap dealer or major swap participant were to become an ERISA fiduciary to an ERISA plan, it would be prohibited from entering into a swap with that ERISA plan absent an exemption.[39] Commenters stated that the penalties for violating ERISA's prohibited transaction provisions are significant and would discourage swap dealers or major

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> [C]an demonstrate that the recipient of the advice knows or, under the circumstances, reasonably should know, that the person is providing the advice or making the recommendation in its capacity as a purchaser or seller of a security or other property, or as an agent of, or appraiser for, such a purchaser or seller, whose interests are adverse to the interests of the plan or its participants or beneficiaries, and that the person is not undertaking to provide impartial investment advice.

DOL's proposed fiduciary rule, 29 CFR 2310.3-21(c)(2), 75 FR at 65277.

[36] See, e.g., ERIC Feb. 22 Letter, at passim; SIFMA/ISDA Feb. 17 Letter, at 5; AMG-SIFMA Feb. 22 Letter, at 8; ABC/CIEBA Feb. 22 Letter, at 2-3.

[37] See, e.g., ABC/CIEBA Feb. 22 Letter, at 2-3; SIFMA/ISDA Feb. 17 Letter, at 5; AMG-SIFMA Feb. 22 Letter, at 8.

[38] Section 406(b) of ERISA (29 U.S.C. 1106(b)) states that an ERISA fiduciary with respect to an ERISA plan shall not–(1) deal with the assets of the plan in his own interest or for his own account, (2) in his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries, or (3) receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.

[39] In addition to other statutory exemptions, Section 408(a) of ERISA (29 U.S.C. 1108(a)) gives DOL authority to grant administrative exemptions from prohibited transactions prescribed in Section 406 of ERISA.

swap participants from dealing with ERISA plans.[40]

Prior to proposing the business conduct standards rules, the Commission received submissions from stakeholders concerning the interaction with ERISA, DOL's proposed fiduciary rule and current regulation regarding the definition of ERISA fiduciaries.[41] Thus, Commission and DOL staffs consulted on issues regarding Special Entity definitions that reference ERISA and the intersection of ERISA fiduciary status with the Dodd-Frank Act business conduct provisions.[42]

Informed by discussions between the Commission and DOL staffs, the Commission published its proposed business conduct standards rules. Many commenters, however, expressed ongoing concern that the proposed business conduct standards rules, if adopted in final form without clarification, could have unintended consequences for swap dealers and major swap participants dealing with ERISA plans. Commenters remained concerned that compliance with the business conduct standards could cause a swap dealer or major swap participant to be an ERISA fiduciary to an ERISA plan, which would trigger the prohibited transaction provisions of ERISA.[43] Specifically, commenters expressed concerns that the business conduct standards could: (1) Cause a swap dealer or major swap participant to become an ERISA fiduciary under current law;[44] (2) require a swap dealer or major swap participant to cause a third-party advisor to fail to meet DOL's Qualified Professional Asset Manager ("QPAM") prohibited transaction

[40] See, e.g., AMG-SIFMA Feb. 22 Letter, at 8 ("This substantial penalty would serve as a serious disincentive for swap dealers and [major swap participants] from engaging in swap transactions with Special Entities subject to ERISA."); SIFMA/ISDA Feb. 17 Letter, at 5-6 ("there is a serious risk that [swap dealers] will refuse to engage in swap transactions with an ERISA plan to avoid the risks of costly ERISA violations").
[41] See, e.g., SIFMA/ISDA Oct. 22, 2010 Letter, at 8 fn. 19 (A swap dealer "should not be an advisor in circumstances where it is not a fiduciary under [DOL's proposed] standard.").
[42] Proposing release, 75 FR at 80640 and 80650 fn. 101.
[43] See, e.g., ABC/CIEBA Feb. 22 Letter, at passim; ERIC Feb. 22 Letter, at passim.
[44] SIFMA/ISDA Feb. 17 Letter, at 5; AMG-SIFMA Feb. 22 Letter, at 8; ABC/CIEBA Feb. 22 Letter, at 2-3.

class exemption;[45] (3) require a swap dealer or major swap participant to perform certain activities that could make it an ERISA fiduciary under DOL's proposed fiduciary rule, such as calculating and providing a daily mark that is the mid-market value of a swap or providing a scenario analysis of a swap;[46] (4) require a swap dealer or major swap participant to engage in advisor-like activities such as those required under proposed § 23.401(c)–Know your counterparty, proposed § 23.434–Institutional suitability, or proposed § 23.440–Swap dealers acting as advisors to Special Entities;[47] or (5) cause a swap dealer to fail to satisfy the counterparty exception or "limitation" provision in DOL's proposed fiduciary rule.[48]

Many commenters also requested that the Commission and DOL publicly coordinate the respective proposed rules to avoid swap dealers and major swap participants being deemed ERISA fiduciaries.[49] On April 28, 2011, DOL submitted a letter to the Chairman of the CFTC regarding its views on DOL's proposed fiduciary rule and potential intersections with the business conduct standards statutory provisions and the Commission's proposed rules.[50] The letter stated that DOL's proposed fiduciary rule "is not broadly intended to impose ERISA fiduciary obligations on persons who are merely counterparties to plans in arm's length commercial transactions. . . . [and] is not intended to upend these expectations by imposing ERISA fiduciary norms on parties who are on the opposite side of plans in such arm's length

[45] SIFMA/ISDA Feb. 17 Letter, at 5 fn. 13; AMG-SIFMA Feb. 22 Letter, at 6; ERIC Feb. 22 Letter, at 14; see also DOL Amendment to Prohibited Transaction Exemption (PTE) 84-14 for Plan Asset Transactions Determined by Independent Qualified Professional Asset Managers, 75 FR 38837, Jul. 6, 2010 ("DOL QPAM PTE 84-14").
[46] See, e.g., ABC/CIEBA Feb. 22 Letter, at 5-6; SIFMA/ISDA Feb. 17 Letter, at 32.
[47] See, e.g., SIFMA/ISDA Feb. 17 Letter, at 5 fn. 13; AMG-SIFMA Feb. 22 Letter, at 6; ERIC Feb. 22 Letter, at 14.
[48] See, e.g., SIFMA/ISDA Feb. 17 Letter, at 5-6, 19-21, 23-24, and 39; ABC/CIEBA Feb. 22 Letter, at passim; ERIC Feb. 22 Letter, at passim.
[49] AFSCME Feb. 22 Letter, at 4; BlackRock Feb. 22 Letter, at 2 and 5; AMG-SIFMA Feb. 22 Letter, at 9; ERIC Feb. 22 Letter, at 2 and 4; Sen. Kerry May 18 Letter, at 1; Sen. Harkin May 3 Letter, at 1-2; Rep. Bachus Mar. 15 Letter, at 2; Rep. Smith July 25 Letter, at 1-2; Sen. Johnson Oct. 4 Letter, at 2.
[50] DOL Apr. 28 Letter.

deals."[51] The letter concludes, "[in DOL's] view, with careful attention to fairly straightforward drafting issues, we can ensure that the DOL regulation and the CFTC business conduct standards are appropriately harmonized."[52] Subsequently, the Commission received additional comments stating that, although supportive of DOL's statement of intent and analysis of DOL's proposed fiduciary rule, the letter did not resolve all of their concerns and was non-binding.[53]

On September 19, 2011, DOL announced that it would re-propose its rule on the definition of fiduciary and expected the new proposed rule to be issued in early 2012.[54] DOL also stated that it "will continue to coordinate closely with the . . . Commission to ensure that this effort is harmonized with other ongoing rulemakings."[55] The Commission has continued to coordinate with DOL to ensure that the final business conduct standards rules are appropriately harmonized with ERISA and DOL regulations.[56] DOL has reviewed the Commission's final business conduct standards rules for swap dealers and majors swap participants and provided the Commission with the following statement:

> The Department of Labor has reviewed these final business conduct standards and concluded that they do not require swap dealers or major swap participants to engage in activities that would make them fiduciaries under the Department of Labor's current five-part test defining fiduciary advice 29 C.F.R. § 2510.3-21(c). In the Department's view, the CFTC's final business conduct standards neither conflict with the Department's existing regulations, nor compel swap dealers or major swap participants to engage in fiduciary conduct. Moreover, the Department states that it is fully committed to ensuring that any changes to the current ERISA fiduciary advice regulation are carefully harmonized with the final business conduct standards, as adopted by the CFTC and the SEC, so that there are no unintended consequences for swap dealers and major swap participants

[51] DOL Apr. 28 Letter, at 1.
[52] DOL Apr. 28 Letter, at 3.
[53] See, e.g., ABC/CIEBA June 3 Letter, at 3.
[54] Office of Public Affairs News Release, U.S. Dept. of Labor, U.S. Labor Department's EBSA to re-propose rule on definition of a fiduciary (Sept. 19, 2011).
[55] Id.
[56] Final § 23.440–Requirements for swap dealers acting as advisors to Special Entities and § 23.450–Requirements for swap dealers and major swap participants acting as counterparties to Special Entities address the issues raised by commenters. See Sections IV.B. and IV.C. of this adopting release for a discussion of final §§ 23.440 and 23.450.

who comply with these business conduct standards.[57]

After considering the comments and DOL's statement, the Commission has determined that the final business conduct standards are appropriately harmonized with ERISA and DOL regulations. The Commission understands from DOL that compliance with the business conduct standards statutory provisions and Commission rules will not, by itself, cause a swap dealer or major swap participant to be an ERISA fiduciary to an ERISA plan. Furthermore, DOL stated its intention to continue to coordinate and appropriately harmonize with Commission rules when it re-proposes its rule on the definition of fiduciary. Thus, the Commission has determined that issues and concerns raised by commenters regarding ERISA requirements have been addressed appropriately.

C. Securities and Exchange Commission Municipal Advisor Registration

The amendments to the CEA in Section 731 of the Dodd-Frank Act also direct the Commission to adopt business conduct standards rules for swap dealers and major swap participants dealing with Special Entities, which include "a State, State agency, city, county, municipality, or other political subdivision of a State" ("State and municipal Special Entities").[58] In addition, Section 975 of the Dodd-Frank Act amended Section 15B of the Exchange Act to provide for new regulatory oversight of "municipal advisors,"[59] that provide advice to a "municipal entity"[60] with respect to, among other things, municipal financial products, which

[57] A copy of the statement is included as Appendix 2 of this adopting release.
[58] Section 4s(h)(2)(C)(ii) of the CEA (7 U.S.C. 6s(h)(2)(C)(ii)).
[59] The definition of "municipal advisor" means a person (who is not a municipal entity or an employee of a municipal entity) (i) that provides advice to or on behalf of a municipal entity with respect to municipal financial products (including municipal derivatives) or the issuance of municipal securities, including advice with respect to the structure, timing, terms, and other similar matters concerning such financial products or issues, or (ii) that undertakes a solicitation of a municipal entity. The definition includes financial advisors, third-party marketers, and swap advisors that engage in municipal advisory activities. 15 U.S.C. 78o-4(e)(4).
[60] Section 975 of the Dodd-Frank Act amended Section 15B(e)(8) of the Exchange Act to define the term "municipal entity" as any State, political subdivision of a State, or municipal corporate instrumentality of a State,

include municipal derivatives. Municipal advisors are required to register with the SEC[61] and are subject to the rules of the Municipal Securities Rulemaking Board ("MSRB"), a self-regulatory organization ("SRO").[62] On January 6, 2011, the SEC published in the Federal Register proposed rules for the Registration of Municipal Advisors ("SEC Proposed MA Rules").[63]

The intersection of the business conduct standards provisions under Section 731 of the Dodd-Frank Act and the municipal advisor provisions under Section 975 raises two important issues. The first issue concerns the regulatory intersection of requirements for SEC-registered municipal advisors and Commission-registered commodity trading advisors ("CTA") that may serve as qualified independent representatives to a Special Entity under Section 4s(h)(5) and proposed § 23.450. Section 4s(h)(5) of the CEA mandates the Commission to establish a duty for swap dealers or major swap participants that offer to or enter into a swap with a Special Entity to have a reasonable basis to believe that the Special Entity has a qualified independent representative.[64] Thus, an independent representative under Section 4s(h)(5) that advises State and municipal Special Entities will be subject to registration with the Commission as a CTA,[65] except for those independent representatives who are employees of such entity or otherwise excluded or exempt under the CEA or Commission rules. Similarly, municipal advisors include financial advisors and swap advisors that engage in municipal advisory activities, including providing advice with respect to municipal derivatives, with municipal entities, which include all State and municipal

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including (A) any agency, authority, 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. 15 U.S.C. 78o-4(e)(8).

[61] 15 U.S.C. 78o-4(a)(1).

[62] 15 U.S.C. 78o-4(b)(2).

[63] SEC Proposed Registration of Municipal Advisors, 76 FR 824, Jan. 6, 2011 ("SEC Proposed MA Rules").

[64] Section 4s(h)(5) of the CEA (7 U.S.C. 6s(h)(5)).

[65] Section 1a(12) of the CEA (7 U.S.C. 1a(12)) defines ''commodity trading advisor'' to be any person who for compensation or profit, engages in the business of advising others, either directly or through publications, writings, or electronic media, as to the value of or the advisability of trading in any swap, among other CEA jurisdictional products.

Special Entities. Additionally, registered CTAs "who are providing advice related to swaps" are expressly excluded from the definition of "municipal advisor."[66] Accordingly, a registered CTA would be subject to the Commission's regulatory requirements, but not those of the SEC or MSRB, even if such CTA registration were required solely for swap advice provided to a municipal entity.[67] Given these intersections, commenters requested that the Commission coordinate with the SEC to appropriately harmonize the regulatory regime for Commission-registered CTAs that advise municipalities with the regulatory regime for SEC-registered municipal advisors.[68]

A second issue raised by commenters concerns whether compliance with the proposed business conduct standards rules would cause a swap dealer or major swap participant dealing with a State or municipal Special Entity to be deemed to be a municipal advisor.[69] For example, some commenters asked whether a swap dealer that complies with Section 4s(h)(4)(B) and proposed § 23.440, which requires a swap dealer that "acts as an advisor to a Special Entity" to "act in the best interests" of the Special Entity, would trigger the municipal advisor definition. These commenters opposed such an outcome and requested that the Commission and SEC coordinate and harmonize the proposed rules.[70]

After considering the comments, the Commission has taken steps to ensure that the business conduct standards provisions are appropriately harmonized with the SEC and MSRB regulatory

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[66] The exclusion includes "any commodity trading advisor registered under the Commodity Exchange Act or persons associated with a commodity trading advisor who are providing advice related to swaps." 15 U.S.C. 78o-4(e)(4)(C).

[67] To the extent that a registered CTA engages in any municipal advisory activities other than advice related to swaps, registration may still be required with the SEC. See SEC Proposed MA Rules, 76 FR at 833; see also proposed rule 17 CFR 15Ba1-1(d)(2)(iii), 76 FR at 882.

[68] See, e.g., SFG Feb. 22 Letter, at 2 ("[t]here is a need for a single, harmonized regulatory scheme for credentialing and registering swap advisors"); GFOA Feb. 22 Letter, at 2.

[69] See, e.g., SIFMA/ISDA Feb. 17 Letter, at 6, 19-21, 24, and 34-35; BDA Feb. 22 Letter, at 2.

[70] See, e.g., SIFMA/ISDA Feb. 17 Letter, at 24 and 34 (the Commission and SEC should adopt a unified standard for recognizing when "advice" is being given).

regime for municipal advisors. Commission staff has engaged in several consultations with the staffs of the SEC, MSRB, and the National Futures Association ("NFA") regarding the regulatory regimes for municipal advisors and CTAs that provide advice to municipal entities with respect to swaps. The Commission is considering several options with respect to CTAs and municipal advisors, including proposing a CTA registration exemption for CTAs that are registered municipal advisors whose CTA activity is limited to swap advice to municipal entities. The Commission is also considering developing rules for CTAs that would be comparable to those adopted by the SEC and MSRB for municipal advisors. Such rules could be adopted by the Commission or, for CTAs that are members of NFA, by NFA. Commission staff continues to consult with SEC staff regarding municipal advisor registration requirements to address the treatment of swap dealers and major swap participants that comply with the Commission's business conducts standards rules. At this time, the rules for the registration of municipal advisors remain at the proposal stage. Therefore, the Commission believes it has appropriately harmonized these final rules and will continue to work with the SEC as it approaches finalization of the SEC's Proposed MA Rules.

D. Commodity Trading Advisor Status for Swap Dealers

The Commission noted in its proposed rules that swap dealers would likely be acting as CTAs when they make recommendations to their counterparties, and particularly recommendations that are tailored to the needs of their counterparty.[71] Classification as a CTA under the CEA subjects a person to various statutory and regulatory requirements including, among others, the anti-fraud provisions of Section 4o of the CEA and registration with the

[71] Proposing release, 75 FR at 80647-48.

Commission.[72] In addition, a CTA, depending on the nature of the relationship, may also owe fiduciary duties to its clients under applicable case law.[73]

Commenters expressed concerns about the implications of swap dealers being treated as CTAs and urged the Commission to make clear that a swap dealer would not be a CTA solely by virtue of providing swap "recommendations" to counterparties. One of these commenters noted that a swap dealer operates in a principal-to-principal market and plays a different role than that of a typical CTA that provides advice to "retail" clients.[74] This commenter contended that a swap dealer should not be required to register as a CTA in addition to registering in its capacity as a swap dealer. A second commenter stated that by using the term "advisor" rather than "commodity trading advisor" in the relevant provisions of Section 4s(h)(4), Congress likely regarded the provisions of the CEA regulating CTAs as unrelated to those adopted under Section 4s(h)(4).[75] This commenter requested that the Commission specifically state that no requirement or combination of requirements under the proposed rules would cause a swap dealer, including a swap dealer that makes a recommendation to a Special Entity, to be treated as a CTA.[76]

A "commodity trading advisor" includes any person who, for compensation or profit, engages in the business of advising others, either directly or through publications, writings, or electronic media, as to the value of or the advisability of trading in any swap.[77] The CEA, however, excludes from the CTA definition banks, floor brokers, and futures commission merchants ("FCMs"), among others, whose advice is "solely incidental to the conduct of their business or profession." Section 1a(12)(B)(vii) of the CEA also grants the Commission authority

[72] 7 U.S.C. 6m and 6o.
[73] See Commodity Trend Serv., Inc. v. CFTC, 233 F.3d 981, 990 (7th Cir. 2000).
[74] CEF Feb. 22 Letter, at 17.
[75] SIFMA/ISDA Feb. 17 Letter, at 32 fn. 75.
[76] Id., at 34.
[77] Section 1a(12) of the CEA (7 U.S.C. 1a(12)).

to exclude "such other persons not within the intent of [the CTA definition] as the Commission may specify . . ."; however, such exclusion is limited to advice that is "solely incidental to the conduct of their business or profession." The Commission has determined to provide a similar exclusion for swap dealers whose advice is solely incidental to their business as swap dealers. In determining that a swap dealer's recommendations to a counterparty regarding proposed swap transactions or trading strategies should be considered "solely incidental" to the conduct of its business, the Commission considered the definition of "swap dealer." Section 1a(49) of the CEA defines the term "swap dealer" as a person who (1) holds itself out as a dealer in swaps; (2) makes a market in swaps; (3) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or (4) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.[78]

Based on the types of activities that define a swap dealer's business, commenters' views and the statutory scheme under Section 4s(h), the Commission has determined that making swap related recommendations to counterparties is most appropriately considered "solely incidental" to the conduct of a swap dealer's business as a dealer or market maker in swaps, including customized swaps, and is not CTA business. Specifically, the Commission has determined that when making recommendations to a counterparty with respect to an otherwise arm's length principal-to-principal swap transaction with a counterparty a swap dealer will be acting solely incidental to its business as a swap dealer as defined in the CEA and Commission rules. Thus, the Commission has determined to exercise its authority under Section 1a(12)(B)(vii) to add a new exclusion from the CTA definition applicable to swap dealers, including swap dealers that may be excluded or exempt from registration under the CEA or Commission rules, in existing

[78] Section 1a(49) of the CEA (7 U.S.C. 1a(49)).

§ 4.6. Under new § 4.6(a)(3) a swap dealer is excluded from the definition of the term "commodity trading advisor" provided that its "advisory activities" are solely incidental to its business as a swap dealer.[79] "Swap dealer" is defined for purposes of the rule by reference to the definitions in Section 1a(49) of the CEA and § 1.3, and would include "associated persons"[80] acting on behalf of a swap dealer.

With respect to the scope of the "solely incidental" exclusion for swap dealers, the Commission is generally of the view that making recommendations to a counterparty would not cause a swap dealer to be a CTA.[81] The exclusion would cover customizing a swap for a counterparty in response to a counterparty's expressed interest or on the swap dealer's own initiative.[82] Also, preparing a term sheet for purposes of outlining proposed terms of a swap for negotiation or otherwise would be an activity solely incidental to a swap dealer's business.

There are advisory activities that the Commission would consider to be beyond the scope of the "solely incidental" exclusion, and depending on the facts and circumstances could cause a swap dealer to be a CTA within the statutory definition. For example, a swap dealer that has general discretion to trade the account of, or otherwise act for or on behalf of, a counterparty would be engaging in activity that is not solely incidental to the business of a swap dealer. Limited discretion related to the execution of a particular counterparty order, however, would not cause a swap dealer to be a CTA. Also, the exclusion would not apply if a swap dealer received separate compensation for, or otherwise profited primarily from, advice provided to a

[79] While swap dealers that make recommendations will be excluded from the CTA definition, they must comply with other applicable provisions (i.e., § 23.434–Suitability and § 23.440–Requirements for swap dealers acting as advisors to Special Entities).

[80] "Associated person of a swap dealer or major swap participant" is a defined term in Section 1a(4) of the CEA (7 U.S.C. 1a(4)).

[81] See Section III.G. of this adopting release for a discussion of the term "recommendation" in connection with the institutional suitability rule in § 23.434.

[82] The "solely incidental" exclusion also would encompass providing information to a counterparty that is general transaction, financial, or market information, or swap terms in response to a request for quote.

counterparty. Furthermore, a swap dealer that enters into an agreement with its counterparty to provide advisory services or a swap dealer that otherwise holds itself out to the public as a CTA would also not be within the "solely incidental" exclusion. These examples are not exhaustive. There may be other circumstances in which a swap dealer's activity would fall outside the available exclusion. A determination of whether activity is "solely incidental" would necessarily need to be viewed in context based on the particular facts and circumstances.

III. Final Rules for Swap Dealers and Major Swap Participants Dealing With Counterparties Generally

The final business conduct standards rules dealing with counterparty relationships are contained in subpart H of new part 23 of the Commission's Regulations.[83] This section of the adopting release discusses the following rules that apply to swap dealers' and, unless otherwise indicated, major swap participants' dealings with counterparties generally: § 23.400–Scope; § 23.401–Definitions; § 23.402–General provisions; § 23.410–Prohibition on fraud, manipulation and other abusive practices; § 23.430–Verification of counterparty eligibility; § 23.431–Disclosures of material information; § 23.432–Clearing disclosures; § 23.433–Communications-fair dealing; and § 23.434–Recommendations to counterparties-institutional suitability. A section-by-section description of the final rules follows.

A. Sections 23.400, 23.401 and 23.402–Scope, Definitions and General Provisions

1. Section 23.400–Scope

a. Proposed § 23.400–Scope

Proposed § 23.400 set forth the scope of subpart H of new part 23 of the Commission's Regulations, which stated that the rules contained in subpart H were not intended to limit or

[83] The "solely incidental" CTA exclusion for swap dealers is promulgated in part 4 of the Commission's Regulations.

restrict the applicability of other provisions of the CEA, Commission rules and regulations, or any other applicable laws, rules and regulations.[84] Moreover, the proposed rule provided that subpart H would apply to swap dealers and major swap participants in connection with swap transactions, including swaps that are offered but not entered into.[85] Some of the proposed rules required compliance prior to entering into a swap, while others, such as the requirement to provide a daily mark, were to be in effect during the entire life of a swap.

b. Comments and Final § 23.400–Scope

The Commission received numerous comments regarding issues that relate to the general scope of the proposed business conduct standards, though not necessarily concerning the text of the proposed "scope" rule. One commenter requested that the Commission clarify that the business conduct standards rules would not apply to unexpired swaps executed prior to the effective date of the final rules.[86] Another commenter asked the Commission to clarify that certain business conduct standards rules impose duties for swap dealers and major swap participants that continue after the execution of a swap.[87] The Commission confirms that the business conduct standards will not apply to unexpired swaps executed before the effective date of this adopting release and will apply in accordance with the implementation schedule set forth in Section V.C. of this adopting release; however, the Commission will consider a material amendment to the terms of a swap to be a new swap and subject to subpart H of part 23 of the

[84] Proposing release, 75 FR at 80640.

[85] In the proposing release, the Commission commented that the external business conduct standards rules would be most applicable when swap dealers and major swap participants have a pre-trade relationship with their counterparty. Proposing release, 75 FR at 80641. The Commission noted that for swaps initiated on a designated contract market ("DCM") or swap execution facility ("SEF") where the swap dealer or major swap participant does not know the counterparty's identity prior to execution, the disclosure and due diligence obligations would not apply. See Section III.D.3. and fn. 338 of this adopting release for a discussion of final § 23.431–Disclosures of material information, which address the disclosure duties of swap dealers and major swap participants pursuant to Section 4s(h)(3)(B) with respect to bilateral swaps and swaps executed on a DCM or SEF.

[86] SIFMA/ISDA Feb. 17 Letter, at 8.

[87] See CFA/AFR Aug. 29 Letter, at 11.

Commission's Regulations. For swaps that are subject to the business conduct standards rules, the Commission clarifies that certain rules by their terms impose ongoing duties on the swap dealer or major swap participant (e.g., § 23.410(a)–Prohibitions on fraud, § 23.410(c)–Confidential treatment of counterparty information, and § 23.433–Communications–fair dealing); however, other rules by their terms do not impose ongoing duties on the swap dealer or major swap participant (e.g., § 23.430–Verification of counterparty eligibility).[88]

Another concern raised by commenters was the meaning of the word "offer" in the context of negotiating a swap transaction because certain requirements are triggered when an offer occurs. Other commenters expressed views on the Commission's decision to use the authority granted by Congress to draft discretionary rules for swap transactions instead of solely drafting rules that are explicitly mandated by statute. There were comments suggesting that the discretionary rules should be delegated to an SRO.[89] Commenters also suggested that the rules should not apply to certain sophisticated counterparties or that counterparties be afforded the opportunity to opt in or opt out of these rules.[90] Some believed that swap dealers and major swap participants should be subject to different regulations.[91] Others were concerned about the extraterritorial reach of the Commission's Regulations.[92] Some commentators were concerned that violating the rules could

[88] Although certain rules do not impose an ongoing duty on a swap dealer or major swap participant with respect to the swap, a swap dealer or major swap participant would still be required to comply with the duty with respect to subsequent swaps offered or entered into with a counterparty.
[89] See, e.g. SIFMA/ISDA Feb. 17 Letter, at 3 and 25-26.
[90] See, e.g. SIFMA/ISDA Feb. 17 Letter, at 26; NACUBO Feb. 22 Letter, at 3-4; VRS Feb. 22 Letter, at 3-4; HOOPP Feb. 22 Letter, at 3; NFP Energy End Users, Ex Parte Communication, Jan. 19, 2011 (citing NFP Energy End Users Sept. 20, 2010 Letter, at 14-15).
[91] See, e.g., AMG-SIFMA Jan. 18 Letter, at 2-3; MFA Feb. 22 Letter, at 1-4; CEF Feb. 22 Letter, at 5-6; BlackRock Apr. 12 Letter, at 1-5.
[92] See, e.g., Societe Generale Feb. 18 Letter, at 8-13; Barclays Jan. 11 Letter, at 5-7; Bank of Tokyo May 6 Letter, at 5-6; Barclays Feb. 17 Letter, at passim.

be a basis for a private right of action under the CEA.[93] The Commission addresses these issues in the discussion below.

i. Meaning of "Offer"

Certain of the business conduct standards duties under the rules are triggered at the time an "offer" is made.[94] Two commenters suggested that the rules should be modified to clarify when an "offer" occurs.[95] One of the commenters suggested that the Commission should define "offer" to mean when sufficient terms are offered that, if accepted, would create a binding agreement under contract law.[96] They believe that this is necessary because, unlike in securities or futures, the terms of the product are not preset but can be negotiated.

The Commission confirms that the term "offer," as used in the business conduct standards rules in subpart H, has the same meaning as in contract law, such that, if accepted, the terms of the offer would form a binding contract.[97] The Commission notes, however, that not all of the rules are triggered when an offer is made. For example, the suitability duty is triggered when a swap dealer makes a "recommendation."[98] The final fair dealing rule[99] will apply to all communications by a swap dealer or major swap participant in connection with a swap, including communications made prior to an offer. Other final rules (e.g., the anti-fraud and

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[93] See, e.g., VRS Feb. 22 Letter, at 3; ABC/CIEBA Feb. 22 Letter, at 9-10; SIFMA/ISDA Feb. 17 Letter, at 4, 5-6, 10, and 34-35; FHLBanks June 3 Letter, at 6 and 8; AMG-SIFMA Feb. 22 Letter, at 4-5 and 7-8; CEF Feb. 22 Letter, at 3-4 and 9-10; Exelon Feb. 22 Letter, at 3.

[94] See, e.g., final § 23.430(a) – Verification of counterparty eligibility ("before offering to enter into . . . a swap with that counterparty"); final § 23.450(b)(1) – Requirements for swap dealers and major swap participants acting as counterparties to Special Entities ("Any swap dealer or major swap participant that offers to enter or enters into a swap with a Special Entity . . .").

[95] See APPA/LPPC Feb. 22 Letter, at 4; SIFMA/ISDA Feb. 17 Letter, at 35-36.

[96] See SIFMA/ISDA Feb. 17 Letter, at 35 fn. 84.

[97] See, e.g., Restatement (Second) of Contracts § 24 (1981) ("An offer is the manifestation of willingness to enter into a bargain, so made as to justify another person in understanding that his assent to that bargain is invited and will conclude it."). In addition, as stated in § 23.400, nothing in these rules is intended to limit or restrict the applicability of other applicable laws, rules and regulations, including the federal securities laws.

[98] See Section III.G. of this adopting release for a discussion of § 23.434–Recommendations to Counterparties–Institutional Suitability.

[99] See Section III.F.3. of this adopting release for a discussion of final § 23.433.

confidential treatment rules) will be triggered as indicated by their terms. In addition, the Commission expects that for practical purposes swap dealers and major swap participants will comply with certain of their business conduct standards duties through counterparty relationship documentation negotiated with their counterparties well before an "offer" or a "recommendation" is made.[100]

Swap dealers and major swap participants will be permitted to arrange with third parties, such as the counterparty's prime broker, a method of providing disclosures or verifying that a Special Entity has an independent representative to satisfy its obligations under the rules. But the swap dealer or major swap participant will remain responsible for compliance with the rules.

ii. Discretionary Rules

In the proposing release, the Commission noted that some of the requirements and duties in the proposed rules were mandated by specific provisions in the Dodd-Frank Act, while others were proposed under the Commission's discretionary authority.[101] Some commenters recommended that the final rules be limited to what is mandated by statute until the CFTC gains more familiarity with these markets as they develop.[102] Another commenter expressed a contrary view that Congress intended the Commission to use its discretionary authority because, if it did not, such authority would not have been granted.[103] A commenter suggested that the rules that are promulgated based on the Commission's discretionary authority, such as suitability and scenario analysis, should apply only to a subset of eligible contract participants ("ECPs") that

[100] For example, the verification of counterparty eligibility, know your counterparty and the verification of a Special Entity's independent representative would be completed prior to any recommendation or offer. Other forms of documentation may suffice depending on the circumstances. For instance, if a counterparty requests a quote from a swap dealer with which it does not have relationship documentation, the counterparty could book the swap through its prime broker with which the swap dealer may have pre-negotiated documentation.
[101] See proposing release, 75 FR at 80639.
[102] See BlackRock Feb. 22 Letter, at 1-2; Encana Feb. 22 Letter, at 2.
[103] CFA/AFR Feb. 22 Letter, at 18.

require additional protections.[104] Another commenter suggested that if the Commission does adopt the discretionary rules, it should implement any such additional proposals as SRO rules and allow sophisticated counterparties to opt out of the heightened protections that they may not need or want.[105]

One commenter stated that the Commission's approach in proposing discretionary rules that used industry best practices was reasonable because the proposals have already been endorsed by the industry as workable and achievable.[106] The commenter stated that the Commission should go further, however, because the industry's standards of conduct have been so poor that the industry's own suggestions may not go far enough.

The Commission has determined to adopt the rules proposed under the Commission's discretionary authority along with the mandatory rules, albeit with the changes and for the reasons discussed in the applicable sections of this adopting release that address each final rule. In exercising that discretion, the Commission has acted consistently with the intent of Congress as expressed in Section 4s(h)(3)(D) to establish business conduct standards that the Commission determines are appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the CEA.[107] Many of the discretionary rules adopted by the Commission are based generally on existing Commission and SRO rules for registrants and industry best practices, and extending them to swap dealers and, where appropriate, to major swap participants will promote regulatory consistency. As such, the discretionary rules reflect existing business conduct standards that are time-tested, appropriate for swap dealers and major swap participants, and are well within the Commission's broad discretionary rulemaking authority under

[104] CEF Feb. 22 Letter, at 4-5.
[105] SIFMA/ISDA Feb. 17 Letter, at 3 and 25-26.
[106] CFA/AFR Feb. 22 Letter, at 19.
[107] See also Sections 4s(h)(1)(D), 4s(h)(5)(B) and 4s(h)(6).

Section 4s(h). As a result, the final rules strike an appropriate balance between protecting the public interest and providing a workable compliance framework for market participants. With regard to the comments that suggest the Commission should implement any discretionary rules as SRO rules, the Commission declines to take such an approach. The Commission has relied in the past on SROs to fulfill a number of important functions in the derivatives market, and it will continue to do so in the future. Moreover, the Commission will consider SRO guidance, where relevant and appropriate, in interpreting the Commission's final rules that are based on SRO rules.[108] If, in the future, it becomes beneficial to delegate certain functions regarding the business conduct standards to SROs, the Commission will do so at that time. Delegating all discretionary rules to the SROs now, however, is premature and not consistent with the regulatory scheme that was mandated by Congress.[109]

iii. Different Rules for Swap Dealers and Major Swap Participants

Some commenters recommended that there be different business conduct standards rules for swap dealers and major swap participants.[110] Another commenter stated that the rules concerning "know your counterparty," treatment of confidential information, trading ahead and front running, the requirement to provide a daily mark, fair dealing, and the determination of counterparty suitability should not apply to major swap participants.[111] This commenter believed that major swap participants, however, should receive the benefits of those rules when acting as counterparties to swap

[108] For further discussions of SRO guidance see Section III.A.3.b. of this release at fn. 188 discussing final § 23.402(b) (know your counterparty), Section III.F.3. of this release at fn. 500 discussing final § 23.433 (communications-fair dealing), and Section III.G.3. of this release at fn. 542 discussing final § 23.434 (recommendations to counterparties–institutional suitability).

[109] The SEC has taken a consistent approach in its proposed business conduct standards rules. For example, the SEC's "know your counterparty," suitability and fair communications rules are based on similar requirements under the rules of the Financial Industry Regulatory Authority ("FINRA"). See SEC's proposed rules, 76 FR at 42414 fn. 125, 42415 fn. 128, and 42418 fn. 151. See also FINRA Rule 2090 (know your customer), FINRA Rule 2111 (suitability), and NASD Rule 2210 (communications with the public).

[110] See AMG-SIFMA Jan. 18 Letter, at 2-3; MFA Feb. 22 Letter, at 1-4; CEF Feb. 22 Letter, at 5-6; BlackRock Apr. 12 Letter, at 1-5; BlackRock June 3 Medero and Prager Letter, at 4-5.

[111] MetLife Feb. 22 Letter, at 4-5, contra CFA/AFR Nov. 3 Letter, at 7.

dealers. They argued that major swap participants, regardless of their size, cannot be presumed to possess a level of market or product information equal to that of swap dealers and are less likely than swap dealers to be members of a swap execution facility ("SEF"), a designated contract market ("DCM") or a derivatives clearing organization ("DCO"). The commenter believed that major swap participants are unlikely to have systems and personnel comparable to that of a swap dealer to allow them to model and value complex instruments.[112] As a result, they argued that major swap participants, when dealing with swap dealers, should be able to: (1) Elect where to clear trades; (2) receive risk disclosure, the required scenario analyses for complex high-risk bilateral swaps, information about incentives or compensation the dealer is getting, and any new product analysis that the swap dealer does for its risk management purposes; and (3) receive the protection from the suitability provision the same as any other counterparty would receive.

The statutory business conduct standards requirements, generally, do not distinguish between swap dealers and major swap participants. However, the Commission has considered the definitions of swap dealer and major swap participant, which are based on the nature of their swap related businesses, including marketing activities, and has determined, where appropriate, not to apply certain discretionary rules to major swap participants. The final rules for major swap participants do not include the suitability duty, pay-to-play, "know your counterparty" and scenario analysis provisions. Removing these requirements alleviates some of the regulatory burden on major swap participants without materially impacting the protections for counterparties envisioned by Congress. This is discussed further in the sections below that address these relevant rules.

With respect to one commenter's request that major swap participants be the beneficiaries of

[112] MetLife Feb. 22 Letter, at 4-5.

the business conduct standards rules,[113] Congress appears to have made a contrary determination as indicated, for example, in Section 4s(h)(3), which explicitly relieves swap dealers from the duty to provide disclosures to major swap participants. Following this approach in the statute, the Commission has determined not to require that swap dealers provide major swap participants with the same protections afforded to other counterparties. Nor is the Commission requiring swap dealers to allow major swap participants to opt in to receive certain protections, such as a daily mark, suitability or scenario analysis, that are afforded to counterparties generally. That would impose a burden on swap dealers that is not contemplated by the statutory scheme. Of course, major swap participants are free to negotiate with swap dealers for such protections on a contractual basis.

iv. Opt in or Opt out for Certain Classes of Counterparties

Some commenters suggested that the Commission should (1) provide an exemption from the external business conduct standards for swap dealers when they transact with certain sophisticated investors, which might include certain Special Entities, or (2) narrowly tailor the external business conduct standards to make them elective for the counterparty.[114] These commenters suggested that the Commission should set the threshold for parties that decide to opt out to include "qualified institutional buyers" as defined in Rule 144A[115] under the Securities Act of 1933 ("Securities Act")[116] and corporations having assets under management of $100 million or more.

Another commenter suggested that the Special Entity provisions should not be applicable to

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[113] Id.
[114] See VRS Feb. 22 Letter, at 4; SIFMA/ISDA Feb. 17 Letter, at 26; NACUBO Feb. 22 Letter, at 3-4.
[115] 17 CFR 230.144A.
[116] 15 U.S.C. 77a et seq. All references to the Securities Act are to the Securities Act, as amended by the Dodd-Frank Act.

certain not-for-profit electricity and natural gas providers because of their sophistication in dealing with swaps concerning such commodities.[117] One commenter believed that the business conduct standards rules should not apply to sophisticated Special Entities,[118] and another commenter suggested that they should not apply to non-ERISA pension plans.[119] According to these commenters, many of the protections in place for Special Entities will slow down the process for entering into swaps and make it more difficult for Special Entities to do business. Two other commenters believed that the rules will increase the price of swaps without any material benefit.[120] One of them suggested that the Commission instead should (1) provide an exemption from the external business conduct standards rules for swap dealers when transacting with certain sophisticated investors, which would include certain government plans such as the commenter, or (2) narrowly tailor the rules to make them elective for the counterparty.[121]

That is not the approach that Congress took in Section 4s(h) of the CEA. With a few exceptions not relevant here, the statute does not distinguish among counterparties or types of transactions.[122] Nevertheless, as discussed below in connection with the relevant rules, the Commission has determined to permit means of compliance with the final rules that should promote efficiency and reduce costs and, where appropriate, allow the parties to take into account the sophistication of the counterparty.[123] The final rules grant swap dealers and major

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[117] See NFP Energy End Users, Ex Parte Communication, Jan. 19, 2011 (citing NFP Energy End Users Sept. 20, 2010 Letter, at 14-15).
[118] VRS Feb. 22 Letter, at 3 (business conduct standards rules should not apply to sophisticated Special Entities).
[119] HOOPP Feb. 22 Letter, at 3 (business conduct standards rules should not apply to sophisticated non-ERISA plans such as HOOPP).
[120] VRS Feb. 22 Letter, at 3-4; EEI June 3 Letter, at 6.
[121] VRS Feb. 22 Letter, at 3-4.
[122] Section 4s(h) distinguishes among counterparties in the Special Entity provisions (Sections 4s(h)(4) and (5)), and among swaps transactions where the counterparty to the swap dealer or major swap participant is a swap dealer, major swap participant, or SBS Entity (Section 4s(h)(3)).
[123] For example, swap dealers will be able to rely on counterparty representations with respect to sophistication, among other things, to tailor their compliance with the suitability rule – § 23.434. To promote efficiency and lower

swap participants, with approval of their counterparties, discretion in selecting a reliable, cost-effective means for providing required information, including using websites with password protection.[124] Additionally, the Commission adopted approaches for swap dealers and major swap participants dealing with Special Entities to streamline the process for complying with the Special Entity provisions without undermining the intent of Congress in enacting those provisions.

In addition, an opt in or opt out regime for counterparties could create incentives for swap dealers and major swap participants that would be inconsistent with congressional intent in enacting the business conduct standards. Rather than raising standards, pressure from swap dealers or major swap participants could discourage counterparties from electing to receive such protections and could effectively force counterparties to waive their rights or be shut out of many swaps transactions.[125] Moreover, the Commission generally frowns on attempts to get customers to waive protections under its rules.[126] As a result, the Commission declines to adopt such an opt in or opt out regime.

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costs, the rules allow swap dealers and major swap participants to incorporate, as appropriate, material information covered by the disclosure requirements in counterparty relationship documentation or other standardized formats to avoid having to make repetitious disclosures on a transaction-by-transaction basis.

[124] Section 23.402(e) – Manner of disclosure. The Commission notes, however, that the disclosure rules are principles based and set standards for required disclosures. The standards apply to each swap covered by the rules. Therefore, whether any particular disclosure or format (e.g., custom tailored or standardized in counterparty relationship documentation) meets the standard in connection with any particular swap will depend on the facts and circumstances. Swap dealers and major swap participants will be responsible for complying with the disclosure standards for each swap.

[125] One commenter suggested that the Commission should impose a minimum comprehension requirement on counterparties. See Copping Jan. 12 Submission. The Commission declines to do so as it is beyond the scope of the business conduct standards rules, which govern swap dealer and major swap participant behavior and not counterparties. Moreover, Congress determined to limit swaps trading, except on a DCM, to ECPs, implicitly finding ECPs to be qualified to engage in such transactions. Nevertheless, the final rules follow the statutory scheme, which establishes a robust disclosure regime and Special Entity protections, among others. The Commission has determined to use its discretionary rulemaking authority to provide for suitability and scenario analysis, in particular. Taken together, the final rules materially enhance the ability of counterparties to assess the merits of entering into any particular swap transaction and reduce information asymmetries between swap dealers and major swap participants and their counterparties.

[126] See, e.g., First American Discount Corp. v. CFTC, 222 F. 3d 1008, 1016-17 (D.C. Cir. 2000) (the Commission contended that permitting introducing brokers to waive the required guarantee agreement with its FCM would undermine the protections provided by Commission Regulation § 1.10(j) (17 CFR 1.10(j))).

v. SEF Transactions

Some commenters stated that certain business conduct standards rules should not apply to SEF transactions where the swap dealer or major swap participant learns the identity of the counterparty only immediately prior to the execution of the swap such as in a request for quote ("RFQ") system.[127] Another commenter opined that Section 4s(h)(7) is intended to exclude certain transactions from all of the requirements of the Commission's business conduct standards rules.[128] The commenter stated that, because the Commission only mentions the exemption with respect to verification of counterparty eligibility[129] and the requirements for swap dealers acting as counterparties to Special Entities,[130] the exclusion could be read as applying only to those rules. The commenter believed that the proper reading of Section 4s(h)(7) requires that all transactions initiated by a Special Entity on a SEF or DCM are excluded from the business conduct standards rules, not merely those that are initiated by a Special Entity where the identity of the counterparty is not known.[131] The commenter believed the two prongs are intended to be disjunctive and carve out from the business conduct standards rules (1) any transaction a Special Entity enters into on a SEF or DCM, or (2) all SEF or DCM transactions where the swap dealer or major swap participant does not know the identity of the counterparty.[132]

Based on the statutory language, the Commission's view is that Section 4s(h)(7) creates an exclusion that applies when two conditions are met: (1) When a transaction is initiated by a Special

[127] See SIFMA/ISDA Feb. 17 Letter, at 7 (asserting that the Commission should clarify that the following proposed exceptions would be available to a swap dealer or major swap participant in an RFQ system where the counterparty's identity is known only immediately prior to the execution of the swap: § 23.430(c)–Verification of counterparty eligibility, § 23.431(b)–Disclosures of material information, § 23.450(g) – Acting as counterparties to Special Entities, and § 23.451(b)(2)(iii)–Pay-to-play prohibitions); State Street Feb. 22 Letter, at 2-3; SWIB Feb. 22 Letter, at 2.
[128] ABC/CIEBA June 3 Letter, at 6-7.
[129] See proposed § 23.430(c).
[130] See proposed § 23.450(g).
[131] ABC/CIEBA June 3 Letter, at 6-7.
[132] Id.

Entity on a DCM or SEF; and (2) the swap dealer or major swap participant does not know the identity of the counterparty to the transaction. Consistent with Section 4s(h)(7), the Commission has determined that certain of the business conduct standards rules will apply only where the swap dealer or major swap participant knows the identity of the counterparty prior to execution. These are the provisions for "know your counterparty," true name and owner, verification of eligibility, disclosures, suitability, and the Special Entity rules.[133]

For uncleared swaps executed on a SEF, swap dealers and major swap participants have ongoing duties to counterparties the same as they would in uncleared non-SEF transactions. For example, the duties to provide a daily mark, engage in fair dealing, and maintain confidentiality of counterparty information will continue to apply.

For swaps where the identity of the counterparty is known just prior to execution on a SEF, the Commission has determined that the business conduct standards rules, including the disclosure duties, will apply. Section 4s(h)(7), which limits application of the Special Entity provisions of the business conduct standards in anonymous DCM and SEF transactions, informs the applicability of other business conduct standards that are also anonymous DCM or SEF transactions. It would be inconsistent with the statutory language and blur the line of when disclosures are required, for example, to exempt swaps from the business conduct standards duties where the identity of the counterparty is known just prior to execution on a SEF. Under the final rules, swap dealers and major swap participants will have to develop mechanisms for

[133] Swap market participants should be aware that the Commission's anti-evasion rule in § 23.402(a) requires swap dealers or major swap participants to have policies and procedures to prevent them from evading or facilitating an evasion of any provision of the Act or Commission Regulation. The Commission expects such policies and procedures to preclude routing pre-arranged trades through a SEF or DCM for the purpose of avoiding compliance with the business conduct standards rules. For example, where a swap dealer or major swap participant has a relationship with a counterparty and has discussed a transaction prior to "anonymous" execution on a SEF, the Commission will consider whether the transaction was structured to avoid compliance with the business conduct standards rules in determining whether to bring an action for failure to have or comply with written policies and procedures to prevent evasion under § 23.402(a).

making disclosures in connection with such transactions on a SEF, which may include working with the SEF itself, to develop functionality to facilitate disclosures.[134]

vi. Extraterritoriality

A few commenters addressed the international reach of the proposed rules. Some commenters stated that the business conduct standards rules should apply only to swaps with a U.S. customer and a U.S. based salesperson.[135] For other swaps, the commenters stated the Commission should defer to foreign regulators[136] and exercise supervision through memoranda of understanding.[137] One commenter also recommended a new registration category for foreign dealers.[138]

The Commission expects to address extraterritorial issues under the Dodd-Frank Act in a separate release, which will include the issues raised by these commenters concerning the application of the business conduct standards rules to foreign customers and dealers.

vii. Private Rights of Action

Several commenters voiced concerns over the potential for litigation that could arise because of the business conduct standards rules.[139] They are concerned that litigation costs will increase as a result and be passed on to counterparties. Commenters noted that the proposed rules may indirectly subject swap dealers and major swap participants to private rights of action because of

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[134] Providing required disclosures under § 23.431 through such mechanisms will not be considered evasion under § 23.402(a).

[135] See, e.g., Societe Generale Feb. 18 Letter, at 8-13; Barclays Jan. 11 Letter, at 5; Bank of Tokyo May 6 Letter, at 5-6; Barclays Feb. 17 Letter, at 8-9.

[136] See Bank of Tokyo May 6 Letter, at 6.

[137] See Societe Generale Feb. 18 Letter, at 8.

[138] Id.

[139] See VRS Feb. 22 Letter, at 3; ABC/CIEBA Feb. 22 Letter, at 9-10; SIFMA/ISDA Feb. 17 Letter, at 4, 5-6, 10 and 34-35; FHLBanks June 3 Letter, at 6 and 8; AMG-SIFMA Feb. 22 Letter, at 4-5 and 7-8; CEF Feb. 22 Letter, at 3-4 and 9-10; Exelon Feb. 22 Letter, at 3.

the statutory language in Section 4s(h).[140] While the Commission cannot exempt swap dealers and major swap participants from private rights of action under Section 22 of the CEA, and issues related to private rights of action are beyond the scope of this rulemaking, in this adopting release and in the rule text, the Commission has provided guidance to swap dealers and major swap participants for complying with the final rules. In addition, in the absence of fraud, the Commission will consider good faith compliance with policies and procedures reasonably designed to comply with the business conduct standards rules as a mitigating factor when exercising its prosecutorial discretion for violation of the rules.

viii. Inter-affiliate Transactions

One commenter suggested that the Commission clarify that certain of the requirements applicable to swap transactions and swap dealing activities do not apply to transactions among affiliated entities because such inter-affiliate transactions do not implicate the concerns for systemic risk and market integrity that the Dodd-Frank Act is intended to address and there is very limited potential for fraudulent conduct.[141] Another commenter suggested that, with regard to banks, the Commission should provide relief from the business conduct standards with respect to transactions among bank group members when the transaction is with a group member that is a registered swap dealer or major swap participant.[142]

The Commission confirms that swap dealers and major swap participants need not comply with the subpart H external business conduct standards rules for swaps entered into with their affiliates where the transactions would not be "publicly reportable swap transactions." Under

[140] For example, Section 22 of the CEA provides a private right of action for any violation of the CEA, and Section 4s(h)(l) states that "[e]ach registered swap dealer and major swap participant shall conform with such business conduct standards . . . as may be prescribed by the Commission by rule or regulation . . . ."
[141] Shell June 3 Letter, at 1.
[142] Bank of Tokyo May 3 Letter, at 4-5.

§ 43.2, recently adopted in the real time reporting rulemaking, a publicly reportable swap transaction means, among other things, any executed swap that is an arm's length transaction between two parties that results in a corresponding change in the market risk position between the two parties.[143] The definition of a publicly reportable swap transaction provides, by way of example, that internal transactions to move risk between wholly-owned subsidiaries of the same parent, without having credit exposure to the other party would not require public dissemination because such swaps are not arm's-length transactions. Such transactions, however, are subject to the anti-evasion requirements of § 23.402(a) and the anti-fraud provisions in § 23.410.

2. Section 23.401–Definitions

a. Proposed § 23.401

Proposed § 23.401 contained definitions for several terms that are relevant to the Commission's proposed business conduct standards rules. These include the terms "counterparty," "major swap participant," "Special Entity"[144] and "swap dealer." The term counterparty was defined to include prospective counterparties. The proposed definitions of "swap dealer" and "major swap participant" incorporated by reference the proposed definitions in the Commission's entity definitions rulemaking.[145] In addition, these terms included, as appropriate under this subpart, anyone acting for or on behalf of such persons, including associated persons as defined in Section 1a(4) of the CEA.

b. Comments

The Commission did not receive any comments regarding the proposed definitions of swap

[143] Real Time Public Reporting, 77 FR 1182 at 1187, Jan. 9, 2012.
[144] See Section IV.A. of this adopting release for a discussion of the comment letters received and the Commission's determination regarding the definition of the term "Special Entity."
[145] See Further Definition of "Swap Dealer," "Security-Based Swap Dealer," Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant," 75 FR 80174, Dec. 21, 2010.

dealer or major swap participant.[146] One commenter stated that the Commission should revise the proposed definition of counterparty to exclude swap dealers and major swap participants.[147] The commenter asserted that the Commission should revise the definition of counterparty and clarify that none of the business conduct standards rules applies where swap dealers or major swap participants transact with another swap dealer or major swap participant.[148]

c. Final § 23.401

The Commission has determined to adopt the definitions of counterparty, swap dealer and major swap participant as proposed (renumbered as § 23.401(a)–Counterparty, § 23.401(b)–Major swap participant and § 23.401(d)–Swap dealer). The Commission declines to revise the definition of counterparty to exclude swap dealers and major swap participants. Certain rules by their terms, such as § 23.431-Disclosures of Material Information and § 23.434-Institutional Suitability, do not apply to transactions among swap dealers or major swap participants. However, the Commission has determined that it would be inappropriate and inconsistent with the statute to exclude such transactions from other rules, such as § 23.433–Communications–fair dealing.

3. Section 23.402–General Provisions[149]

a. Section 23.402(a)–Policies and Procedures to Ensure Compliance and Prevent Evasion

i. Proposed § 23.402(a)

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[146] A commenter urged the Commission to refine the definition of ECP so that the discretionary rules would provide protections only for a subset of unsophisticated ECPs. Alternatively, this commenter asked the Commission to exempt swap dealers and major swap participants from compliance with the external business conduct standards when they face counterparties who are sophisticated enough to evaluate swap transactions without support from the swap dealer or major swap participant. CEF Feb. 22 Letter, at 4-5, see also Wells Fargo May 11 Letter, at passim. See Section III.A.1. of this adopting release for a discussion of § 23.400–Scope, including how the Commission addressed these issues.

[147] CEF Feb. 22 Letter, at 7-8.

[148] Id.

[149] The Commission proposed § 23.402(b)–Diligent supervision, but has determined not to adopt it as a final rule. See fn. 21. As a result, the paragraphs in final § 23.402 have been renumbered as reflected in the final rules.

Proposed § 23.402(a) required swap dealers and major swap participants to have policies and procedures reasonably designed to ensure compliance and prevent evasion of any provision of the CEA or any Commission Regulation, and to implement and monitor compliance with such policies and procedures as part of their supervision and risk requirements under subpart J of part 23.[150]

ii. Comments

One commenter directly addressed proposed § 23.402(a) and asserted that the rule would require a swap dealer or major swap participant to have a policy with respect to each statutory provision or regulation that potentially applies to a swap dealer or major swap participant.[151] According to the commenter, because many regulations only apply in limited circumstances, the scope of a swap dealer or major swap participant's policies and procedures should be limited to material provisions of the CEA and Commission Regulations.[152]

Another commenter, while not directly addressing proposed § 23.402(a), recommended that the Commission convert certain prescriptive requirements of the proposed rules and permit swap dealers and major swap participants to comply by establishing and enforcing policies and procedures.[153] Conversely, another commenter opposed an approach that would deem swap dealers or major swap participants to be in compliance with the business conduct standards for

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[150] The Commission has proposed that swap dealers and major swap participants adopt policies and procedures regarding compliance with the CEA and Commission Regulations. See, e.g., Governing the Duties of Swap Dealers, 75 FR 71397; 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 ("CCO proposed rules"); Implementation of Conflict-of-Interest Standards by Swap Dealers and Major Swap Participants, 75 FR 71391, Nov. 23, 2010 ("Conflict-of-Interest Standards by Swap Dealers").

[151] CEF Feb. 22 Letter, at 19 (Appendix A).

[152] Id.

[153] SIFMA/ISDA Feb. 17 Letter, at 11 (discussing proposed § 23.410(b)–Confidential Treatment of Counterparty Information); see also FIA/ISDA/SIFMA Aug. 26 Letter, at 17 (discussing the SEC's proposed institutional suitability requirements and supporting the implementation of the SEC's proposed "know your counterparty" rule through policies and procedures).

complying with policies and procedures.[154]

iii. Final § 23.402(a)

The Commission has considered the comments and has determined to adopt § 23.402(a) as proposed. The Commission clarifies, however, that a swap dealer or major swap participant may consider the nature of its particular business in developing its policies and procedures and tailor such policies and procedures accordingly.[155] A swap dealer or major swap participant, however, remains responsible for complying with all applicable provisions of the CEA and Commission Regulations, including subpart H of part 23.

A swap dealer or major swap participant will be expected to have policies and procedures reasonably designed both to ensure compliance and avoid evasion of the applicable requirements of the CEA and Commission Regulations, including subpart H of part 23. Good faith compliance with such policies and procedures will be considered by the Commission in exercising its prosecutorial discretion in connection with violations of the CEA and Commission Regulations. To be considered good faith compliance, the Commission will consider, among other things, whether the swap dealer or major swap participant made reasonable inquiry and took appropriate action where the swap dealer or major swap participant had information that would cause a reasonable person to believe that any person acting for or on behalf of the swap dealer, major swap participant or any counterparty was violating the CEA or the Commission's Regulations in connection with the swaps related business of the swap dealer or major swap participant.

[154] CFA/AFR Aug. 29 Letter, at 12 (also noting, however, "it is certainly appropriate for the [SEC] to require SBS Entities to establish, maintain, document and enforce policies and procedures reasonably designed to achieve compliance with business conduct rules").

[155] As part of the materials submitted in an application for registration as a swap dealer or major swap participant, an applicant may submit its written policies and procedures to "demonstrate, concurrently with or subsequent to the filing of their Form 7–R with the National Futures Association, compliance with regulations adopted by the Commission pursuant to section[] . . . 4s(h) . . . of the [CEA] . . . ." The Commission adopted final registration rules on the same day as these business conduct standards rules. See also proposed § 3.10(a)(1)(v)(A), Proposed Rules for Registration of Swap Dealers and Major Swap Participants, 75 FR 71379, Nov. 23, 2010.

b. Section 23.402(b)–Know Your Counterparty

i. Proposed § 23.402(c)

Among the Commission's proposed business conduct rules was a "know your counterparty" requirement.[156] Proposed § 23.402(c) (renumbered as final § 23.402(b)) required swap dealers and major swap participants to 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.[157]

The Commission stated that, among other purposes, proposed § 23.402(c) 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."[158] In proposing § 23.402(c), the Commission noted that it was guided by 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.[159]

ii. Comments

The Commission received several comments representing a diversity of views on proposed

[156] Proposing release, 75 FR at 80641.
[157] Id., at 80657.
[158] Id., at 80641; 7 U.S.C. 6c(a)(7).
[159] Proposing release, 75 FR at 80641 fn. 25 (citing NFA Interpretive Notice 9013 – NFA Compliance Rule 2-30: Customer Information and Risk Disclosure (Staff, Nov. 30, 1990; revised Jul. 1, 2000)).

§ 23.402(c). As a general matter, some commenters believed the "know your counterparty" rule should not be adopted because it was not mandated by the Dodd-Frank Act.[160] These commenters expressed concern about a number of specific issues as well.

One commenter stated that the application of proposed § 23.402(c) and certain other proposed rules to major swap participants in connection with their trading with swap dealers and other registered market intermediaries is inappropriate because they are customers of swap dealers or registered market intermediaries and should be treated as such rather than as dealers or quasi-dealers.[161]

Commenters stated that proposed § 23.402(c) seemed to transform swap dealers and major swap participants into "service providers," which they contend is a departure from their actual status as counterparties.[162] In this regard, these commenters believed the Commission erred by misapplying principles of agency to arm's length, principal-to-principal relationships.[163] These commenters contend that, to the extent swap dealers and major swap participants are transacting with counterparties at arm's length, the Commission should clarify that the "know your counterparty" and corresponding recordkeeping requirements do not apply.[164] Similarly, these commenters expressed concern that requiring swap dealers and major swap participants to obtain financial information from their counterparties would be inconsistent with ordinary business practice and would place the counterparties at a severe negotiating and informational disadvantage to the swap dealer or major swap participant.[165]

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[160] See, e.g., ABC/CIEBA Feb. 22 Letter, at 13-14; SIFMA/ISDA Feb. 17 Letter, at 8-9.
[161] MetLife Feb. 22 Letter, at 4-5.
[162] See, e.g., ABC/CIEBA Feb. 22 Letter, at 14; SIFMA/ISDA Feb. 17 Letter, at 9; HOOPP Feb. 22 Letter, at 3; BlackRock June 3 Medero and Prager Letter, at 5.
[163] See, e.g., SIFMA/ISDA Feb. 17 Letter, at 9.
[164] See, e.g., MFA Feb. 22 Letter, at 5.
[165] See, e.g., ABC/CIEBA Feb. 22 Letter, at 14; AMG-SIFMA Feb. 22 Letter, at 10.

Commenters opposed to proposed § 23.402(c) also took issue with the Commission's reference to NFA Compliance Rule 2-30 (Customer Information and Risk Disclosure).[166] In their view, the Commission's proposal to require a swap dealer or major swap participant to conduct an independent investigation in order to obtain information necessary to evaluate a counterparty's flexibility is unclear and a costly departure from NFA Compliance Rule 2-30 and FINRA Rule 2090 (Know Your Customer).[167] The commenters stated that the SRO rules are intended to protect retail customers and are ill-suited to a sophisticated institutional market.[168] By transforming an SRO rule into a Commission regulation, these commenters believed that the Commission's proposal exposes swap dealers and major swap participants to unnecessary and significant private litigation risk and associated costs.[169]

The concern regarding the proposal's potential to increase legal risk and transaction costs extended to those commenters who were generally supportive of the requirement in proposed § 23.402(c) that swap dealers and major swap participants use reasonable due diligence to know and retain a record of the essential facts concerning each counterparty.[170] As one commenter stated, "if the derivatives markets are unduly constrained on account of increased legal risk, the intended benefits of the external business conduct rules will not be realized."[171]

Another commenter strongly supported proposed § 23.402(c) as an essential component of an effective business conduct standards rule regime and urged the Commission to strengthen the recordkeeping requirements associated with the proposed "know your counterparty" rule.[172]

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[166] See, e.g., SIFMA/ISDA Feb. 17 Letter, at 8; MFA Feb. 22 Letter, at 3.
[167] Id.
[168] Id.
[169] Id.
[170] See, e.g., FHLBanks June 3 Letter, at 6.
[171] Id.
[172] CFA/AFR Feb. 22 Letter, at 6 and 19.

However, the commenter agreed with those generally opposed to the proposal on one point: That it may be appropriate to scale any "know your counterparty" requirements according to the nature of the relationship between the counterparties. Accordingly, the commenter agreed that, where a truly arm's length relationship exists, for example, it may be appropriate to limit the "know your counterparty" obligation to information necessary to comply with the law.[173]

In connection with the "know your counterparty" rule, commenters urged the Commission to harmonize its rules with those proposed by the SEC.[174] These commenters stated their belief that Congress sought to assure through Section 712(a) of the Dodd-Frank Act that the CFTC and SEC adopt comparable and consistent regulations.[175] These commenters also highlighted that, from a cost-benefit perspective, inconsistent or conflicting requirements would increase the costs to market participants of implementing the measures necessary to comply with the CEA.[176]

iii. Final § 23.402(b)

The Commission has determined to adopt proposed § 23.402(c) (renumbered as § 23.402(b)) with changes to reflect certain of the comments it received. In making this determination, the Commission concluded that final § 23.402(b) is fully authorized by the discretionary rulemaking authority vested in the Commission by Section 4s(h). In Section 4s(h), 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.[177] The Commission considers the rule to be an appropriate exercise of its discretionary authority because a "know your counterparty" requirement is an integral

[173] Compare CFA/AFR Feb. 22 Letter, at 19, with SIFMA/ISDA Feb. 17 Letter, at 8-9.
[174] See, e.g., FIA/ISDA/SIFMA Sept. 14 Letter, at 2-3.
[175] Id., at 2.
[176] Id.
[177] Section 4s(h)(3)(D); see also Sections 4s(h)(1)(D), 4s(h)(5)(B) and 4s(h)(6).

component of, and consistent with, sound principles of legal and regulatory compliance and operational and credit risk management.[178] Many of the entities that will be subject to this requirement should already have in place, as a matter of normal business practices, "know your counterparty" policies and procedures by way of their membership in an SRO[179] or, for banks, compliance with standards set forth by their prudential regulators.[180] Given this fact, the Commission believes the additional costs of complying with this requirement, if any, will be minimal.

Final § 23.402(b) seeks to harmonize the Commission's approach with the SEC's proposed rules.[181] As one commenter noted, the SEC's "know your counterparty" proposal benefited from the comments the Commission received on proposed § 23.402(c).[182] This same commenter highlighted the congressional mandate in Section 712(a) of the Dodd-Frank Act that the Commission and the SEC consult for the purposes of assuring regulatory consistency and comparability, to the extent possible. The Commission believes that the "know your counterparty" rule is an area where the Commission and the SEC can achieve consistency. At the same time, there will be some variation to account for the comments received on the Commission's proposal and the fact that the Commission regulates different products, participants, and markets.

The Commission agrees with comments calling for the exclusion of major swap participants from the "know your counterparty" requirements. In most cases, major swap participants will

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[178] See Derivatives Policy Group, "Framework for Voluntary Oversight," at Section V.III.B. (Mar. 1995) ("DPG Framework").
[179] See, e.g., NFA Compliance Rule 2-30; see also FINRA Rule 2090.
[180] See also Trading & Capital-Markets Activities Manual, sections 2050.3, 2050.4, 2060.3, 2060.4, 3030.1, and 3030.3 (Bd. of Gov. Fed. Reserve Sys. Jan. 2009).
[181] SEC's proposed rules, 76 FR at 42414.
[182] See FIA/ISDA/SIFMA Aug. 26 Letter, at 3.

themselves be counterparties to or customers of swap dealers. By definition, their business will not be dealing in or making a market in swaps.[183] Accordingly, the Commission is deleting major swap participants from final § 23.402(b).

With respect to the requirement in proposed § 23.402(c) that the swap dealer evaluate the previous swap experience, financial wherewithal and flexibility, trading objectives and purposes of the counterparty, commenters expressed several objections. Rather than fostering counterparty protections, commenters asserted, this requirement could actually place counterparties at a negotiating and information disadvantage relative to swap dealers.[184] Further, commenters claimed that such protections are unnecessary when swap dealers and counterparties are dealing in arm's length transactions and are more appropriate when swap dealers make recommendations to counterparties.[185]

In light of the foregoing comments, the Commission believes that certain of the protections provided for in proposed § 23.402(c) are better addressed in connection with § 23.434–Recommendations to counterparties–institutional suitability.[186] Accordingly, the Commission is removing from final § 23.402(b) the requirements in proposed § 23.402(c) to "effectively service the counterparty" and "implement any special instructions from the counterparty." Through these changes, the Commission clarifies that the final "know your counterparty" rule does not, by itself, create an "advisor" status or impose a fiduciary duty on a swap dealer.

The Commission believes comments opposing proposed § 23.402(c) on the basis that it transforms NFA Compliance Rule 2-30 (Customer Information and Risk Disclosure) from an

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[183] The definition of "major swap participant" states that the term "means any person who is not a swap dealer." Section 1a(33) of the CEA (7 U.S.C. 1a(33)).
[184] See, e.g., ABC/CIEBA Feb. 22 Letter, at 14.
[185] See, e.g., MFA Feb. 22 Letter, at 4.
[186] See Section III.G. of this adopting release for a discussion of § 23.434.

SRO rule to a Commission regulation are misplaced. The Commission was guided by NFA Compliance Rule 2-30 as a model for the proposal, with modification where appropriate to achieve the Commission's policy objectives, including assisting swap dealers to avoid violations of Section 4c(a)(7) of the CEA.[187] The Commission believes that NFA Compliance Rule 2-30 and the precedent developed under it will serve as useful guidance to the Commission and the public in the application of the final rule.[188] However, as stated above, final § 23.402(b), which essentially codifies sound business practices,[189] is an important component of the Commission's overall business conduct standards framework. The Commission views NFA's and the Commission's "know your counterparty" requirements as complementary.

Given the changes from the proposal to final § 23.402(b), the Commission believes it has ameliorated much of the burden commenters attributed to compliance risk associated with the "know your counterparty" requirements. Based on the foregoing, the Commission is promulgating final § 23.402(b) with modification from the proposal to account for the specific comments received and to conform, where appropriate, to the SEC's proposed "know your counterparty" rule. Accordingly, final § 23.402(b) requires that each swap dealer shall implement policies and procedures reasonably designed to obtain and retain a record of the essential facts concerning each counterparty whose identity is known to the swap dealer that are necessary for conducting business with such counterparty.[190] For purposes of final § 23.402(b), the essential facts concerning a counterparty are: (1) Facts required to comply with applicable

[187] Section 4c(a)(7) of the CEA 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." See also discussion at fn. 158.
[188] See, e.g., NFA Interpretive Notice 9004 – NFA Compliance Rule 2-30: Customer Information and Risk Disclosure (Board of Directors, effective June 1, 1986; revised January 3, 2011).
[189] See DPG Framework, at Section V.III.B.
[190] Final § 23.402(b) will not apply to swaps that are executed on a SEF or DCM where the swap dealer does not know the identity of the counterparty to the transaction.

laws, regulations and rules; (2) facts required to implement the swap dealer's credit and operational risk management policies in connection with transactions entered into with such counterparty; and (3) information regarding the authority of any person acting for such counterparty.

In adopting this final rule, the Commission makes clear that recordkeeping, in accordance with final § 23.402(g), must be sufficient so as to enable the Commission to determine compliance with final § 23.402(b). Unlike the SEC proposed rule, the Commission has determined not to include the following as an essential fact in final § 23.402(b): "If the counterparty is a Special Entity, such background information regarding the independent representative as the swap dealer reasonably deems appropriate."[191] This requirement is specifically addressed in Section 4s(h)(5) of the CEA as well as in the final rules that address the independent representative requirement.[192]

As with other business conduct standards rules, final § 23.402(b) does not allow counterparties to opt out. However, swap dealers will be able to reduce the costs of compliance by receiving written representations from their counterparties at the outset of the relationship rather than on a transaction-by-transaction basis, where appropriate, and in accordance with the requirements of final § 23.402(d)–Reasonable Reliance on Representations.

c. Section 23.402(c)–True Name and Owner

i. Proposed § 23.402(d)

Proposed § 23.402(d) (renumbered as final § 23.402(c)) required swap dealers and major swap participants to keep records that show the true name, address, and principal occupation or business of each counterparty, as well as the name and address of any other person guaranteeing

[191] SEC's proposed rules, 76 FR at 42414.
[192] See Section IV.C.3. of this adopting release for a discussion of final § 23.450.

the performance of such counterparty and any person exercising any control with respect to the positions of such counterparty.[193] This rule was proposed under the Commission's discretionary rulemaking authority in Section 4s(h).

ii. Comments

The Commission did not receive any comments regarding proposed § 23.402(d).

iii. Final § 23.402(c)

As stated in the proposing release, proposed § 23.402(d) was based on existing Commission Regulation § 1.37(a)(1),[194] which applies to FCMs, introducing brokers, and members of a DCM. The Commission has determined that it is in the public interest to hold swap dealers and major swap participants to this same standard. Further, the Commission has determined that the recordkeeping requirements under this rule will assist swap dealers and major swap participants in meeting their other duties pursuant to the business conduct standards in subpart H of part 23 (e.g., the "verification of counterparty eligibility" requirement of final § 23.430). Accordingly, the Commission is adopting proposed § 23.402(d) (renumbered as § 23.402(c)).

d. Section 23.402(d)–Reasonable Reliance on Representations

i. Proposed § 23.402(e)

Proposed § 23.402(e) (renumbered as final § 23.402(d)) stated that swap dealers and major swap participants that seek to rely on counterparty representations to satisfy any of the business conduct standards rules must have a reasonable basis to believe that the representations are reliable under the circumstances.[195] In other words, proposed § 23.402(e) would have allowed swap dealers and major swap participants, as appropriate, to reasonably rely, absent red flags, on

[193] Proposing release, 75 FR at 80641.
[194] 17 CFR 1.37(a)(1).
[195] Proposing release, 75 FR at 80641.

representations of counterparties to meet due diligence obligations. The counterparty's representations must have included information that was sufficiently detailed for the swap dealer or major swap participant to form a reasonable conclusion that the relevant requirement was satisfied.

ii. Comments

The Commission did not receive comments directly addressing proposed § 23.402(e). However, many commenters addressed the concept in proposed § 23.402(e) of reasonable reliance on representations in connection with the due diligence requirements under certain other proposed rules, such as proposed § 23.430–Verification of Counterparty Eligibility, proposed § 23.434–Recommendations to Counterparties–Institutional Suitability, and proposed § 23.450(d)–Requirements for Swap Dealers and Major Swap Participants Acting as Counterparties to Special Entities.[196] Commenters were particularly concerned with the language in these proposed rules that the representations be reliable "taking into consideration the facts and circumstances of a particular relationship, assessed in the context of a particular transaction" and that the representations be "sufficiently detailed."[197] According to some commenters, the proposed rules that permitted reliance on representations, including proposed § 23.402(e), would require transaction-by-transaction diligence that would delay execution and increase costs for swap dealers, major swap participants and their counterparties.[198] Several commenters also

[196] See, e.g., ABA/ABC Feb. 22 Letter, at 2-3; ABC/CIEBA Feb. 22 Letter, at passim; AMG-SIFMA Feb. 22 Letter, at 9-11; APGA Feb. 22 Letter, at 2-3 and 6-7; APPA/LPPC Feb. 22 Letter, at 4; BlackRock Feb. 22 Letter, at 3; CalPERS Oct. 4 Letter, at 1; CEF Feb. 22 Letter, at 12, 16, 19-20, and 23; CFA/AFR Feb. 22 Letter, at 6, 8 and 13; Comm. Cap. Mkts. May 3 Letter, at 2; Davis & Harman Mar. 25 Letter, at 5-6; FHLBanks Feb. 22 Letter, at 4-5; Ropes & Gray Feb. 22 Letter, at 3-4; SIFMA/ISDA Feb. 17 Letter, at 12, 15-16, 27, 27 fn. 59, 35-36 and 36 fn. 85; SWIB Feb. 22 Letter, at 4-5; VRS Feb. 22 Letter, at 5. See also NFA Aug. 25, 2010 Letter, at 2.

[197] See, e.g., SIFMA/ISDA Feb. 17 Letter, at 36; proposing release, 75 FR at 80660.

[198] See, e.g., SIFMA/ISDA Feb. 17 Letter, at 35-36; ABC/CIEBA Feb. 22 Letter, at 9-10; BlackRock Feb. 22 Letter, at 3; see also SIFMA/ISDA Feb. 17 Letter, at 15-16 (discussing proposed § 23.430, Verification of Counterparty

asserted that a swap dealer or major swap participant should not have an affirmative duty to investigate the counterparty's representations.[199]

iii. Final § 23.402(d)

The Commission has considered the comments discussed above and, as a result, has determined to refine the language in proposed § 23.402(e) (renumbered as § 23.402(d)). The revised language permits a swap dealer or major swap participant to rely on the written representations of a counterparty to satisfy its due diligence requirements under subpart H of part 23. The Commission has determined, however, that a swap dealer or major swap participant cannot rely on a representation if the swap dealer or major swap participant has information that would cause a reasonable person to question the accuracy of the representation. In other words, a swap dealer or major swap participant cannot ignore red flags when relying on representations to satisfy its due diligence obligations.

The nature and specificity of the representations required under subpart H of part 23 vary depending on the specific rule. Therefore, the Commission has separately described in the discussion of the relevant provisions the content and level of detail a particular representation

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Eligibility, "an SD/MSP must conduct affirmative diligence in order to determine whether it is reasonable to rely on provided representations. Such an approach effectively makes the relevant representation(s) superfluous.").

[199] See, e.g., SIFMA/ISDA Feb. 17 Letter, at 15-16 ("[swap dealers] should be permitted to . . . rely[] on a written representation by the counterparty. . . absent actual notice of countervailing facts (or facts that reasonably should have put the [swap dealer or major swap participant] on notice), which would trigger a consequent duty to inquire further"); ABC/CIEBA Feb. 22 Letter, at 10-11 fn. 3 (asserting the Commission should adopt a standard used under Rule 144A of the federal securities laws, which would not impose a duty to inquire further "unless circumstances existed giving reason to question the veracity of a certification"); AMG-SIFMA Feb. 22 Letter, at 10-11 ("A swap dealer or [major swap participant] should be able to rely on an investment adviser's representation unless the swap dealer or [major swap participant] has information to the contrary."); Comm. Cap. Mkts. May 3 Letter, at 2 ("The dealer should be required to probe beyond that representation only if it has reason to believe that the Special Entity's representations with respect to its independent representative are inaccurate."); BlackRock Feb. 22 Letter, at 3 ("The CFTC should specifically permit the [swap dealer] to rely, absent notice of facts that would require further inquiry . . . .").

must have to satisfy the due diligence obligation of a particular rule.[200]

The Commission reaffirms that, if agreed to by the counterparty, counterparty representations may be contained in counterparty relationship documentation and may be deemed renewed with each subsequent offer or transaction. However, a swap dealer or major swap participant may only rely on representations in the counterparty relationship documentation if the counterparty agrees to timely update any material changes to the representations.[201] In addition, the Commission expects swap dealers and major swap participants to review the representations on a periodic basis to ensure that they remain appropriate for the intended purpose. The Commission believes that "best practice" would be at least an annual review in connection with the required annual compliance review by the chief compliance officer pursuant to proposed § 3.3.[202]

e. Section 23.402(e)–Manner of Disclosure

i. Proposed § 23.402(f)

Proposed § 23.402(f) (renumbered as final § 23.402(e)) provided flexibility to swap dealers and major swap participants by allowing them to provide information required by subpart H of part 23, including required disclosures, by any reliable means agreed to in writing by the counterparty.[203]

ii. Comments

One commenter suggested that the Commission establish minimum requirements defining

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[200] See Sections III.A.3.b., III.C., III.G., IV.B., and IV.C. in this adopting release for a discussion of the following final rules, respectively: § 23.402(b)–Know your counterparty; § 23.430–Verification of counterparty eligibility; § 23.434–Institutional suitability; § 23.440–Requirements for swap dealers acting as advisors to Special Entities; and § 23.450–Requirements for swap dealers and major swap participants acting as counterparties to Special Entities.

[201] Such an agreement to update representations contained in counterparty relationship documentation is only with respect to subsequent (i.e., new) swaps offered or entered into. The requirement to update representations is in the context of the execution of the subsequent swap. The Commission does not intend to require an ongoing duty to update representations except in connection with a new transaction.

[202] CCO proposed rules, 75 FR at 70887.

[203] Proposing release, 75 FR at 80642.

"reliable means" within the rule.[204] In addition, the use of password protected web pages to satisfy the daily mark obligation was identified as a potential area of concern. The commenter recommended that permitted interfaces should provide counterparties with tools to initiate, track and close valuation disputes and the interfaces should be designed to prevent any unintentional or fraudulent addition, modification, or deletion of a valuation record.[205] Another commenter opposed permitting pre-transaction oral disclosures to satisfy a disclosure obligation, even where such disclosures are supplemented by post-transaction written documentation.[206]

iii. Final § 23.402(e)

The Commission is adopting proposed § 23.402(f) (renumbered as § 23.402(e)) with a change to account for disclosures for certain swaps initiated on a SEF or DCM. For such swaps, no written agreement by the counterparty regarding the manner of disclosure is necessary, but the manner of disclosure must be reliable. Otherwise, for swaps executed bilaterally and not on a SEF or DCM, the rule requires counterparties to agree, in writing, to the manner of disclosure.

In addition, the Commission is clarifying in this adopting release that oral disclosures are permitted if agreed to by the counterparty and the disclosures are confirmed in writing. To avoid confusion and misunderstanding among the parties, however, written disclosures are the preferred manner of disclosure. Written disclosures also facilitate diligent supervision and auditing of compliance with the disclosure duties and record retention rule.

In response to comments received prior to the publication of the proposing release, daily marks may be provided by password protected web pages.[207] This approach is consistent with

[204] Markit Feb. 22 Letter, at 3.
[205] Id.
[206] CFA/AFR Nov. 3 Letter, at 6.
[207] See proposing release, 75 FR at 80646 fn. 62.

industry suggestions and reflects cost of compliance concerns.[208] Regarding the concerns raised by the commenter,[209] the Commission's internal business conduct rules in new subpart J of part 23 of the Commission's Regulations[210] require swap dealers and major swap participants to have policies and procedures in place that ensure communications, including the daily mark, are reliable and timely.

Final § 23.402(e) provides flexibility to swap dealers and major swap participants to take advantage of technological innovations while accommodating industry practice and counterparty preferences. The Commission anticipates that technology will be adapted to expedite and reduce the costs associated with satisfying the disclosure requirements in the Commission's business conduct standards generally.

f. Section 23.402(f)–Disclosures in a Standard Format

i. Proposed § 23.402(g)

Proposed § 23.402(g) (renumbered as final § 23.402(f)) allowed 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.[211]

ii. Comments

The Commission received letters from several commenters regarding proposed

[208] Id.
[209] Markit Feb. 22 Letter, at 3.
[210] See proposed §§ 3.3, 23.600, 23.602 and 23.606, Governing the Duties of Swap Dealers, 75 FR 71397.
[211] Proposing release, 75 FR at 80642.

§ 23.402(g).[212] Generally, the commenters endorsed the proposed rule, but raised a variety of concerns, including the scope, substance, timing, frequency and cost of the standardized disclosures. Regarding scope and substance, some commenters suggested that the Commission promote or develop standardized disclosures to ensure adequate and consistent information, which would streamline the disclosure process, foster legal certainty and reduce costs.[213] One commenter proposed, as an alternative to disclosing material information, limiting the required disclosure to the provision of robust market risk scenario analyses, defined in scope, in advance of all swaps.[214] Several commenters requested that the form of disclosure be specified by the Commission as it has done for futures trading under § 1.55.[215] One commenter suggested that DCOs prepare certain standardized disclosures for cleared swaps.[216]

Regarding the timing and frequency of standard form disclosures, virtually all commenters agreed that, for standardized swaps, disclosures by swap dealers and major swap participants to counterparties should be allowed on a relationship basis and not required on a transaction-by-transaction basis.[217] For non-standardized swaps, one commenter challenged the statement in the proposing release that "the Commission believes that most bespoke transactions . . . will require some combination of standardized and particularized disclosures[]"[218] asserting that bespoke issues can be anticipated and included in standardized disclosures as part of counterparty

[212] See FHLBanks Feb. 22 Letter, at 3-4; ABC/CIEBA Feb. 22 Letter, at 13; ABC Aug. 29 Letter, at 2 and 10-11; CEF Feb. 22 Letter, at 13; BlackRock Feb. 22 Letter, at 6-7; APGA Feb. 22 Letter, at 3; ATA Feb. 22 Letter, at 3; State Street Feb. 22 Letter, at 3-4; SIFMA/ISDA Feb. 17 Letter, at 16-18; NY City Bar Feb. 22 Letter, at 2-3; CFA/AFR Feb. 22 Letter, at 8.
[213] See, e.g., FHLBanks Feb. 22 Letter, at 3-4.
[214] NY City Bar Feb. 22 Letter, at 2-3.
[215] See, e.g., APGA Feb. 22 Letter, at 3; ATA Feb. 22 Letter, at 3; State Street Feb. 22 Letter, at 3-4; CEF Feb. 22 Letter, at 13. In addition, the NY City Bar recommended standardized disclosures similar to those currently used for listed options rather than the federal securities law model, which is directed at retail investors and not sophisticated ECPs in the swaps market. NY City Bar Feb. 22 Letter, at 2. See also 17 CFR 1.55.
[216] CEF Feb. 22 Letter, at 13.
[217] See, e.g., FHLBanks Feb. 22 Letter, at 3; ABC/CIEBA Feb. 22 Letter, at 13; ABC Aug. 29 Letter, at 2 and 10-11; CEF Feb. 22 Letter, at 4; BlackRock Feb. 22 Letter, at 6-7.
[218] Proposing release, 75 FR at 80643.

relationship documentation or other written agreements.[219] A different commenter commended the Commission for recognizing that standardized disclosures alone would not be adequate to elucidate the risks in customized swaps.[220] Another commenter acknowledged that there are certain instances in which standardized disclosures may not provide adequate information and requested that the Commission clarify that counterparties may require additional disclosure from swap dealers and major swap participants.[221]

In addition, a commenter requested guidance regarding the required disclosures and customary non-reliance language in swap documents.[222] This commenter stated: "It is anomalous to require swap dealers and major swap participants to make certain disclosures to their end-user counterparties pursuant to the proposed rule while those swap dealers and major swap participants continue to include non-reliance agreements in swap transaction documentation providing their end-user counterparties may not rely on disclosures."[223] The commenter requested that the Commission clarify that any non-reliance provisions contained in swap transaction documentation must exclude any disclosure mandated by the Dodd-Frank Act and the rules promulgated thereunder.[224]

iii. Final § 23.402(f)

The Commission is adopting proposed § 23.402(g) (renumbered as § 23.402(f)) with a slight modification for clarity purposes. The language referencing "a standard format, including in a master . . . agreement . . ." was changed to "counterparty relationship documentation."

Regarding comments related to scope and substance and the request that the Commission

[219] SIFMA/ISDA Feb. 17 Letter, at 18.
[220] CFA/AFR Feb. 22 Letter, at 8.
[221] FHLBanks Feb. 22 Letter, at 4.
[222] Id.
[223] Id.
[224] Id.

develop a standardized disclosure form for swaps, the Commission has determined that a § 1.55[225] type disclosure form for swaps would be inconsistent with the requirements of Section 4s(h)(3). Because the types of swaps covered by the disclosure duties will not be limited to standardized products and will include negotiated, bilateral transactions, swap dealers and major swap participants are required to develop the disclosures appropriate to the transactions that they offer to and enter into with counterparties. Unlike standardized exchange traded futures and options, swaps can be bespoke instruments with a wide range of non-standardized economic features that materially influence cash flows, which do not lend themselves to a single form, futures-style risk disclosure statement developed by the Commission.[226]

In addition, commenters suggested that the Commission provide standardized disclosure to promote legal certainty. On the contrary, such a disclosure could increase uncertainty because it would necessarily have to be general enough to cover all conceivable swaps, to such an extent that the purpose of disclosure would not be served. Congress enacted this robust disclosure regime to reduce information asymmetry and give counterparties the material information to make an informed and reasoned decision before placing assets at risk. A Commission generated standard disclosure also runs the risk of offering a roadmap for evasion, or it would require constant updates to maintain pace with innovations that are engineered and may not be covered by the standard language.

To address legal certainty concerns, the Commission is clarifying in this adopting release that, in the absence of fraud, it will consider good faith compliance with policies and procedures

[225] 17 CFR 1.55.

[226] The Commission has proposed a swap risk disclosure statement for commodity pool operators ("CPOs") and CTAs. See Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations, 76 FR 7976, Feb. 11, 2011. The proposed swap risk disclosure statement for CPOs and CTAs does not affect the swap disclosure requirements under Section 4s(h)(3)(B) or any rules promulgated pursuant to that statutory provision.

reasonably designed to comply with the business conduct standards rules as a mitigating factor when exercising its prosecutorial discretion for violation of the rules.

The Commission expects that swap dealers and major swap participants will develop their own standard disclosures to meet certain aspects of the disclosure requirements, where appropriate, that will be tailored to the types of swaps that they offer and will be provided to counterparties in counterparty relationship documentation or through other reliable means. Such an approach will help to minimize costs without diminishing the quality of risk disclosures provided to counterparties. Where such standardized disclosures are inadequate to meet the requirements of final § 23.402(f), swap dealers and major swap participants will have to make particularized disclosures in a timely manner that are sufficient to allow the counterparty to assess the material risks and characteristics of the swap. In addition, swap dealers and major swap participants will need to have policies and procedures to address when and how disclosures will be provided to counterparties, including particularized disclosures in connection with complex swaps. Factors that would be relevant include, but are not limited to, the complexity of the transaction, the degree and nature of any leverage,[227] the potential for periods of significantly reduced liquidity, and the lack of price transparency.[228] This approach is consistent with over-the-counter ("OTC") industry best practice recommendations for high-risk, complex financial

[227] The leverage characteristic is particularly relevant when the swap includes an embedded option, including one in which the counterparty has sold an option to the dealer or the dealer retains the option to alter the terms of the swap under certain circumstances. Such features can significantly increase counterparty risk exposure in ways that are not transparent.

[228] "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." The Counterparty Risk Management Policy Group, "Containing Systemic Risk: The Road to Reform, The Report of the CRMPG III," at 56 (Aug. 6, 2008) ("CRMPG III Report").

instruments.[229]

With respect to scenario analysis, counterparties will be able to opt in to receive scenario analysis for swaps that are not "made available for trading" on a DCM or SEF.[230] The Commission declines, however, to determine, as suggested by commenters, that standard form scenario analysis is sufficient to meet all business conduct standards disclosure requirements, which include material risks, characteristics, incentives and conflicts of interest.[231]

Regarding the suggestion that DCOs be required to provide certain standardized disclosures (other than the daily mark) for cleared swaps, the Commission is not mandating such a rule in this rulemaking because Section 4s(h) of the CEA and subpart H of part 23 only govern swap dealers and major swap participants. Swap dealers and major swap participants will be permitted, however, to arrange with third parties, including DCOs and SEFs, to provide disclosures to a counterparty to satisfy the swap dealer's or major swap participant's obligation under § 23.431. The Commission expects that a DCO or SEF may make available certain information, such as the material economic terms of cleared swaps, similar to the contract specifications provided by DCMs today. Swap dealers and major swap participants may make arrangements so that such information from the DCO or SEF satisfies certain disclosure obligations (e.g., material characteristics of the swap). Regardless, the swap dealer or major swap participant will remain responsible for compliance with § 23.431. Lastly, the Commission is providing guidance that non-reliance provisions routinely included in counterparty relationship documentation will not relieve swap dealers and major swap participants of their duty to comply in good faith with the business conduct standards requirements. It will be up to the adjudicator in a particular case to

[229] Id.
[230] See Section III.D.3.b. of this adopting release for a discussion of final § 23.431(b); see also discussion of Section 2(h)(8) of the CEA and swaps "made available for trading" on a DCM or SEF at infra fn. 394.
[231] See NY City Bar Feb. 22 Letter, at 2-3.

determine the extent of any liability of the swap dealer or major swap participant to a counterparty under the business conduct standards rules, depending on the facts and circumstances.

g. Section 23.402(g)–Record Retention

i. Proposed § 23.402(h)

Proposed § 23.402(h) (renumbered as final § 23.402(g)) required swap dealers and major swap participants to create and retain a written record of their compliance with the requirements of the external business conduct rules in subpart H. Such requirements would be (1) part of the overall recordkeeping obligations imposed on swap dealers and major swap participants in the CEA and subpart F of part 23 of the Commission's Regulations, (2) maintained in accordance with § 1.31[232] of the Commission's Regulations, and (3) accessible to applicable prudential regulators.[233]

ii. Comments

A commenter requested clarification regarding the requirement to create a written record of compliance with the external business conduct rules. In particular, guidance was requested regarding whether master agreements, which contain certain counterparty representations, qualify as a "written record of compliance" within the rule.[234] Another commenter suggested that the Commission strengthen the recordkeeping requirements throughout to ensure that records are detailed enough to allow regulators to easily determine compliance.[235]

iii. Final § 23.402(g)

After considering the comments, the Commission has determined to adopt § 23.402(h) as

[232] 17 CFR 1.31.
[233] Proposing release, 75 FR at 80642.
[234] CEF Feb. 22 Letter, at 19.
[235] CFA/AFR Feb. 22 Letter, at 6, 7, 13, 18 and 20.

proposed (renumbered as § 23.402(g)). In addition, the Commission confirms that counterparty relationship documentation containing standard form disclosures, other material information and counterparty representations may be part of the written record of compliance with the external business conduct rules that require certain disclosures and due diligence. Further, swap dealers and major swap participants may choose to use internet based applications to provide disclosures and daily marks.[236] Swap dealers and major swap participants are required to have policies and procedures for documenting disclosures and due diligence. Recordkeeping policies and procedures should ensure that records are sufficiently detailed to allow compliance officers and regulators to determine compliance.

B. Section 23.410–Prohibition on Fraud, Manipulation and Other Abusive Practices

1. Sections 23.410(a) and (b)

a. Proposed § 23.410(a)

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.[237] To implement this provision, the Commission proposed several rules, including proposed § 23.410(a), which incorporated the statutory text in Section 4s(h)(4)(A).[238] The statutory provision prohibits fraudulent, deceptive and manipulative practices

[236] Swap dealers and major swap participants will have to retain a record of all required information irrespective of the method used to convey such information.

[237] In addition, Section 753 of the Dodd-Frank Act provided the Commission with expanded anti-manipulative and deceptive practices authority by amending Section 6(c) of the CEA. (7 U.S.C. 9). On July 14, 2011, the Commission published in the Federal Register final rules to implement the new anti-manipulative and deceptive practices authority. Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 FR 41398, Jul. 14, 2011 ("Prohibition on Manipulative and Deceptive Devices") (to be codified at 17 CFR Part 180).

[238] The Commission also proposed §§ 23.410(b) and 23.410(c), which prohibited swap dealers and major swap participants from disclosing confidential counterparty information and trading ahead and front running counterparty orders, respectively. See proposing release, 75 FR at 80642.

by swap dealers and major swap participants.[239] While the heading of Section 4s(h)(4) reads "Special Requirements for Swap Dealers Acting as Advisors," the plain language of the statutory text within that section includes both more general and more specific restrictions. The fraudulent, deceptive and manipulative practices provision in Section 4s(h)(4)(A), by its own terms, is not limited to the advisory context or to swap dealers.[240]

Proposed § 23.410(a) followed the statutory text and applied to swap dealers and major swap participants acting in any capacity, e.g., as an advisor or counterparty.[241] The first two paragraphs of the proposed rule focused on Special Entities and prohibited 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 of the proposed rule was not limited to conduct with Special Entities and prohibited swap dealers and major swap participants from engaging in any act, practice or course of business that is fraudulent, deceptive or manipulative.[242]

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[239] In addition to the proposed antifraud rule, swap dealers and major swap participants are 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) and (3), and 9(a)(2) of the CEA (7 U.S.C. 6b, 9(c)(1) and (3), and 13(a)(2)), and §§ 180.1 and 180.2 (17 CFR 180.1 and 180.2)).

[240] Section 4s(h)(4)(A) states:

(A) IN GENERAL.—It shall be unlawful for a swap dealer or major swap participant—

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

(ii) 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

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

[241] Proposing release, 75 FR at 80642.

[242] This language mirrored 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 [Securities Act] 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 . . . .") (internal citations omitted).

b. Comments

The Commission received a number of comments both supporting and opposing aspects of proposed § 23.410(a). One commenter urged that the fraud prohibition in Section 4s(h)(4) should apply only when a swap dealer is acting as an advisor to a Special Entity.[243] The commenter asserted that, while the prohibitions of Section 4s(h)(4)(A) do not themselves contain language limiting them to instances where a swap dealer is an advisor, the title "Special Requirements for Swap Dealers Acting as Advisors" should be read as limiting the scope of any rules promulgated thereunder.[244] The commenter further asserted that the lack of scienter in proposed § 23.410(a)(3) is particularly misplaced as the language of Section 4s(h)(4)(A)(iii) mirrors Section 206(4) of the Investment Advisers Act of 1940 ("Advisers Act"),[245] which is in the context of an advisor relationship, and that in cases where there is not an advisor relationship, the scienter standards of Rule 10b-5[246] under the Exchange Act should prevail.[247] This commenter stated that the Commission should adopt a scienter requirement when a swap dealer or major swap participant acts merely as a counterparty to a non-Special Entity and does not act as an advisor as it would be unfair to subject swap dealers or major swap participants, not acting as advisors, to liability without a showing of bad faith.[248] The Commission also received comments urging that proposed § 23.410(a) not be adopted as it is redundant of the rules promulgated in part 180.[249]

Other commenters supported proposed § 23.410(a). One commenter asserted that the rule

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[243] SIFMA/ISDA Feb. 17 Letter, at 10.
[244] Id.
[245] 15 U.S.C. 80b-6.
[246] 17 CFR 240.10b-5.
[247] SIFMA/ISDA Feb. 17 Letter, at 10.
[248] Id.
[249] See CEF Feb. 22 Letter, at 12; Barnard May 23 Letter, at 2.

prohibiting fraud and manipulation by swap dealers and major swap participants is appropriate as long as these principles are properly applied to swap markets.[250] Another commenter supported the proposed rule because it believed the rule was largely consistent with the recommendations contained in the July 2009 report of the Investors' Working Group,[251] and another commenter believed it would strengthen the protection of market participants, encourage investor confidence and promote integrity within the financial system.[252] One commenter asserted that the title "Special Requirements for Swap Dealers Acting as Advisors" should not limit the scope of the rule where the statutory language is broad, applying to "any device, scheme or artifice to defraud," and that Congress intended to apply these principles to the broad range of conduct engaged in by swap dealers and major swap participants with regard to counterparties generally and Special Entities in particular.[253] This commenter believed that, under the proposed rule, it should be considered an abusive practice to recommend a swap or trading strategy that achieves the counterparty's aim in a way that includes risks to the counterparty greater than those it seeks to hedge and to recommend customized swaps where the counterparty could achieve the same result at a lower cost through standardized swaps.[254]

c. Final § 23.410(a) and (b)

After considering the comments, the Commission decided to adopt § 23.410(a) as proposed. Inclusion of the rule in subpart H of part 23 of the Commission's Regulations provides swap dealers, major swap participants and counterparties with easy reference to the business conduct

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[250] Exelon Feb. 22 Letter, at 4.
[251] CII Feb. 10 Letter, at 1 (citing A Report by the Investors' Working Group, An Independent Taskforce Sponsored by CFA Institute Centre for Financial Market Integrity and Council of Institutional Investors, U.S. Financial Regulatory Reform: The Investors' Perspective (July 2009)).
[252] CFA/AFR Feb. 22 Letter, at 1.
[253] Id., at 6-7.
[254] Id.

requirements under Section 4s(h) of the CEA without any additional cost to market participants.

With respect to the concern regarding the rule's protections for counterparties other than Special Entities, § 23.410(a) mirrors the language of the statute. In addition, the prohibition against engaging in "any act, practice, or course of business that is fraudulent, deceptive, or manipulative" has been interpreted by the courts as imposing a non-scienter standard under the Advisers Act.[255] Even if the Commission were to limit the rule to require proof of scienter and apply the rule only when a swap dealer is acting as an advisor to a Special Entity, that would not restrict a court from taking a plain meaning approach to the language in Section 4s(h)(4) in a private action under Section 22 of the CEA.[256] In addition, because comparable non-scienter fraudulent and manipulative practices provisions will apply to SBS Entities in enforcement actions under Sections 9(j) [257] and 15F(h)(4)[258] of the Exchange Act and Sections 17(a)(2) and (3) of the Securities Act, it would be inconsistent to impose a different intent standard for swap dealers and major swap participants.[259]

Finally, in response to commenters who urged that it would be unfair to subject swap dealers or major swap participants to the non-scienter provision of the rule, the Commission decided to provide an affirmative defense in final § 23.410(b) for swap dealers and major swap participants in cases alleging non-scienter violations of § 23.410(a)(2) and (3) based solely on violations of

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[255] See discussion at fn. 242.
[256] 7 U.S.C. 25.
[257] Section 763(g) of the Dodd-Frank Act amended the Exchange Act by adding Section 9(j), which states in relevant part that "It shall be unlawful for any person . . . to effect any transaction in . . . any security-based swap, in connection with which such person . . . engages in any transaction, practice, or course of business which operates as a fraud or deceit upon any person." Courts have interpreted "operates as a fraud" provisions under a non-scienter standard. On November 8, 2010, the SEC published proposed rule 17 CFR 240.9j-1 in the Federal Register to clarify that the provisions of Section 9(j) apply to fraud in connection with (1) entering into a security-based swap and (2) the exercise of any right or performance of any obligation under a security-based swap. Prohibition Against Fraud, Manipulation, and Deception in Connection With Security-Based Swaps, 75 FR 68560, Nov. 8, 2010.
[258] This provision mirrors Section 4s(h)(4) of the CEA.
[259] One commenter stated that that the CFTC and SEC should harmonize their regulatory structures for combating disruptive and manipulative activities. SIFMA/ISDA Feb. 17 Letter, at 10.

the business conduct standards rules in subpart H. The affirmative defense enables swap dealers and major swap participants to defend against such claims by establishing that they complied in good faith with written policies and procedures reasonably designed to meet the requirements of the particular rule that is the basis for the alleged § 23.410(a)(2) or (3) violation. Whether the affirmative defense is established will depend on the facts and circumstances of the case. However, by way of non-exclusive example, a swap dealer or major swap participant would be unable to establish that it acted in good faith if the evidence showed that it acted intentionally or recklessly in connection with the violation. Similarly, policies and procedures that were outdated or failed to address the scope of swap business conducted by the swap dealer or major swap participant would not be considered reasonable.

With respect to whether any particular type of conduct would be abusive within the prohibitions under final § 23.410(a) as urged by commenters, the Commission will evaluate the facts and circumstances of any particular case in light of the elements of an offense under the final rule. This is consistent with the approach that the Commission took in adopting § 180.1.[260]

2. Section 23.410(c)–Confidential Treatment of Counterparty Information

a. Proposed § 23.410(b)

The Commission proposed § 23.410(b) (renumbered as final § 23.410(c)), which prohibited swap dealers and major swap participants from disclosing confidential counterparty information,[261] using its discretionary rulemaking authority under Section 4s(h)(1)(A).[262] The

[260] In the release promulgating Commission Regulation § 180.1, the Commission stated: "In response to commenters requesting that front running and similar misuse of customer information be considered a form of fraud-based manipulation under final Rule 180.1, the Commission declines to adopt any per se rule in this regard, but clarifies that final Rule 180.1 reaches all manner of fraud and manipulation within the scope of the statute it implements, CEA section 6(c)(1)." Prohibition on Manipulative and Deceptive Devices, 76 FR at 41401.

[261] Proposing release, 75 FR at 80642.

[262] 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

proposed rule extended existing Commission standards that protect the confidentiality of customer orders.

b. Comments

The Commission received comments regarding the proposed prohibition against disclosing confidential counterparty information. One commenter stated that the confidentiality of counterparty information should be left to private negotiation rather than imposed by Commission rule.[263] The commenter urged that if the Commission determines to promulgate a rule protecting the confidentiality of such information, the Commission should alternatively require swap dealers and major swap participants to establish, maintain and enforce policies and procedures reasonably designed to prevent the improper use or disclosure of any counterparty information that the swap dealer or major swap participant has agreed with the counterparty to keep confidential.[264] The commenter also stated that the confidentiality rule should be implemented as an SRO rule and should allow sophisticated counterparties to opt out of heightened protections they may not want or need.[265] The commenter expressed concern that the proposed rule would restrict swap dealers and major swap participants in properly servicing counterparties through discussions with the swap dealer's or major swap participant's affiliates.[266] Further, the commenter asserted that there would be facts and circumstances that

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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. July 15, 2010) (statement of Sen. Lincoln). In consultations with stakeholders, Commission staff learned that these concerns are shared by counterparties more generally. As a result, the Commission proposed 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. See proposing release, 75 FR at 80658.

[263] SIFMA/ISDA Feb. 17 Letter, at 11.

[264] Id.

[265] Id.

[266] Id., at 10-11.

would warrant particular disclosures in certain contexts.[267]

Another commenter asserted that the confidential treatment and trading ahead rules should not apply to major swap participants because they are customers of swap dealers and should be treated as such, rather than as dealers or quasi-dealers.[268] Another commenter stated that the Commission should avoid specifying in detail the conduct that would violate the rule because doing so could have unintended consequences of limiting its scope. This commenter stated that a broad, enforceable principles based approach is the best approach for promoting market integrity.[269]

c. Final § 23.410(c)

Upon consideration, the Commission has determined to adopt proposed § 23.410(b) (renumbered as § 23.410(c)) with several changes. First, the final rule has been changed to also permit swap dealers and major swap participants[270] to disclose confidential information to an SRO designated by the Commission or as required by law. The proposed rule addressed disclosure only to the CFTC, Department of Justice ("DOJ") and applicable prudential regulators. Second, the Commission has clarified that the final rule will protect confidential counterparty information from disclosure to third parties, as well as from improper use by the swap dealer or major swap participant. It is not intended to restrict the necessary and appropriate use of the information by the swap dealer or major swap participant, but is intended to address material conflicts of interest that must be identified and managed to avoid trading or other activities on the basis of confidential counterparty information that would tend to be materially

[267] Id., at 11.
[268] MetLife Feb. 22 Letter, at 4-5.
[269] CFA/AFR Feb. 22 Letter, at 12.
[270] The Commission has determined to impose the final rule on both swap dealers and major swap participants, which is consistent with the application of Section 4s(h)(4)(A), prohibiting manipulative, deceptive and fraudulent practices, to both swap dealers and major swap participants.

adverse to the interests of the counterparty.[271] By promulgating final § 23.410(c), the Commission does not intend to prohibit legitimate trading activities, which, depending on the facts and circumstances, would include, among other things, (1) bona fide risk-mitigating and hedging activities in connection with the swap, (2) purchases or sales of the same or similar types of swaps consistent with commitments of the swap dealer or major swap participant to provide liquidity for the swap, or (3) bona-fide market-making in the swap.[272]

The final rule requires swap dealers and major swap participants to have written policies and procedures reasonably designed to protect material confidential information provided by or on behalf of a counterparty from disclosure and use by any person acting for or on behalf of the swap dealer or major swap participant. Such policies and procedures should be designed to identify and manage material conflicts of interest between a swap dealer or major swap participant and a counterparty through, for example, information barriers and restrictions on access to confidential counterparty information on a "need-to-know" basis.[273] Information barriers can be used to restrict the dissemination of information within a complex organization and to prevent material conflicts by limiting knowledge and coordination of specific business activities among different units of the entity. Examples of information barriers include restrictions on information sharing, limits on types of trading and greater separation between various functions of the firm. Such information barriers have been recognized in the federal

[271] The final rule is aimed at improper disclosure of the counterparty's position, the transaction and the counterparty's intentions to enter or exit the market, which may be detrimental to the interests of the counterparty.
[272] The Commission notes by analogy that Section 621 of the Dodd-Frank Act, to be codified at Section 27B of the Securities Act (15 U.S.C. 77z-2a), provides for exceptions to the conflict of interest prohibitions in that section for risk-mitigating hedging activities in connection with an asset-backed security, purchases or sales made consistent with commitments to the underwriter or others to provide liquidity for the asset-backed security, or bona-fide market making in the asset-backed security. The Commission's final § 23.410(c) provides for exceptions for disclosure and use for effective execution of the order, risk mitigation and hedging, and when authorized in writing by the counterparty.
[273] For example, the Commission expects that the swap dealer would generally have information barriers between its sales desk and proprietary trading desk.

securities laws and rules as a means to address or mitigate potential conflicts of interest or other inappropriate activities within an organization.

Depending on the facts and circumstances, the Commission would consider it to be an abuse of confidential counterparty information for a swap dealer or major swap participant to disclose or use such information for its own benefit if such use or disclosure would tend to be materially adverse to the interests of the counterparty.[274] Final § 23.410(c) does not prohibit disclosure or use that is necessary for the effective execution of any swap for or with the counterparty, to hedge or mitigate any exposure created by such swap or to comply with a request of the Commission, DOJ, any SRO designated by the Commission, or applicable prudential regulator, or is otherwise required by law.

In response to the commenter that expressed concern that the proposed rule would restrict swap dealers and major swap participants in properly servicing counterparties through discussions with the swap dealer's or major swap participant's affiliates,[275] it is not the intent of the rule to prohibit certain interactions needed to execute the swap but is to ensure that the counterparty's confidential information is disseminated only on a "need to know" basis. Further, in response to a commenter that stated that there may be facts or circumstances that would

[274] The financial industry has long-held standards relating to confidential treatment of counterparty information similar to those set forth in the final rule. While not endorsing any particular industry practice, the Commission notes, for example, that one industry group has recommended that financial institutions "have internal written policies and procedures in place governing the use of and access to proprietary information provided to them by trading counterparties as a basis for credit evaluations." Improving Counterparty Risk Management Practices, Counterparty Risk Management Policy Group (June 1999) ("CRMPG I Report"), at 5; see also Toward a Greater Financial Stability: A Private Sector Perspective, Counterparty Risk Management Policy Group (July 2005) ("CRMPG II Report"), at 47 (recommending that firms evaluate operational risks with customized legal documents that deviate from a firm's existing procedures for handing confidential counterparty information). Also without endorsement by the Commission, one firm's code of conduct states that employees "must maintain the confidentiality of the information with which you are entrusted, including complying with information barriers procedures applicable to your business. The only exception is when disclosure is authorized or legally mandated. . . . Confidential or proprietary information . . . provided by a third party [is provided with] the expectation that the information will be kept confidential and used solely for the business purpose for which it was conveyed." Goldman Sachs Code of Business Conduct and Ethics (amended, effective January 11, 2011).

[275] See SIFMA/ISDA Feb. 17 Letter, at 10-11.

warrant particular disclosures or uses in certain contexts,[276] the Commission included a provision in the rule that allows for use or disclosure of confidential counterparty information if authorized in writing by the counterparty.

The Commission decided it is appropriate to establish an explicit confidential treatment duty for swap dealers and major swap participants with respect to confidential counterparty information. Because swap dealers and major swap participants principally act as counterparties rather than as agents or brokers (unlike FCMs), in the absence of such an explicit duty, it could be more difficult to establish that disclosure or misuse of confidential counterparty information is fraudulent, deceptive or manipulative. Depending on the facts and circumstances, however, as set forth in final § 23.410(b), good faith compliance with reasonably designed policies and procedures will constitute an affirmative defense to a non-scienter violation of final § 23.410(a)(2) or (3) for improper disclosure or abuse of counterparty information.

The Commission considered the commenter's suggestion that confidential treatment of counterparty information should be left to negotiation between counterparties or, alternatively, be implemented as an SRO rule or on an opt in or opt out basis.[277] The Commission determined that such alternatives would be inconsistent with Congress' intent that the Commission promulgate rules that raise business conduct standards for the protection of all counterparties.[278] The final rule is in accordance with current industry practices where confidential treatment is routinely part of negotiations among the parties that is then incorporated into the counterparty

[276] See id., at 11.
[277] See SIFMA/ISDA Feb. 17 Letter, at 11.
[278] See Section III.A.1. of this adopting release for a discussion of "Discretionary Rules" and "Opt in or Opt out for Certain Classes of Counterparties."

relationship documentation.[279]

Adopting a confidential treatment rule will ensure that all counterparties, irrespective of their negotiating power, will be able to protect their confidential information from disclosure and abuse by swap dealers and major swap participants. Counterparties will continue to be free to negotiate additional protections based on their individual needs. By establishing such a duty, the Commission is not changing the "counterparty" nature of the relationship between a swap dealer or major swap participant and a counterparty. Nor is the Commission imposing a general fiduciary duty on swap dealers or major swap participants. Violation of the confidential treatment duty, however, depending on the facts and circumstances, could constitute a fraudulent, deceptive or manipulative practice.

3. Proposed § 23.410(c)–Trading Ahead and Front Running Prohibited–Not Adopted as Final Rule

a. Proposed § 23.410(c)

The Commission proposed § 23.410(c), which prohibited swap dealers and major swap participants from front running or trading ahead of counterparty swap transactions.[280] The proposed rule was based on trading standards applicable to FCMs and introducing brokers that prohibit trading ahead of customer orders.[281]

b. Comments

One commenter urged that the Commission not adopt the trading ahead and front running rule or, in the alternative, apply the rule only when the swap dealer or major swap participant has

[279] See SIFMA/ISDA Feb. 17 Letter, at 11 (stating that the definition, treatment, use and disclosure of confidential information are routinely the subject of negotiation between the parties).
[280] Proposing release, 75 FR at 80642.
[281] See, e.g., 17 CFR 155.3-4.

an executable order and not when a swap is still under negotiation.[282] The commenter asserted that the prohibition on trading during the negotiation of a swap fails to appreciate the distinction between bilateral swaps and orders for standardized products, as bilateral swap terms must be negotiated, which can take weeks or months, and counterparties may negotiate with multiple dealers to obtain the best price.[283] The commenter further asserted that enforcement of a front running ban would be untenable, disruptive to the market and prevent hedging activity related either to the pending transaction or the other liabilities of the swap dealer or major swap participant.[284] The commenter urged that, if the Commission were to adopt the proposed rule, then it should prohibit only a transaction (1) that is entered into for a non-hedging purpose on the basis of actual knowledge of a non-public, executable order of a counterparty, (2) that exhibits consistent and estimable positive price correlation to the pending executable counterparty swap transaction, and (3) whose execution is substantially likely to materially affect the price of that pending executable swap transaction.[285] The commenter asserted that, without an actual knowledge standard, the proposed rule would prohibit transactions by other parts of an organization not privy to the order.[286] Finally, the commenter urged the Commission to clarify its proposed "specific" consent standard and the duration of the prohibition.[287]

In addition, the commenter urged the Commission to clarify that the following trades would not be considered front running under proposed § 23.410(c): (1) When a swap dealer or major swap participant enters a trade at the request of another customer; (2) when the specifics of a pending counterparty transaction are as yet undefined; (3) when a swap dealer or major swap

[282] SIFMA/ISDA Feb. 17 Letter, at 13.
[283] Id., at 12.
[284] Id.
[285] Id., at 13.
[286] Id.
[287] Id.

participant trades in the ordinary course of hedging other transactions, assets or liabilities; (4) when there is not a clear price-related nexus to the pending swap transaction; (5) if the transaction would not affect the counterparty; and (6) if the transaction is an anticipatory hedge of the subject transaction and disclosed to the counterparty.[288] The commenter also urged that the prohibition should only exist until the transaction is executed or cancelled, or the relevant information ceases to be material, non-public information, and the proposed rule should not require further specific consent to trade with respect to specific transactions at specific times.[289]

Another commenter stated that it did not object to applying the front running prohibition to trades executable on a DCM and for which a swap dealer or major swap participant is merely an intermediary.[290] However, the commenter believed proprietary trading desks should be able to trade freely as long as they are unaware of the counterparty's order.[291] Without such a limitation, the commenter asserted, swap dealers may have little incentive to accept swap orders that can be executed electronically or may refuse to accept orders for such transactions altogether.[292]

Further, the commenter urged that the proposed front running prohibition should not apply to bilaterally negotiated and settled swaps. Since some swaps take months to negotiate, the commenter believed front running rules would severely limit a swap dealer's ability to be in the market.[293] The commenter stated that front running should be defined in a manner more appropriate for the swaps markets as the present definition could be interpreted to force a swap dealer to stop, or severely limit, physical trading related to the swap.[294] The commenter urged the

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[288] Id., at 13-14.
[289] Id.
[290] CEF Feb. 22 Letter, at 10-11.
[291] Id.
[292] Id., at 11.
[293] Id.
[294] Id.

Commission to eliminate the front running rules or to exclude swap markets with actual physical underlying commodities from such rules.[295]

Another commenter stated that the proposed rule is tailored to a securities broker-dealer model and is not suited to the commodities market.[296] The commenter asserted that instruments relating to derivatives of an underlying physical market are not susceptible to insider trading or broker-dealer abuses, and that the disclosures required in proposed § 23.410(c) would chill the open interaction that occurs between counterparties in a competitive swaps market.[297]

Another commenter stated that prohibiting front running would have unintended consequences that would, along with other proposed rules, increase the administrative and compliance burden on swap dealers.[298] The combined effect of the proposed rules, the commenter asserted, would slow the process of swap trading and increase costs by requiring additional time, effort, and risks taken in trading swaps.[299]

One commenter that generally supported the proposed rule recommended imposing a time limit on the trading ahead prohibition for swaps under negotiation and believed swap dealers should be required to disclose the time limit to counterparties.[300] Alternatively, the commenter urged that swap dealers should have reasonable grounds for believing the counterparty does not intend to enter into the transaction in the near future.[301]

Another commenter that supported the proposed rule urged that the entire front running section be removed because it is duplicative of the rules promulgated by the Commission under

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[295] Id.
[296] Exelon Feb. 22 Letter, at 3.
[297] Id.
[298] HOOPP Feb. 22 Letter, at 2.
[299] Id.
[300] CFA/AFR Feb. 22 Letter, at 7.
[301] Id.

Section 6(c)(1) of the CEA (the new general fraudulent, deceptive and manipulative practices provision).[302]

c. Commission Determination

The Commission has considered the comments and has determined not to promulgate proposed § 23.410(c). The fraudulent, deceptive and manipulative practices rule in final § 23.410(a), coupled with the confidential treatment rule in final § 23.410(c), should effectively protect counterparties from abuse of their material confidential information by swap dealers and major swap participants.[303] The Commission agrees with the commenter that stated that, depending on the facts and circumstances, improperly trading ahead or front running counterparty orders would constitute fraudulent, deceptive or manipulative conduct under final § 23.410(a) and § 180.1, among other fraudulent, deceptive and manipulative practices protections under the CEA and Commission Regulations.

In response to commenters seeking clarity as to the types of transactions that would constitute illegal trading ahead or front running by a swap dealer or major swap participant, the Commission declines to adopt the request of certain commenters to list the trades or specific situations that would not be considered illegal trading ahead or front running in violation of the anti-fraud and confidential treatment rules in final § 23.410(a) and final § 23.410(c), respectively. The Commission expects swap dealers and major swap participants to implement policies and procedures, including establishing appropriate information barriers and other means to protect material confidential counterparty information, that would allow the swap dealer or major swap participant to continue to provide liquidity in the swap or engage in bona-fide

[302] CEF Feb 22 Letter, at 12; see also Prohibition on Manipulative and Deceptive Devices, 76 FR 41398.
[303] The Commission's other deceptive and manipulative practices provisions, including Sections 4b and 6(c)(1) of the CEA and § 180.1 of the Commission's Regulations also prohibit trading ahead and front running.

market-making in the swap. The Commission states, however, that use of confidential counterparty information to trade ahead of or front run a counterparty's order would tend to be materially adverse to the interests of the counterparty, depending on the facts and circumstances, and would be considered an abuse of final §§ 23.410(a) and (c), among other similar protections under the CEA and Commission Regulations.

The Commission's decision not to adopt proposed § 23.410(c) was informed by commenters who stated that the proposed rule would have unintended consequences of severely hampering the ability of swap dealers and major swap participants to conduct swaps business and would have the potential to impose additional costs on swap transactions. While abuse of counterparty information, including trading ahead, will still be prohibited under the manipulative, deceptive and fraudulent practices rule in final § 23.410(a) and the confidential treatment rule in final § 23.410(c), among other provisions, the approach adopted by the Commission should eliminate the uncertainties identified by commenters in the proposed trading ahead and front running rule, and allow legitimate trading by swap dealers and major swap participants. The Commission, however, will continue to monitor market conduct to determine whether, in the future, there is a need to address explicitly abuses related to trading ahead and front running of counterparty swap transactions.

C. Section 23.430–Verification of Counterparty Eligibility

1. Proposed § 23.430

The Dodd-Frank Act makes it unlawful for any person, other than an ECP,[304] to enter into a swap unless it is executed on or subject to the rules of a DCM.[305] Section 4s(h)(3)(A) also requires the Commission to establish a duty for swap dealers and major swap participants to

[304] "Eligible contract participant" is a defined term in Section 1a(18) of the CEA. (7 U.S.C. 1a(18)).
[305] See Section 2(e) of the CEA. (7 U.S.C. 2(e)).

verify that any counterparty meets the eligibility standards for an ECP. Proposed § 23.430 required swap dealers and major swap participants to verify that a counterparty meets the definition of an ECP prior to offering to enter into or entering into a swap and to determine whether the counterparty is a Special Entity as defined in Section 4s(h)(2)(C) and proposed § 23.401.[306]

The Commission contemplated 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. In addition, under proposed § 23.402(g), such written representations could be expressed in a master agreement or other written agreement and, if agreed to by the parties, could be deemed to be renewed with each subsequent swap transaction, absent any facts or circumstances to the contrary. 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.[307]

2. Comments

The Commission received several comments regarding proposed § 23.430.[308] Two commenters recommended that swap dealers and major swap participants be able to rely principally on counterparty representations regarding eligibility.[309] It was asserted that only actual notice of countervailing facts or facts that reasonably put the swap dealer or major swap

[306] Proposing release, 75 FR at 80643.
[307] This provision was informed by the statutory language in Sections 2(e) and 4s(h)(7).
[308] See SIFMA/ISDA Feb. 17 Letter, at 15-16; CFA/AFR Feb. 22 Letter, at 8; CEF Feb. 22 Letter, at 12, 19 and 20; FHLBanks Feb. 22 Letter, at 4-5; APGA Feb. 22 Letter, at 2-3.
[309] See SIFMA/ISDA Feb. 17 Letter, at 16 (recommending no affirmative duty to investigate representations or obtain detailed factual representations). Accord CEF Feb. 22 Letter, at 12, 19 and 20.

participant on notice should trigger a duty to inquire further, consistent with industry practice.[310] One commenter supported sufficiently detailed representations to facilitate eligibility determinations and regulatory compliance audits.[311] Other commenters requested that the proposed rule be amended to specifically allow counterparties to make eligibility representations in master agreements.[312] A different commenter recommended that the Commission sponsor and promote standardized due diligence documentation to facilitate compliance, reduce costs and promote legal certainty.[313] Certain commenters questioned whether the verification duty was an ongoing duty throughout the life of the swap.[314] Two commenters suggested amending the rule to require an update whenever there is a change impacting a counterparty's eligibility or status.[315] A commenter recommended additional guidance regarding red flags and the nature and timing of evidence necessary to establish ECP status.[316] Lastly, a commenter supported the proposed exemption from the verification duty for SEF and DCM transactions.[317]

3. Final § 23.430

After considering the comments, the Commission has determined to adopt the rule with three changes. First, the Commission is adding a new § 23.430(c), Special Entity election, which will require a swap dealer or major swap participant to determine whether a counterparty is eligible to elect to be a Special Entity and notify such counterparty as provided for in the Special Entity

[310] SIFMA/ISDA Feb. 17 Letter, at 16 fn. 35 (citing Regulation D (17 CFR 230.501-508) and Rule 144A (17 CFR 230.144A) transactional practice under the federal securities laws).
[311] CFA/AFR Feb. 22 Letter, at 8.
[312] See, e.g., NFA Aug. 25, 2010 Letter, at 2; SIFMA/ISDA Feb. 17 Letter, at 16; APGA Feb. 22 Letter, at 2-3.
[313] FHLBanks Feb. 22 Letter, at 4.
[314] SIFMA/ISDA Feb. 17 Letter, at 16. In addition, the commenter questioned whether the loss of ECP status would limit the counterparty's ability to terminate, modify or novate the swap.
[315] CFA/AFR Feb. 22 Letter, at 8; SIFMA/ISDA Feb. 17 Letter, at 16 (asserting that swap dealers and major swap participants should be able to rely on eligibility representations deemed to be made at the inception of each swap transaction and covenant to notify if ECP status ceases).
[316] CFA/AFR Feb. 22 Letter, at 8.
[317] CEF Feb. 22 Letter, at 12.

definition in final § 23.401(c)(6).[318] Second, the Commission has added a new safe harbor, § 23.430(d), to clarify that a swap dealer or major swap participant may rely on written representations of counterparties to meet the requirements in the rule. Third, the Commission is clarifying that the exemption from verification applies to all transactions on a DCM and to anonymous transactions on a SEF.

In addition, the Commission is providing the following guidance in response to the comments it received. A swap dealer or major swap participant must determine ECP and Special Entity status before offering to enter into or entering into a swap.[319] Counterparties will be able to make representations about their status at the outset of a transaction or in counterparty relationship documentation and update that representation if there is a change in status.[320] Parties will not be required to terminate a swap based solely on a change in the counterparty's ECP status during the term of the swap.

In addition, swap dealers and major swap participants may rely on the written representations of counterparties in the absence of red flags. With respect to the level of detail required in the representation, a swap dealer or major swap participant will be deemed to have a "reasonable basis" to rely on a representation that a counterparty is eligible under the rule if the counterparty identifies the paragraph of the ECP definition plus, in the case of a Special Entity, the paragraph of the Special Entity definition that applies to it, and the swap dealer or major swap participant does not have a reason to believe the representation is inaccurate. In the absence of counterparty

[318] This addition is related to the Commission's determinations regarding the final Special Entity definition relating to certain Special Entities defined in Section 3 of ERISA. See Section IV.A. of this adopting release.

[319] OTC derivatives industry best practice advises professional intermediaries, prior to entering into any transaction, to evaluate the counterparty's legal capacity, transactional authority and credit. See DPG Framework, at Section V.III.B.

[320] The Commission expects swap dealers and major swap participants to have policies and procedures in place that require the review of counterparty relationship documentation to ensure that representations and disclosures under subpart H of part 23 remain accurate. Such review should be part of its annual compliance review in accordance with subpart J of part 23. See proposed §§ 23.600 and 23.602, Governing Duties of Swap Dealers, 75 FR 71397.

representations, the swap dealer or major swap participant will have to engage in sufficient due diligence to have a reasonable basis to believe that the counterparty meets the eligibility standards for an ECP and whether it is a Special Entity.

Further, the Commission is not adopting standardized due diligence documentation at this time. The rule is principles based and allows the parties flexibility in developing efficient means to address the requirements of the rule. By providing non-exclusive guidance as to the types of representations that will meet the "reasonable basis" standard, the Commission believes that the parties will be able to comply with the rule without incurring undue cost. Lastly, the Commission is confirming that, with respect to transactions initiated on a SEF, the verification exemption is only applicable to anonymous transactions consistent with Section 4s(h)(7). The proposed exemption from the verification duty did not mention DCM transactions, unlike Section 4s(h)(7) of the CEA, because Section 2(e) of the CEA does not limit participation in DCM swap transactions to ECPs. However, for the sake of clarity, the Commission has added language to final § 23.430 that confirms that swap dealers and major swap participants do not have to verify ECP status for DCM transactions, whether anonymous or otherwise.

D. Section 23.431–Disclosure of Material Risks, Characteristics, Material Incentives and Conflicts of Interest Regarding a Swap

Proposed § 23.431 is a multipart rule that tracks Section 4s(h)(3)(B) of the CEA. Based on the structure of and comments relating to proposed § 23.431, the following discussion is divided into six sections: Proposed § 23.431–generally; material risk disclosure; scenario analysis; material characteristics; material incentives and conflicts of interest; and daily mark. Each of the six sections includes a summary of the proposed subsections of § 23.431, public comments, and a description of the final rule and Commission guidance.

1. Proposed § 23.431–Generally

Section 4s(h)(3)(B) of the CEA requires swap dealers and major swap participants to disclose to their counterparties material information about the risks, characteristics, incentives and conflicts of interest regarding the swap. The requirements do not apply if both counterparties are any of the following: Swap dealer; major swap participant; or SBS Entities. Proposed § 23.431 implemented the statutory disclosure requirements and provided specificity with respect to certain types of material information that must be disclosed under the rule. The Commission stated that information is material if there is a substantial likelihood that a reasonable counterparty would consider it important in making a swap-related decision.[321] The Dodd-Frank Act does not address the timing and form of the required disclosures. To satisfy its disclosure obligation, swap dealers and major swap participants would be required to make such disclosures at a time prior to entering into the swap and in a manner that was reasonably sufficient to allow the counterparty to assess the disclosures.[322] Swap dealers and major swap participants would have flexibility to make these disclosures using reliable means agreed to by the counterparties, as provided in proposed § 23.402(f).[323] The proposed rules allowed standardized disclosure of some required information, where appropriate, if the information is applicable to multiple swaps of a particular type or class.[324] The Commission noted, however, that most bespoke transactions

[321] Proposing release, 75 FR at 80643; 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)).
[322] Proposing release, 75 FR at 80643.
[323] Additionally, under proposed § 23.402(h), swap dealers and major swap participants were required to maintain a record of their compliance with the proposed rules.
[324] Cf. SIFMA/ISDA Oct. 22, 2010 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).

would require some combination of standardized and particularized disclosures.[325]

2. Comments–Generally

Commenters had a variety of general concerns with the disclosure rules including: (1) The proposed rules should be tailored to the institutional swaps market, not retail futures or securities markets;[326] (2) the proposed rules should not apply when a counterparty is a certain size and level of sophistication;[327] (3) counterparties should be able to opt in to or opt out of the proposed rules;[328] (4) the proposed rules alter the relationship between counterparties and swap dealers or major swap participants;[329] (5) the Commission should coordinate with the SEC and DOL to ensure that the proposed rules do not trigger ERISA fiduciary status or municipal advisor status;[330] (6) only mandatory statutory rules should be promulgated at this time and discretionary rules (e.g., scenario analysis) should be delayed;[331] (7) the statute does not require the same rules for both swap dealers and major swap participants; different, less burdensome rules consistent with the statute should be drawn for major swap participants;[332] (8) uncertainty regarding compliance with principles based disclosure rules;[333] and (9) the costs outweigh the benefits of

[325] Proposing release, 75 FR at 80643.
[326] See SIFMA/ISDA Feb. 17 Letter, at 3-4 and 18; COPE Feb. 22 Letter, at 3-5; VRS Feb. 22 Letter, at 3-4; Exelon Feb. 22 Letter, at 2-4; CEF Feb. 22 Letter, at 2-4; NY City Bar Feb. 22 Letter, at 2.
[327] See VRS Feb. 22 Letter, at 1 and 4; NACUBO Feb. 22 Letter, at 3-4; HOOPP Feb. 22 Letter, at 3; CEF Feb. 22 Letter, at 4-5.
[328] See VRS Feb. 22 Letter, at 4; NACUBO Feb. 22 Letter, at 3-4; ABC/CIEBA Feb. 22 Letter, at 13.
[329] See BlackRock Feb. 22 Letter, at 2; CEF Feb. 22 Letter, at 3-4 and 8.
[330] See Rep. Bachus Mar 15 Letter, at 1-3; SIFMA/ISDA Feb. 17 Letter, at 9; BlackRock Feb. 22 Letter, at 2 and 6; ABC/CIEBA Feb. 22 Letter, at 2-3; ERIC Feb. 22 Letter, at 2-3; AFSCME Feb. 22 Letter, at 4-5; AMG-SIFMA Feb. 22 Letter, at 8-9.
[331] See BlackRock Feb. 22 Letter, at 2; SIFMA/ISDA Feb. 17 Letter, at 3; CEF Feb. 22 Letter, at 8.
[332] See MFA Feb. 22 Letter, at 1-3; BlackRock Feb. 22 Letter, at 2; MetLife Feb. 22 Letter, at 1 and 4-5; CEF Feb. 22 Letter, at 5-6.
[333] See, e.g., FHLBanks Feb. 22 Letter, at 3-4; FHLBanks June 3 Letter, at 8-9; NY City Bar Feb. 22 Letter, at 2; SIFMA/ISDA Feb. 17 Letter, at 4 and 16-18. Contra CFA/AFR Feb. 22 Letter, at 18.

the proposed rule.[334]

3. Final § 23.431–Generally

Regarding the comment that the proposed rule should be tailored to the institutional swaps market, not retail futures or securities market, as indicated in the proposing release, the disclosure rules follow the statute and are informed by industry practices and best practice recommendations. The Commission reviewed OTC derivatives industry reports, as well as futures and securities regulations and related SRO business conduct rules, prior to drafting the rule.[335] In particular, reports by the Derivatives Policy Group ("DPG") and Counterparty Risk Management Policy Group ("CRMPG") included industry best practice recommendations regarding product disclosures.[336] These OTC derivatives industry reports confirmed that the industry is familiar with product disclosure. In addition, a commenter reported that:

> Swap dealers also generally distribute to their end-user counterparties at the outset of a new swap relationship standardized documentation setting forth the material characteristics, risks and conflicts of interest with respect to the swaps to be entered into with such end-user counterparty under an ISDA Master Agreement or other master documentation.[337]

Moreover, the plain language of Section 4s(h)(3)(B) requires disclosure of the material risks, characteristics, incentives and conflicts of interest relating to the swap. Based on the statutory language, industry practice and industry best practice recommendations, the Commission believes that the final rule is tailored appropriately to the swaps market.

With respect to whether the disclosure duties should apply when a counterparty is a certain

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[334] See BlackRock Feb. 22 Letter, at 6-7; VRS Feb. 22 Letter, at 3-4; MFA Feb. 22 Letter, at 5-6; HOOPP Feb. 22 Letter, at 2-3; ABC/CIEBA Feb. 22 Letter, at 13; COPE Feb. 22 Letter, at 2-4; COPE June 3 Letter, at 5-6; Exelon Feb. 22 Letter, at 2-3; ETA June 3 Letter, at 20-21; CalPERS Feb. 18 Letter, at 3-4; CEF Feb. 22 Letter, at 2.
[335] Proposing release, 75 FR at 80639.
[336] See DPG Framework, supra fn. 178; CRMPG I Report, supra fn. 274; CRMPG II Report, supra fn. 274; CRMPG III Report, supra fn. 228.
[337] See FHLBanks Feb. 22 Letter, at 2.

size and level of sophistication, and whether counterparties should be able to opt in to or opt out of the protections of the disclosure rule, the Commission notes that Section 4s(h)(3)(B) only limits the disclosure duty when a swap transaction is between swap dealers, major swap participants, and/or SBS Entities. The only exception in Section 4s(h)(3)(B) allows counterparties to obtain the daily mark for cleared swaps upon request.[338] Given that the statute provides such limited opt in/opt out for disclosures, the final rule is consistent with the plain language of the statute by not allowing counterparties to opt in to or opt out of the disclosure rule other than as provided by the statute.[339]

Commenters claimed that the proposed disclosure rule alters the relationship between counterparties and swap dealers or major swap participants from arm's length dealings to advisory relationships.[340] The Commission disagrees and confirms that the business conduct standards rules alone do not cause a swap dealer or major swap participant to assume advisory responsibilities or become a fiduciary.[341] The final rule tracks the statute and includes explanatory language regarding the timing and content of the statutory, principles based disclosure duty, and was informed by industry practices[342] and industry best practice

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[338] The Commission also has clarified that the § 23.431 disclosure obligations do not apply to transactions that are initiated on a SEF or DCM where the swap dealer or major swap participant does not know the identity of the counterparty to the transaction. See final § 23.431(c) (previously numbered as proposed § 23.431(b)). See also Section 4s(h)(7) of the CEA with respect to the Special Entity provisions.

[339] See Section III.A.1. of this adopting release for a discussion of "Opt in or Opt out for Certain Classes of Counterparties."

[340] Several commenters urged the Commission to coordinate with the SEC and DOL to ensure that the final rule does not trigger ERISA fiduciary or municipal advisor status. The Commission confirms that it continues to coordinate with both agencies on these issues. See Section II of this adopting release for a discussion of "Regulatory Intersections." See also Section III.A.1. of this adopting release for a discussion of "Discretionary Rules" and "Different Rules for Swap Dealers and Major Swap Participants." Regarding the relative costs and benefits of the disclosure rules, see Section VI.C.4. of this adopting release for a discussion of § 23.431.

[341] The Commission is amending § 4.6 to exclude swap dealers from the CTA definition, which the Dodd-Frank Act amended to include swaps, when their advice is solely incidental to its business as a swap dealer. See Section II.D. of this adopting release. See also Section II.B. of this adopting release for a discussion of how compliance with the business conduct standards rules, including the disclosure duties, will be considered by DOL.

[342] See supra at fn. 336 and accompanying text.

recommendations.[343] The statute and the disclosure rules are intended to level the information playing field by requiring swap dealers and major swap participants to provide sufficient information about a swap to enable counterparties to make their own informed decisions about the appropriateness of entering into the swap. The additional language in the rule, including "at a reasonably sufficient time prior to entering into a swap" and "information reasonably designed to allow a counterparty to assess," along with the material risks and characteristics standards in the rule, is intended to provide guidance to swap dealers and major swap participants in complying with the rule. This guidance will assist swap dealers and major swap participants in designing reasonable policies and procedures to comply with the requirements of the statute and the final rule.

The Commission has promoted efficiency and reduced costs by allowing swap dealers and major swap participants to use standardized formats to make required disclosures, as appropriate, in counterparty relationship documentation.[344] Depending on the facts and circumstances, disclosures in a standard format may be appropriate if the information is applicable to multiple swaps of a particular type and class, particularly standardized swaps. Similarly, whether standard form disclosures are appropriate for certain bespoke swaps will depend on the facts and circumstances. Factors that would be relevant are the complexity of the transaction, including,

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[343] The CRMPG III Report provides the following best practice guidance regarding disclosure:

> [I]t is critical that participants in the markets for high-risk complex instruments must understand the risks that they face. An investor or derivative counterparty should have the information needed to make informed decisions. While the Policy Group has recommended that each participant must develop a degree of independence in decision-making, large integrated financial intermediaries have a responsibility to provide their counterparties with appropriate documentation and disclosures. Disclosures must meet the standards established by the relevant regulatory jurisdiction. The Policy Group believes that appropriate disclosures should often go beyond those minimum standards, both through enhancement for instruments currently requiring disclosure, and by establishing documentation standards for instruments that currently require little or none.

CRMPG III Report, at 59.

[344] See Section III.A.3.f. of this adopting release for a discussion of proposed § 23.402(g)–Disclosures in a standard format (renumbered as final § 23.402(f)).

but not limited to, the degree and nature of any leverage,[345] the potential for periods of significantly reduced liquidity, and the lack of price transparency.[346] This approach is consistent with OTC derivatives industry best practice recommendations for high-risk, complex financial instruments.[347] Given the evolutionary nature of swaps, and especially bespoke swaps, swap dealers and major swap participants will be required to have and implement reasonably designed policies and procedures concerning when and how to make particularized disclosures on a transactional basis to account for changing characteristics, as well as different and newly identified risks, incentives and conflicts of interest. The statute is unequivocal regarding the duty to provide disclosures of the material risks, characteristics, incentives and conflicts of interest for each swap.

Regarding commenters' recommendations to delay discretionary rules and urging different rules for major swap participants, the Commission has addressed those issues above.[348] In response to commenters concerns about compliance with principles based disclosure duties, the Commission will, in the absence of fraud, consider good faith compliance with policies and procedures reasonably designed to comply with the disclosure rules as a mitigating factor when exercising its prosecutorial discretion for violation of the disclosure rule.

a. Section 23.431(a)(1)–Material Risk Disclosure

i. Proposed § 23.431(a)(1)

The proposed rule tracked the statutory obligations under Section 4s(h)(3)(B)(i) and required the swap dealer or major swap participant to disclose information to enable a counterparty to

[345] This characteristic is particularly relevant when the swap includes an embedded option that increases leverage. Such features can significantly increase counterparty risk exposure in ways that are not transparent. See also fn. 227.
[346] CRMPG III Report, at 56; see also text at fn. 228.
[347] CRMPG III Report, at 56.
[348] See Section III.A.1.b.ii. and iii. of this adopting release for a discussion of "Discretionary Rules" and "Different Rules for Swap Dealers and Major Swap Participants."

assess the material risks of a particular swap. The Commission anticipated that swap dealers and major swap participants typically would rely on a combination of standardized disclosures and more particularized disclosures to satisfy this requirement. The proposed rule identified certain types of risks that are associated with swaps generally, including market,[349] credit,[350] operational,[351] and liquidity risks.[352] Required risk disclosure included sufficient information to enable a counterparty to assess its potential exposure during the term of the swap and at expiration or upon early termination. The Commission noted that, consistent with industry "best practices," information regarding specific material risks had to 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.[353] As described in the proposing release, disclosures under the proposed rule should consider the effect of future economic factors and other material events that could cause the swap to experience such losses. Disclosures also should 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. The Commission noted that 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.

ii. Comments

The Commission received comments on a variety of issues related to proposed § 23.431(a)(1). Comments included claims that disclosures would increase costs, delay

[349] Market risk refers to the risk to a counterparty's financial condition resulting from adverse movements in the level or volatility of market prices.
[350] Credit risk refers to the risk that a party to a swap will fail to perform on an obligation under the swap.
[351] Operational risk refers to the risk that deficiencies in information systems or internal controls, including human error, will result in unexpected loss.
[352] 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.
[353] See CRMPG III Report, at 60.

execution, expose parties to additional market risk, intrude on counterparty confidential information and result in ever longer lists of hypothetical risks.[354] However, one commenter specifically disagreed, arguing that the statute requires material risk disclosure and not limited utility, generalized disclosure.[355] With respect to the importance of a robust risk disclosure duty, the commenter[356] referenced transactions profiled in the report from the U.S. Senate Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, "Wall Street and the Financial Crisis: Anatomy of a Financial Collapse," issued April 13, 2011 ("Senate Report").[357]

Another commenter stated that the proposed rule was too vague regarding what material risks must be disclosed, creating legal uncertainty, potential hindsight enforcement, and private rights of action.[358] The commenter claimed that, without guidance, swap dealers and major swap participants may over disclose risks and/or limit the number of their swap counterparties.[359] Certain commenters recommended that the Commission clarify that the "material risks" of a swap are limited to the economic terms of the product and not risks associated with the underlying asset.[360]

Several commenters supported standardized risk disclosures.[361] However, others were

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[354] See, e.g., SIFMA/ISDA Feb. 17 Letter, at 17.
[355] CFA/AFR Aug. 29 Letter, at 19.
[356] Id., at 2-5 and 12.
[357] The report concludes that transactions involving structured collateralized debt obligations ("CDOs") were problematic because they were designed to fail and the disclosures omitted and/or misrepresented the material risks, characteristics, incentives and conflicts of interest related to these types of transactions.
[358] FHLBanks June 3 Letter, at 8-9.
[359] Id.
[360] See, e.g., SIFMA/ISDA Feb. 17 Letter, at 17 (e.g., a particular event in the Middle East that could impact currency markets).
[361] See, e.g., MetLife Feb. 22 Letter, at 5; ATA Feb. 22 Letter, at 3; APGA Feb. 22 Letter, at 3; FHLBanks Feb. 22 Letter, at 1 and 3-4; FHLBanks June 3 Letter, at 8-9; CII Feb. 10 Letter, at 2.

skeptical of the value of mandatory boilerplate disclosures.[362] Other commenters recommended that the Commission specifically require risk disclosures regarding volatility, historic liquidity and value at risk.[363] One commenter recommended that, in lieu of proposed § 23.431, the Commission limit the disclosure duty to a predefined scenario analysis.[364] It was suggested, for example, regarding interest rate sensitivity, that the rule could mandate an analysis of interest rate conditions up to a certain number of standard deviations away from expected interest rate movements based on historical interest rates.[365] It was asserted that such objective standards would promote marketplace and legal certainty.[366]

iii. Final § 23.431(a)(1)

After considering the comments on proposed § 23.431(a)(1), the Commission has determined to adopt the rule as proposed. In addition, the Commission is confirming that the rule will be interpreted consistently with industry best practice regarding the disclosure of material risks.[367] This guidance will assist swap dealers and major swap participants in designing policies and procedures to comply with the final rule. The final rule is tailored to give effect to the plain language of the statute by requiring swap dealers and major swap participants to provide material

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[362] See COPE Feb. 22 Letter, at 3-4; Exelon Feb. 22 Letter, at 2-3; BlackRock Feb. 22 Letter, at 7.
[363] See Better Markets Feb. 22 Letter, at 3 and 7; Barnard May 23 Letter, at 2.
[364] NY City Bar Feb. 22 Letter, at 2.
[365] Id.
[366] Id.
[367] As stated in the proposing release, 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. Proposing release, 75 FR at 80644 (citing CRMPG III Report, at 60). 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. Proposing release, 75 FR at 80644. See also proposed 17 CFR 240.15Fh-3(b)(1), SEC's proposed rules, 76 FR at 42454 (SEC rule regarding material risks requires disclosure, including, but not limited to, "the material factors that influence the day-to-day changes in valuation, the factors or events that might lead to significant losses, the sensitivities of the security-based swap to those factors and conditions, and the approximate magnitude of the gains or losses the security-based swap will experience under specified circumstances"). Accordingly, the Commission's interpretation is consistent with the text of the SEC's proposed risk disclosure rule, which furthers the harmonization goal of the Commission and the SEC.

risk disclosure that allows a counterparty to assess the risks of the swap.

Certain commenters recommended that the Commission clarify that the material risk disclosure requirement under § 23.431(a)(1) is limited to disclosures about the risks associated with the economic terms of the product and not risks associated with the underlying asset.[368] The Commission believes that for most swaps information about the material risks and characteristics of the swap will relate to the risks and characteristics of the economic terms of the swap.[369] For certain swaps, however, where payments or cash-flows are materially affected by the performance of an underlying asset for which there is not publicly available information (or the information is not otherwise accessible to the counterparty), final § 23.431 would require disclosures about the material risks and characteristics that affect the value of the underlying asset to enable a counterparty to assess the material risks of the swap.[370] For example, for a total return swap whose value is based on the performance of a broad-based index consisting of

[368] See SIFMA/ISDA Feb. 17 Letter, at 17.

[369] Such economic terms would include payout structures that embed volatility or optionality features into the transaction, including, but not limited to, caps, collars, floors, knock-in or knock-out rights, or range accrual features. As noted above, disclosures concerning these features would need to provide sufficient information about these features to enable counterparties to make their own informed decisions about the appropriateness of entering into the swap.

[370] Such a requirement is not intended to create, and does not create, any general trading prohibition or general disclosure requirement concerning "inside information" under the CEA. This guidance addresses circumstances where information concerning the risks of the underlying asset generally are not publicly available. For example, where a swap dealer offered a total return swap on a broad-based index based on unique assets that it created or acquired, any potential counterparty would be unable to evaluate that transaction absent some form of disclosure by the swap dealer. This rule would require such disclosure. In contrast, where a swap dealer offers a swap on an underlying asset for which it has nonpublic information, for example, harvest information about an agricultural commodity or production information about an energy commodity, and the asset is one for which risk information is publicly available, the swap dealer or major swap participant would not be required to disclose the nonpublic information it holds. However, depending on the facts and circumstances, the swap dealer might have to disclose nonpublic information as part of its duty to disclose material incentives and conflicts of interest. See Section III.D.3.d.iii. of this release for a discussion of the duty to disclose material incentives and conflicts of interest. In addition, as part of its obligation to disclose the material economic terms of the swap, the swap dealer would have to provide information about the factors that would cause the value of the swap to change including any correlations with the value of the underlying asset. Of course, swap dealers and major swap participants also will be subject to the fair dealing rule and antifraud provisions with respect to their communications with counterparties. See Sections III.B. and III.F. of this release for a discussion of § 23.410–Prohibition on Fraud, Manipulation and Other Abusive Practices, and § 23.433–Communications–Fair Dealing, respectively. In addition, as stated in § 23.400, nothing in these rules is intended to limit or restrict the applicability of other applicable laws, rules and regulations, including the federal securities laws.

unique assets that it created or acquired, a swap dealer or major swap participant would be required to disclose information about the material risks and characteristics of the broad-based index, unless such information is accessible to the counterparty. Disclosure regarding an underlying asset in such circumstances is consistent with the duty to communicate in a fair and balanced manner based on principles of fair dealing and good faith as required by Section 4s(h)(3)(C) and final § 23.433. In connection with a swap based on the price of oil, for example, a swap dealer or major swap participant would not have to disclose information about the drivers of oil prices because such information is readily available to market participants.[371]

Without commenting on the Senate Report's findings, the Commission considered how the final disclosure rules would address transactions similar to those profiled in the Senate Report, as requested by commenters.[372] The final rule addresses the types of concerns raised by the Senate Report and by commenters by requiring the disclosure of material risks, characteristics, incentives and conflicts of interest, as well the duty to communicate in a fair and balanced manner based on principles of fair dealing and good faith. These duties are consistent with longstanding legal, regulatory and industry best practice standards, which are familiar to the financial services industry and the OTC derivatives industry.

The Commission declines to limit the disclosure duty to a predefined scenario analysis as suggested by one commenter. The Commission recognizes the benefits of, and encourages the use of, an analysis such as the one suggested by the commenter[373] to satisfy, in part, the material

[371] With respect to the request by certain commenters that the Commission require material risk disclosures regarding volatility, historic liquidity, and value at risk, the Commission declines to prescribe specific parameters for compliance with the risk disclosure rule beyond the explanatory text of the final rule. Nevertheless, the Commission believes that, depending on the facts and circumstances, including whether the counterparty has elected to receive scenario analysis, disclosure of these risk factors may be appropriate.
[372] See, e.g., Sen. Levin Aug. 29 Letter, at passim; CFA/AFR Feb. 22 Letter, at 2, 10 and 12; CFA/AFR Aug. 29 Letter, at 3-8, 18 and 20.
[373] NY City Bar Feb. 22 Letter, at 2-3.

risk disclosure requirement. In fact, the Commission believes that the use of historical data in tabular form to illustrate specific swap and/or asset prices, volatility, sensitivity, liquidity risks and characteristics is consistent with industry practice.[374] However, the Commission has determined that such analyses may not satisfy all aspects of the principles based disclosure requirement in Section 4s(h)(3)(B) for all swaps. Accordingly, the Commission has determined not to adopt a predefined scenario analysis in lieu of proposed § 23.431.

In response to commenters asking that the Commission develop standardized risk disclosures, the Commission decided not to adopt futures style standard form swap disclosure for the reasons discussed in connection with § 23.402(f)–Disclosures in a standard format.[375]

b. Section 23.431(b)–Scenario Analysis

i. Proposed § 23.431(a)(1)(i)-(v)

The Commission's scenario analysis rule in proposed § 23.431(a)(1)(i)-(v) (renumbered as § 23.431(b)) required swap dealers and major swap participants to provide scenario analyses when offering to enter into a high-risk complex bilateral swap to allow the counterparty to assess its potential exposure in connection with the swap.[376] In addition, the proposed rule allowed counterparties to elect to receive scenario analysis when they were offered bilateral swaps not available for trading on a DCM or SEF. The elective aspect of the rule reflected the expectation that there would be circumstances where scenario analysis would be helpful for certain counterparties, even for swaps that are not high-risk complex. Proposed § 23.431(a)(1) was modeled on the CRMPG III industry best practices recommendation for high-risk complex

[374] See CRMPG III Report, at 60.
[375] See Section III.A.3.f. of this adopting release for a discussion of final § 23.402(f)–Disclosures in a standard format.
[376] Scenario analysis was proposed in addition to required disclosures for swaps that do not qualify as high-risk complex. Such required disclosures included a clear explanation of the economics of the instrument.

financial instruments.[377]

Like the CRMPG III industry best practices recommendation, the term "high-risk complex bilateral swap" was not defined in the proposed rule; rather, certain flexible characteristics were identified to prevent concerns about over- or under-inclusivity. The characteristics included: The degree and nature of leverage,[378] the potential for periods of significantly reduced liquidity and the lack of price transparency.[379] The proposed rule required 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).

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.[380] 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 required 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 required that all material assumptions underlying a given scenario and their impact on swap valuation be disclosed.[381] In requiring such disclosures, however, the Commission did not require swap dealers or major swap participants to disclose proprietary information about pricing models.

The Commission did not propose to define the parameters of the scenario analysis in order to

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[377] CRMPG III Report, at 60-61.
[378] See fn. 227 and 345 discussing risks regarding leverage.
[379] CRMPG III Report, at 56; see also text at fn. 228.
[380] 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.
[381] Material assumptions included (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.

provide flexibility to the parties in designing the analyses in accordance with the characteristics of the bespoke swap at issue and any criteria developed in consultations with the counterparty. Further, the proposed rule required swap dealers and major swap participants to consider relevant internal risk analyses, including any new product reviews, when designing the analyses.[382] As for the format, the proposed rule required 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 were 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 aligned the proposed rule with longstanding industry best practice recommendations.[383]

ii. Comments

The Commission received comments on a broad range of issues regarding the proposed scenario analysis rule. One commenter raised a host of concerns, including: (1) That Section 4s(h)(3)(B) does not require scenario analysis; (2) codifying industry best practice will discourage future private sector initiatives; (3) scenario analysis is a broad concept encompassing many potential analyses that are not relevant for individual transactions and, absent a definition or guidance regarding the parameters of the analysis, it is possible that scenario analysis will be misleading; (4) scenario analysis may cause swap dealers and major swap participants to become ERISA fiduciaries, municipal advisors and/or CTAs; (5) swap dealers and major swap participants may have liability for failing to provide mandatory scenario analysis even though

[382] The Commission proposed that swap dealers and major swap participants adopt policies and procedures regarding a new product policy as part of their risk management system. See proposed § 23.600(c)(3), Governing the Duties of Swap Dealers, 75 FR at 71405.

[383] See DPG Framework, at Section V.II.G.; CRMPG III Report, at 59-61 and Appendix A, Bullet 5; but see SIFMA/ISDA Feb. 17 Letter, at 13-14.

they have reasonable policies and procedures for identifying high-risk complex bilateral swaps; (6) the highly subjective definition of high-risk complex bilateral swap is problematic from a liability perspective, particularly for hindsight enforcement actions and private rights of action; (7) the rule mandates delivery of scenario analysis even if the counterparty neither requests nor wants the analysis; and (8) the mandatory delivery of scenario analysis will delay execution, which increases risk to the counterparty.[384]

Other commenters claimed that the scenario analysis rule would increase counterparty dependence on swap dealers and major swap participants thereby raising moral hazard concerns.[385] Another commenter was concerned that scenario analysis, or portions thereof, is often proprietary, which raises confidentiality and liability issues.[386] The commenter also claimed that the proposed scenario analysis rule is resource intensive and will increase the cost of swaps to counterparties.[387]

Certain commenters were in favor of the proposed scenario analysis rule. For example, a commenter said it would like to receive scenario analysis for the swaps covered by the proposed rule.[388] Another commenter believed that scenario analysis should not be expensive in that swap dealers and major swap participants are expected to take the other side of the swap and already do the analysis, which is easily modified to the counterparty's purpose.[389] Moreover, the commenter asserted that swap dealers and major swap participants must do the analysis as part of the suitability or Special Entity "best interests" analysis.[390] Another commenter supported the

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[384] See SIFMA/ISDA Feb. 17 Letter, at 18-21.
[385] See MFA Feb. 22 Letter, at 6; CEF Feb. 22 Letter, at 9; SIFMA/ISDA Feb. 17 Letter, at 19.
[386] CEF Feb. 22 Letter, at 9-10.
[387] Id.
[388] MetLife Feb. 22 Letter, at 5.
[389] CFA/AFR Feb. 22 Letter, at 9.
[390] Id.

proposed rule, but suggested allowing swap dealers and major swap participants to delegate responsibility for the analysis to appropriately qualified independent third party providers.[391] In addition, this commenter recommended that the scenario analysis be provided on a portfolio basis.[392] Lastly, certain commenters suggested that the proposed scenario analysis only be required at the request of the counterparty.[393]

iii. Final § 23.431(b)

After considering the comments, the Commission has determined to adopt proposed § 23.431(a)(1)(i)-(v) (renumbered as § 23.431(b)) with certain modifications. The Commission revised the proposed rule to eliminate the requirement to provide scenario analysis for "high-risk complex bilateral swaps." Instead, the final rule requires scenario analysis only when requested by the counterparty for any swap not "made available for trading" on a DCM or SEF.[394] To comply with the rule, swap dealers will have to disclose to counterparties their right to receive scenario analysis and consult with counterparties regarding design. These changes eliminate both the mandatory element and definitional issues associated with the term "high-risk complex bilateral swap." They also address counterparty concerns about execution delays and costs. In addition, major swap participants will not have to provide scenario analysis. Because modeling and providing scenario analysis is currently an industry best practice for dealers, the Commission

[391] Markit Feb. 22 Letter, at 3-4; Markit June 3 Letter, at 7.
[392] Id.
[393] See COPE Feb. 22 Letter, at 4; SIFMA/ISDA Feb. 17 Letter, at 21; Exelon Feb. 22 Letter, at 4; CEF Feb. 22 Letter, at 10.
[394] Under Section 2(h)(8) of the CEA, a swap that is subject to the clearing requirement of Section 2(h)(1) must be executed on a DCM or SEF unless no DCM or SEF "makes the swap available to trade" or the swap is subject to the clearing exception under Section 2(h)(7) (i.e., the end-user exception). See Proposed Rules, Swap Transaction Compliance and Implementation Schedule: Clearing and Trade Execution Requirements under Section 2(h) of the CEA, 76 FR 58186, 58191, Sept. 20, 2011 ("Trade Execution Requirements"); see also Proposed Rules, Process for a Designated Contract Market or Swap Execution Facility to Make a Swap Available to Trade, 76 FR 77728, Dec. 14, 2011 ("Process to Make a Swap Available to Trade"). Therefore, final § 23.431(b) only requires a swap dealer to provide scenario analysis upon request for swaps that are not subject to the trade execution requirement under Section 2(h)(8).

is limiting the duty to swap dealers only.

Regarding parameters for scenario analysis, the Commission decided to retain the language in proposed § 23.431(a)(1)(ii), (iv) and (v). The rule is principles based and allows flexibility in designing the analysis. As guidance, the Commission directs swap dealers to industry best practices for scenario analysis for high-risk complex financial instruments.[395] That best practice recommends:

> The analysis should be done over a range of assumptions, including severe downside stress scenarios. Scenario analysis should also include an analysis of what assumptions would result in a significant percentage loss (e.g., 50%) of principal or notional. All implicit and explicit assumptions should be clearly indicated and calculation methodologies should be explained. Significant assumptions should be stress-tested with the results plainly disclosed.[396]

In addition, counterparties may request the type of information and scenario analyses they consider useful. Such flexibility enhances the benefits of scenario analysis to counterparties while limiting the costs of the final rule. The counterparty gets what it needs and the swap dealer has certainty about the type of analysis that will comply with the rule. As noted in the proposing release, swap dealers have informed Commission staff that they currently provide to counterparties scenario analysis upon request and without charge.[397]

Regarding comments that Section 4s(h)(3)(B) does not require scenario analysis, the Commission notes that OTC derivatives industry best practice dating back to 1995 discusses the provision of scenario analysis to illustrate the risks of particular derivative products.[398] In addition, a recent OTC derivatives industry best practice disclosure recommendation for high-risk complex financial instruments calls for "rigorous scenario analyses and stress tests that

[395] See CRMPG III Report, at Appendix A, Bullet 5.
[396] Id.
[397] Proposing release, 75 FR at 80645.
[398] See DPG Framework, at Section V.II.G.

prominently illustrate how the instrument will perform in extreme scenarios, in addition to more probable scenarios."[399] These industry reports, coupled with letters from commenters,[400] are evidence of the value of scenario analysis in supplementing a counterparty's ability to assess the risks and characteristics of swaps and support the Commission's determination that requiring scenario analysis, as provided for in the final rule, is in the public interest. As discussed above in connection with final § 23.400–Scope, the Commission has ample discretionary authority to adopt the scenario analysis rule.[401]

The Commission is not persuaded by the assertion that codifying industry best practice will discourage future private sector initiatives and enhance the potential for hindsight enforcement actions and private rights of action.[402] By adopting industry best practice recommendations, it can be argued that the Commission is encouraging industry efforts to try to shape regulatory solutions to industry problems. The Commission also is not persuaded that adopting industry best practice recommendations will cause hindsight enforcement actions and private suits filed against swap dealers. The Commission notes that litigation risk is not new to swap dealers. Numerous private and enforcement actions involving derivatives have been filed based on theories that existed prior to the enactment of the Dodd-Frank Act.

With regard to the claim that scenario analysis needs a definition and parameters to avoid potentially misleading counterparties, the Commission notes that the final rule, unlike the

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[399] See CRMPG III Report, at 61.
[400] See MetLife Feb. 22 Letter, at 5; CFA/AFR Feb. 22 Letter, at 9; Better Markets Feb. 22 Letter, at 3 and 7; Barnard May 23 Letter, at 2; Markit Feb. 22 Letter, at 3-4. Accord COPE Feb. 22 Letter, at 4; CEF Feb. 22 Letter, at 10 (suggesting changing the rule from mandatory to elective by the counterparty).
[401] See Section III.A.1.ii. of this adopting release for a discussion of "Discretionary Rules."
[402] SIFMA/ISDA Feb. 17 Letter, at 18.

proposed rule, will require scenario analysis only as requested by the counterparty.[403] The final rule also will require consultation with the counterparty and disclosure of the material assumptions and calculation methodologies. These aspects of the rule, coupled with the other disclosure and fair dealing duties, should ameliorate the potential for misleading the counterparty. In addition, the Commission has determined to adopt the CRMPG III Report description of scenario analysis, which provides an appropriate, principles based standard for swap dealers under the final rule.[404] This principles based standard should provide sufficient guidance to swap dealers to achieve consistency regarding the minimum parameters of scenario analyses. As indicated in the final rule, counterparties may request additional information and analyses.

The Commission is not persuaded by claims that the scenario analysis rule would increase counterparty dependence on swap dealers thereby raising moral hazard concerns. As discussed above, the scenario analysis rule has been revised to eliminate the mandatory provision in favor of a counterparty election. In addition, the counterparty election covers swaps that are not "made available for trading" on a DCM or SEF.[405] This narrowing of the rule reduces both swap dealer and counterparty costs, including potential delays in execution. Only counterparties that want and request the scenario analysis will receive it. This approach is consistent with industry practice, which was confirmed during meetings with swap dealers, that upon request of counterparties scenario analysis is provided and without any additional charge.[406] Therefore, the rule should not significantly change the existing practice by unduly increasing counterparty

[403] The final rule does not distinguish between high risk complex swaps and other swaps. This and other changes in the final rule address commenters' concerns about the meaning of "high-risk complex swap" and resulting potential liability issues.
[404] See CRMPG III Report, at Appendix A, Bullet 5.
[405] See discussion of Section 2(h)(8) and swaps "made available for trading" on a DCM or SEF at fn. 394.
[406] Proposing release, 75 FR at 80645.

dependence on swap dealers or creating moral hazard concerns.

With respect to claims that scenario analysis, or portions thereof, are often proprietary, which may raise confidentiality and liability issues,[407] the Commission notes that the final rule does not require the disclosure of "confidential, proprietary information about any model it may use to prepare the scenario analysis." However, the rule does require the disclosure of all material assumptions and an explanation of the calculation methodologies. The Commission does not consider scenario analysis and its material assumptions and calculation methodologies to be confidential, proprietary information. This conclusion is based on several industry reports that confirm that scenario analysis and its material assumptions and calculation methodologies are best practice disclosure.[408] Regarding commenter's concerns relating to liability for the scenario analysis, the Commission believes that forward-looking statements should not unduly expose swap dealers to liability where the scenario analysis is performed consistent with the rule, in consultation with the counterparty and subject to appropriate warnings about the assumptions and limitations underlying the scenario analysis. Such warnings also would be consistent with § 23.433–Communications–fair dealing.[409]

The elective approach in the final rule ameliorates concerns that the proposed scenario analysis rule is resource intensive and will increase the cost of swaps to counterparties. This approach was supported by commenters and should be less burdensome.[410] In addition, the final rule provides for counterparty consultation in the design of a requested scenario analysis. Where the counterparty does not specify the assumptions, the swap dealer will have discretion to design a scenario analysis consistent with the principles established in the rule. This approach should

[407] See CEF Feb. 22 Letter, at 9-10.
[408] See DPG Framework, at Section V.II.G.; CRMPG III Report, at A2.
[409] See Section III.F. of this adopting release for a discussion of § 23.433–Communications–fair dealing.
[410] See, e.g., Exelon Feb. 22 Letter, at 4; COPE Feb. 22 Letter, at 4; SIFMA/ISDA Feb. 17 Letter, at 21.

assist the swap dealer in limiting the costs associated with complying with the final scenario analysis rule. The Commission notes that swap dealers are already preparing some form of scenario analysis of the swap for their own purposes, including new product review, daily product pricing, margin analysis and risk management.

The Commission agrees with the commenter that suggested that swap dealers be able to use appropriately qualified independent third party providers to perform the scenario analysis.[411] However, swap dealers will remain responsible for ensuring compliance with the rule. With respect to the suggestion that the rule require that scenario analysis be provided on a portfolio basis,[412] the Commission notes that the final rule is guided by the statute, which requires disclosure of information about the risks of "the swap." As a result, the Commission has determined that it is appropriate to require swap dealers to provide scenario analysis, upon request, with respect to a particular swap. However, nothing in the rule precludes swap dealers from agreeing to provide scenario analysis on a portfolio basis, upon request. The Commission expects some counterparties may request scenario analysis based on a portfolio while others, for a variety of reasons, including confidentiality of portfolio positions, may not request that analysis. Lastly, the Commission addressed the commenters' concern that scenario analysis may cause swap dealers to become ERISA fiduciaries, municipal advisors and/or CTAs elsewhere in this adopting release.[413]

c. Section 23.431(a)(2)–Material Characteristics

i. Proposed § 23.431(a)(2)

Proposed § 23.431(a)(2) required swap dealers and major swap participants to disclose the

[411] See Markit Feb. 22 Letter, at 2-4; Markit June 3 Letter, at 7.
[412] Id.
[413] See Section II of this adopting release for a discussion of "Regulatory Intersections," including DOL ERISA Fiduciary, SEC Municipal Advisor and CTA status issues.

material characteristics of the swap, including 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 material characteristics included the material terms of the swap that would be included in any "confirmation" of a swap sent by the swap dealer or major swap participant to the counterparty upon execution.[414]

ii. Comments

Commenters raised objections to language in the proposing release concerning delivery of a summary of the material characteristics of the swap to be provided by swap dealers and major swap participants to counterparties prior to entering into a swap.[415] One commenter claimed it would be both unnecessary given the ECP status of the counterparty and potentially confusing due to differences between a pre-execution summary and the post-execution transaction documentation.[416]

Commenters that support the disclosure rule recommended that the rule be interpreted to require for bespoke swaps that disclosures separately detail standardized components of the swap and price of each component, including embedded credit for forgone collateral.[417] In addition, a commenter recommended that the disclosure obligation include the features of the swap that could disadvantage the counterparty.[418]

iii. Final § 23.431(a)(2)

After considering the comments, the Commission has determined to adopt § 23.431(a)(2) as

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[414] Proposing release, 75 FR at 80645.
[415] See Exelon Feb. 22 Letter, at 3; SIFMA/ISDA Feb. 17 Letter, at 21-22.
[416] SIFMA/ISDA Feb. 17 Letter, at 21-22.
[417] See CFA/AFR Feb. 22 Letter, at 10; Better Markets Feb. 22 Letter, at 4-6; Better Markets June 3 Letter, at 13; CFA/AFR Nov. 3 Letter, at 6.
[418] CFA/AFR Feb. 22 Letter, at 11 (for example, situations where the proposed swap has basis risk and/or an interest rate mismatch).

proposed. To address questions about the manner and substance of disclosure that must be provided prior to entering into a swap, and the nature of transaction documentation that will be required post execution, the Commission provides the following guidance. As noted above, for a counterparty to assess the merits of entering into a swap, it will need information about the material risks and characteristics of the swap at a reasonably sufficient time prior to entering into the swap. The disclosure rules grant discretion to swap dealers and major swap participants, consistent with the rules on manner of disclosure, disclosures in a standard format and record retention, to adopt a reliable means of disclosure agreed to by a counterparty.[419]

Disclosures made prior to entering into a swap should not be confused with transaction documentation. The final internal business conduct standards rules in subsection J of part 23 will apply to transaction documentation.[420] The final external business conduct standards rules in subsection H of part 23 establish requirements to make disclosures about the material characteristics, among other information, of the swap. The two sets of rules will work together. To the extent that the final internal business conduct standards rules require that swap dealers and major swap participants provide to counterparties pre-execution information about the characteristics of a swap, such information should be considered by swap dealers and major swap participants in determining what, if any, additional information must be provided to counterparties pre-execution to comply with the material characteristics disclosure duty in § 23.431(a)(2).

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[419] See Sections III.A.3.e., f. and g. of this adopting release for a discussion of final § 23.402(e)–Manner of disclosure, final § 23.402(f)–Disclosures in a standard format, and final § 23.402(g)–Record retention, respectively. While the rules allow disclosures by any reliable means agreed to by the counterparty, pursuant to § 23.402(f) written disclosures are the preferred method to avoid confusion and counterparty disputes. Written disclosures enhance the ability to monitor compliance and facilitate compliance with the record retention requirements in § 23.402(g).

[420] See, e.g., Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants, 75 FR 81519, Dec. 28, 2010.

One commenter requested that the Commission clarify that the disclosure requirement is satisfied when a counterparty has or is provided a copy of each item of documentation that governs the terms of its swap with the swap dealer or major swap participant.[421] The Commission declines to make such a determination because whether the material characteristics disclosure requirement is met in any particular case will be a facts and circumstances determination, based on the standards set forth in the rule. This will be particularly true when certain features including, but not limited to, caps, collars, floors, knock-ins, knock-outs, range accrual features, embedded optionality or embedded volatility increase the complexity of the swap. The disclosure rule, coupled with § 23.433–Communications–Fair Dealing,[422] requires the swap dealer or major swap participant to provide a sound factual basis for the counterparty to assess how these features and others would impact the value of the swap under various market conditions during the life of the swap.[423]

Swap dealers and major swap participants will be permitted to include certain disclosures about material characteristics (other than information normally contained in a term sheet, such as price and dates) in counterparty relationship documentation, where appropriate, consistent with final § 23.402(f)–Disclosures in a standard format.

Commenters sought guidance on whether the material characteristics disclosure duty requires a swap dealer or major swap participant to determine and then disclose how the terms of a

[421] SIFMA/ISDA Feb. 17 Letter, at 21-22.
[422] See Section III.F. of this adopting release for a discussion of § 23.433–Communications–fair dealing.
[423] Because § 23.431(a)(2) creates a flexible disclosure regime, the Commission declines, at this time, to interpret § 23.431(a)(2) as requiring, with respect to bespoke swaps, a separate detailing of all standardized components of the swap and the pricing of each component, including embedded credit, for forgone collateral, especially where the swap dealer has not made a recommendation to the counterparty. However, nothing in the final rule would preclude the parties from negotiating disclosures of this type. See Section III.D.3.d. of this adopting release for a discussion of disclosures in connection with a swap dealer's recommendation.

particular swap relate to the circumstances of a particular counterparty.[424] The Commission believes that, for most swaps, information about the material characteristics of the swap will relate to the economic terms of the swap rather than the circumstances of the particular counterparty. However, if a swap dealer or major swap participant has contractually undertaken to do so, or a swap dealer has made a "recommendation," which triggers a suitability duty or is acting as an advisor to a Special Entity, the swap dealer or major swap participant will be required to act consistently with the relevant duty, including exercising reasonable due diligence and making appropriate disclosures. Of course, in all circumstances, swap dealers and major swap participants are required to communicate in a fair and balanced manner based on principles of fair dealing and good faith in accordance with final § 23.433. Additionally, for a Special Entity, the swap dealer or major swap participant will have to have a reasonable basis to believe that the qualified independent representative will act in the Special Entity's best interests and evaluate the appropriateness of each swap based on the needs and characteristics of the Special Entity before the Special Entity enters into the swap with a swap dealer or major swap participant.[425]

d. Section 23.431(a)(3)–Material Incentives and Conflicts of Interest

i. Proposed § 23.431(a)(3)

Proposed § 23.431(a)(3) tracked the statutory language under Section 4s(h)(3)(B)(ii) and required 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 a particular swap. The Commission also proposed that swap dealers and major

[424] See CFA/AFR Feb. 22 Letter, at 11.
[425] See Section IV.C. of this adopting release for a discussion of § 23.450–Requirements for swap dealers and major swap participants acting as counterparties to Special Entities.

swap participants be required to include with the price of the swap, the mid-market value of the swap as defined in proposed § 23.431(c)(2). In addition, swap dealers and major swap participants were required to disclose any compensation or benefit that they receive from any third party in connection with the swap. The Commission also stated in the proposing release that, in connection with any recommended swap, swap dealers and major swap participants were 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.[426] With respect to conflicts of interest, the Commission stated that it expected such disclosure would include the inherent conflicts in a counterparty relationship, particularly when the swap dealer or major swap participant recommends the transaction. The Commission also indicated it expected 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 conflicts of interest that require disclosure.[427]

ii. Comments

The Commission received comments addressing a variety of issues. Several commenters generally supported the disclosure requirement.[428] One commenter stated that it wanted to receive information about incentives or compensation that the swap dealer was receiving.[429] Two other commenters said they did not object to swap dealers being required to disclose conflicts of

[426] Proposing release, 75 FR at 80645.

[427] This may exist, for example, when the swap dealer or major swap participant acts both as an underwriter in a bond offering and as 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. With respect to swaps entered into with Special Entities, swap dealers and major swap participants are required to disclose the capacity in which they are acting and, if they engage in multiple capacities, disclose the difference in such capacities in accordance with Section 4s(h)(5) of the CEA and proposed § 23.450(f) (renumbered and adopted as final § 23.450(g)).

[428] See, e.g., MetLife Feb. 22 Letter, at 5; COPE Feb. 22 Letter, at 4; Exelon Feb. 22 Letter, at 4.

[429] MetLife Feb. 22 Letter, at 5.

interest because such disclosures would seem to be embedded in the concept of fair dealing.[430] Another commenter recommended allowing the use of standardized disclosures to satisfy conflicts of interest and compensation matters but supported specific disclosure on a transaction-by-transaction basis for any compensation received by the swap dealer or major swap participant in connection with a particular swap.[431]

A commenter approved of the proposed rule and the guidance in the proposing release requiring swap dealers and major swap participants to disclose whether their compensation for a recommended swap would be greater than for another instrument with similar economic terms offered by the swap dealer or major swap participant.[432] However, a different commenter objected to, and requested withdrawal of, that same statement asserting that swap dealers and major swap participants should not be obligated to identify and evaluate comparable instruments on behalf of the counterparty as such a comparative analysis would be an advisory service that is the responsibility of the counterparty and its advisors. [433]

Another commenter urged full disclosure to counterparties of the incentives to swap dealers and major swap participants for use of various market infrastructures (swap data repositories ("SDRs"), DCOs, DCMs, and SEFs).[434] Similarly, the commenter recommended prohibiting fee rebates, discounts, and revenue and profit sharing, which it asserts are substantively the same as preferential access to market infrastructures. The commenter maintained that such practices simply transfer costs to less influential participants who must follow the lead of large liquidity

[430] COPE Feb. 22 Letter, at 4; Exelon Feb. 22 Letter, at 3-4.
[431] CEF Feb. 22 Letter, at 13.
[432] CFA/AFR Feb. 22 Letter, at 11.
[433] SIFMA/ISDA Feb. 17 Letter, at 23.
[434] See Better Markets June 3 Letter, at 6-7.

providers.[435]

In addition, certain commenters that supported the rule also would like the Commission to require separate pricing of each "amalgamated" standardized component of a customized swap and a comparison of the risks and costs of the customized swap with comparable standardized, listed swaps.[436] The commenters identified, for example, embedded credit for forgone collateral as an amalgamated component that should be priced separately. These commenters also urged the Commission to clarify that the material incentives and conflicts of interest disclosure obligation applies not only to specific alternative instruments but also to alternative strategies.[437]

In addition, a commenter recommended that the Commission issue guidance that the following situations are not conflicts of interest that warrant disclosure because counterparties are aware of or expect these common business practices: (1) Simply taking the opposite side of a swap; (2) swap dealers, major swap participants or affiliates entering into other swaps that take an opposite view from that of the counterparty for reasons unrelated to the swap with the counterparty; and (3) swap dealers and major swap participants having a physical business that would benefit from a price movement that would be adverse to the counterparty's economic position under the swap.[438] This same commenter also requested that the final rules formally recognize that no disclosure obligation exists with respect to knowledge regarding a swap's reference commodity (specifically, swaps referencing energy commodities), the physical markets in which it trades, or any particular entity's positions or business in such commodity.[439]

iii. Final § 23.431(a)(3)

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[435] Id.
[436] See Better Markets June 3 Letter, at 13-17; CFA/AFR Feb. 22 Letter, at 11-12; CFA/AFR Nov. 3 Letter, at 6.
[437] Id.
[438] CEF Feb. 22 Letter, at 13.
[439] Id.

After considering the comments, the Commission has determined to adopt the proposed rule with the following revision. In proposed § 23.431(a)(3)(i), when disclosing the price of a swap, swap dealers and major swap participants would have to disclose the "mid-market value" of the swap. In the final rule, the Commission decided to change the term "mid-market value" to "mid-market mark"[440] to more accurately describe the requirement and mitigate concerns that the duty would constitute valuation, appraisal or advisory services or impose a fiduciary status on swap dealers and major swap participants.[441] The Commission notes that information about the spread between the quote and mid-market mark is relevant to disclosures regarding material incentives and provides the counterparty with pricing information that facilitates negotiations and balances historical information asymmetry regarding swap pricing.

In addition, the Commission is clarifying certain guidance provided in the proposing release regarding recommended swaps.[442] The proposing release indicated that, in connection with the duty to disclose material incentives and conflicts of interest, swap dealers and major swap participants would be expected to disclose whether their compensation relating to a recommended swap would be greater than for another instrument with "similar economic terms" offered by the swap dealer or major swap participant.[443] In response to commenter concerns that such disclosure would constitute advice,[444] the Commission has determined to limit the guidance to instances where more than one swap and/or strategy is recommended to accomplish a particular financial objective.[445] Generally, these multi-product presentations include a

[440] Further, the Commission confirms that "mid-market mark" can be determined through mark-to-model calculations when a liquid market does not exist.
[441] The Commission has made the same change in proposed § 23.431(c)–Daily Mark (renumbered as § 23.431(d)).
[442] Proposing release, 75 FR at 80645.
[443] Id.
[444] See SIFMA/ISDA Feb. 17 Letter, at 23.
[445] See also Section III.G.3. of this adopting release and Appendix A to subpart H of part 23 of the Commission's Regulations for a discussion of what constitutes a "recommendation."

comparison of swaps or strategies. In addition, the Commission understands that counterparties often ask dealers for alternatives to a particular swap, which may lead to a comparison. Considering this common industry practice, which facilitates sales, the comparison should include the relative compensation related to the different alternatives. This information is material to the swap dealer's or major swap participant's incentives underlying the recommendations and should assist the counterparty in making an assessment. Lastly, the Commission notes that this guidance does not prevent counterparties from requesting, or swap dealers and major swap participants from providing, comparisons of other swaps or products that may or may not have similar economic terms.

The Commission declines to state categorically that swap dealers and major swap participants will be required to separately price each standardized component of a customized swap, compare the risks and costs of customized swaps with those of standardized swaps, or disclose the embedded cost of credit for forgone collateral. Similarly, the Commission believes that facts and circumstances, including whether the swap dealer or major swap participant recommended the swap, will determine whether a swap dealer or major swap participant is required to disclose that it is trying to move a particular position off its books and that the swap is part of that strategy.[446] Swap dealers and major swap participants will be required to have policies and procedures reasonably designed to identify material incentives and conflicts within the scope of § 23.431(a)(3). The Commission will consider good faith compliance with such policies and procedures when exercising its prosecutorial discretion in connection with any violation of the rule.

[446] See, e.g., the Senate Report, at 518-531 ($2 billion Hudson CDO deal included $1.2 billion in assets from Goldman's balance sheet. The marketing materials did not disclose that $1.2 billion of the assets were from Goldman's balance sheet.).

With respect to the use of standardized disclosures to satisfy conflicts of interest and incentives disclosures, the Commission reminds swap dealers and major swap participants, as it has with respect to other disclosure obligations, that whether such disclosures will be sufficient to satisfy the disclosure rule in connection with any particular swap will depend on the facts and circumstances.[447] As discussed elsewhere in this adopting release, the statute places the disclosure duty on swap dealers and major swap participants to ensure that all material incentives and conflicts of interest relating to the swap are disclosed.

Concerning disclosure to counterparties of the incentives to swap dealers and major swap participants for use of various market infrastructures (DCOs, SDRs, DCMs, and SEFs), the Commission agrees that incentives paid to swap dealers and major swap participants by various market infrastructures for a swap transaction are a required disclosure within the statute and § 23.431(a)(3).[448] With respect to fee rebates, discounts, and revenue and profit sharing, the Commission has determined not to prohibit these payments at this time, but rather to require disclosure of such payments because the payments would constitute material incentives or conflicts of interest in conjunction with the swap. Such disclosure also is encompassed in the duty to communicate in a fair and balanced manner. Further, the failure to disclose this information or other material disclosures under the rule may be a material omission under the Commission's anti-fraud provisions, including final § 23.410(a).

The Commission declines the commenters' request that the Commission issue guidance that certain enumerated situations are not conflicts of interest that warrant disclosure. The plain

[447] See, e.g., Section III.A.3.f. of this adopting release for a discussion of final § 23.402(f)–Disclosures in a standard format.

[448] Such payments can be considered both incentives and conflicts of interest within the meaning of the statute and rule and, either way, must be disclosed. See Section 4s(h)(3)(C) of the CEA and final §23.433-Communications-fair dealing.

language of Section 4s(h)(3)(B)(ii) of the CEA requires disclosure of all material conflicts of interest that a swap dealer or major swap participant has in connection with the swap. Without assessing the list of situations provided by commenters, the Commission notes that the statute does not limit or exempt the disclosure of certain conflicts of interest where counterparties may be aware of or expect certain common business practices.

One commenter requested confirmation that the material incentives and conflicts of interest disclosure obligation does not apply to information known by the swap dealer or major swap participant regarding a swap's reference commodity, the physical markets in which it trades or any particular entity's positions or business in such commodity.[449] Based on the statutory language in Section 4s(h)(3)(B)(ii), the Commission cannot confirm the commenter's point. The statute requires swap dealers and major swap participants to disclose "any material incentives or conflicts of interest that the swap dealer or major swap participant may have in connection with the swap." It is certainly possible, particularly in the energy context mentioned by the commenter, that activities of the swap dealer or major swap participant related to the underlying commodity could create material incentives or conflicts of interest "in connection with" the swap offered to a counterparty. In addition, the Commission believes that transactions similar to those described in the Senate Report[450] would warrant disclosures concerning activities related to the underlying commodity. Without commenting on the transactions themselves, the Commission notes that the Senate Report raised concerns regarding proprietary trading and the limited transparency of underlying assets.[451] Whether such disclosure is required in connection with any

[449] See CEF Feb. 22 Letter, at 13.
[450] Senate Report, at 513-636.
[451] See Section III.D.3.a. of this adopting release for a discussion of § 23.431(a)(1)–Material risk disclosure.

particular swap will depend on the facts and circumstances.[452]

e. Section 23.431(d)–Daily Mark

i. Proposed § 23.431(c)

Section 4s(h)(3)(B)(iii) directs the Commission to adopt rules that require: (1) For cleared swaps, upon request of the counterparty, receipt of the daily mark of the transaction from the appropriate DCO; and (2) for uncleared swaps, receipt of the daily mark of the swap transaction from the swap dealer or major swap participant.[453]

For cleared swaps, proposed § 23.431(c)(1) required swap dealers and major swap participants to notify counterparties of their rights to receive, upon request, the daily mark from the appropriate DCO. For uncleared swaps, proposed § 23.431(c)(2) and (3) required swap dealers and major swap participants to provide a daily mark to their counterparties 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 proposed to define daily mark for uncleared swaps as the mid-market value of the swap, which would specifically not include amounts for profit, credit reserve, hedging, funding, liquidity or any other costs or adjustments.[454] Based on consultations with stakeholders, the consensus was that mid-market value was a transparent measure that would assist counterparties in calculating valuations for their own internal risk management purposes. Further, the Commission proposed 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 noted

[452] Such a requirement is not intended to create, and does not create, any general trading prohibition or general disclosure requirement concerning "inside information." See discussion at fn. 370; see also fn. 499.
[453] The Commission noted that the term "daily mark" is not defined in the statute and that the term "mark" is used colloquially to refer to various types of valuation information. See proposing release, 75 FR at 80645.
[454] Proposing release, 75 FR at 80645-46.

that the daily mark for certain bespoke swaps may be generated using proprietary models. The proposed rule did not require the swap dealer or major swap participant to disclose proprietary information relating to its model.[455]

Lastly, the Commission proposed that swap dealers and major swap participants provide appropriate clarifying statements relating to the daily mark.[456] Such disclosures could 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; nor (3) the value of the swap that is marked on the books of the swap dealer or major swap participant.

ii. Comments

One commenter favored disclosure of a daily mark.[457] The commenter concurred with the Commission's definition of daily mark as the "mid-market value" of the swap.[458] The commenter noted that many end-user counterparties already receive daily swap valuations at mid-market as determined under the definition of "Exposure" included in the 1994 ISDA Credit Support Annex and requested that the Commission clarify that the daily mark valuations under the rule are to be determined by reference to the same definition.[459] Some commenters recommended that the daily mark be calculated on a portfolio basis rather than for each individual swap because margin calls are based on a net or portfolio basis.[460] Several commenters recommended that the rule be revised from a mandatory daily disclosure to "upon request" by the counterparty model.[461]

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[455] Id. at 80646.
[456] Id.
[457] FHLBanks Feb. 22 Letter, at 5.
[458] Id.
[459] Id., at 6.
[460] See, e.g., Exelon Feb. 22 Letter, at 4; CEF Feb. 22 Letter, at 15.
[461] See, e.g., COPE Feb. 22 Letter, at 4; MFA Feb. 22 Letter, at 6; SIFMA/ISDA Feb. 17 Letter, at 23.

Others asserted that daily mark disclosure should be negotiable, including an opt out alternative.[462]

One commenter recommended revising the rule to allow swap dealers and major swap participants to delegate responsibility for providing the daily mark to appropriately qualified independent third party providers.[463] Another commenter stated that counterparties should not rely on swap dealers or major swap participants, but instead should seek marks from independent third parties.[464] Several commenters expressed concern that requiring swap dealers and major swap participants to provide a daily mark may be considered appraisal services that trigger ERISA fiduciary status, which prohibits principal-to-principal swap transactions.[465]

One commenter recommended revising the rule to require swap dealers and major swap participants, upon request of a counterparty, to provide the mark used for determining either party's mark-to-market margin obligation or entitlement under an outstanding swap because this approach is consistent with statutory text and the daily mark requirement for cleared swaps.[466]

A different commenter recommended deeming the daily mark obligation for cleared swaps satisfied if the counterparty can access the information directly from the DCO or its FCM.[467] In addition, the commenter requested that the final rule provide that swap dealers and major swap participants, absent fraud, have no liability for a counterparty's use of the provided daily mark.[468] Further, the commenter asserted that requiring disclosure of the daily mark methodology and assumptions encourages improper reliance by the counterparty on the swap dealer or major swap

[462] See, e.g., ERIC Feb. 22 Letter, at 16-17; CEF Feb. 22 Letter, at 15; MFA Feb. 22 Letter, at 6.
[463] Markit Feb. 22 Letter, at 2-3; Markit June 3 Letter, at 7.
[464] MFA Feb. 22 Letter, at 6.
[465] See BlackRock Feb. 22 Letter, at 6; SIFMA/ISDA Feb. 17 Letter, at 24; ABC/CIEBA Feb. 22 Letter, at 5-6; AMG-SIFMA Feb. 22 Letter, at 7; ERIC Feb. 22 Letter, at 16-17.
[466] SIFMA/ISDA Feb. 17 Letter, at 23-24.
[467] CEF Feb. 22 Letter, at 14.
[468] Id., at 15.

participant.[469] Lastly, one commenter suggested that the rule require swap dealers and major swap participants to deliver the daily mark via communication media that are secure, timely and auditable.[470]

iii. Final § 23.431(d)

After considering the comments, the Commission has determined to adopt § 23.431(c) (renumbered as § 23.431(d)) as proposed, but change the term "mid-market value" to "mid-market mark." This change more accurately describes the requirement and mitigates concerns that the duty would constitute valuation, appraisal or advisory services or impose a fiduciary status on swap dealers and major swap participants.[471] The Commission has determined to define the term daily mark as the "mid-market mark" using its discretionary authority to define terms under the Dodd-Frank Act.[472] Because "mid-market" represents an objective value, it provides counterparties with a baseline to assess swap valuations for other purposes, including margin or terminations. This term has been used by many industry participants since at least 1994.[473]

The Commission notes that certain comments conflict directly with the plain language of Section 4s(h)(3)(B)(iii)(I) and (II) of the CEA. For example, the suggestion that the daily mark be provided on a portfolio basis rather than for each swap conflicts with the plain language of the

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[469] Id.
[470] Markit Feb. 22 Letter, at 2-3.
[471] The Commission has made the same change in final § 23.431(a)(3)–Disclosures of material information, which requires disclosures of material incentives and characteristics. The Commission repeats that, with respect to final § 23.431(d), the Dodd-Frank Act disclosures, including the daily mark and mid-market mark, alone do not cause a swap dealer or major swap participant to be an advisor to a counterparty, including a Special Entity. The Commission does not consider the Dodd-Frank Act disclosures to be advice or a recommendation. See Section II of this adopting release for further discussion of the intersection of the subpart H requirements with DOL and SEC requirements.
[472] Section 721(b)(2) of the Dodd-Frank Act.
[473] See FHLBanks Feb. 22 Letter, at 6-7. In addition, the term "mid-market value" is used in CRMPG I Report, at 7. See also Bank One Corp. v. IRS, 120 T.C. 174 (U.S. Tax Court 2003). 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.

statute.[474] If counterparties want additional marks (e.g., marks on a portfolio basis or marks used to calculate margin), then they are free to negotiate the receipt of such information with swap dealers and major swap participants.

With respect to the recommendation that a swap dealer or major swap participant be deemed to satisfy the daily mark duty for cleared swaps if the counterparty can access the information directly from the DCO or its FCM, the Commission agrees, provided that the swap dealer or major swap participant apprises the counterparty and the counterparty agrees to such substituted compliance. The Commission notes that the swap dealer's or major swap participant's daily mark obligation for cleared swaps is prompted by the request of the counterparty. As a result, under the statute, it is up to the counterparty to decide whether it wishes to receive the daily mark through access to the DCO or FCM or from the swap dealer or major swap participant.

As to the request to limit the liability of swap dealers or major swap participants in relation to a counterparty's use of a provided daily mark, the Commission considers the request to be beyond the scope of the rulemaking.[475] Nevertheless, the Commission notes that it will consider good faith compliance with policies and procedures reasonably designed to meet the daily mark requirements, including the calculation of mid-market mark under final § 23.431(d), in exercising its prosecutorial discretion for violations of the rule.[476]

The Commission disagrees with the assertion that requiring disclosure of the daily mark methodology and assumptions will encourage improper reliance by the counterparty on the swap

[474] Section 4s(h)(3)(B)(iii) of the CEA states: "(I) for cleared swaps, upon the request of the counterparty, receipt of the daily mark of the transaction from the appropriate derivatives clearing organization; and (II) for uncleared swaps, receipt of the daily mark of the transaction from the swap dealer or major swap participant."
[475] See Section III.A.1. of this adopting release for a discussion of "Private Rights of Action."
[476] The Commission agrees with a commenter's suggestion that the rule should require swap dealers and major swap participants to deliver the daily mark via communication media that are secure, timely and auditable. Markit Feb. 22 Letter, at 3. This is consistent with final § 23.431(d)–Daily mark, as well as final § 23.402(e)–Manner of disclosure. See Section III.A.3.e. of this adopting release for a discussion of final § 23.402(e).

dealer or major swap participant. The statutory daily mark requirement is meaningless unless the counterparty knows the methodology and assumptions that were used to calculate the mark. To make its own assessment of the value of the swap for its own purposes, the counterparty has to have information from the swap dealer or major swap participant about how the mid-market mark was calculated. To satisfy the duty to disclose both the methodology and assumptions used to prepare the daily mark, swap dealers and major swap participants may choose to provide to counterparties methodologies and assumptions sufficient to independently validate the output from a model generating the daily mark, collectively referred to as the "reference model." The Commission does not intend that disclosure of the "reference model" would require swap dealers and major swap participants to disclose proprietary information. While the Commission does not define what currently constitutes proprietary information, the Commission is aware that, in light of the disclosure requirements relating to the methodology and assumptions used to prepare the daily mark, market participants may aid in the establishment of appropriate "reference models" and, in so doing, potentially alter the extent of undisclosed proprietary information in the future. With proper disclosures, counterparties should not be misled or unduly rely on the mid-market mark provided by the swap dealer or major swap participant.[477] Therefore, the Commission's final rule requires disclosure of the methodology and assumptions underlying the daily mark. The Commission's determination is based on the statutory disclosure provisions as well as the duty to communicate in a fair and balanced manner based on principles of fair dealing and good faith.

One commenter asked the Commission to confirm that the daily mark received by

[477] Without commenting on the findings of the Senate Report, the Commission notes that the Senate Report included descriptions of certain conduct relating to marks where dealers purportedly refused to explain the basis and methodology for the mark. See Senate Report, at 509-510.

counterparties is to be determined by reference to the same mid-market valuations used in connection with the definition of "Exposure" under the 1994 ISDA Credit Support Annex. The Commission declines to endorse any particular methodology given the principles based nature of the rule.

Further, the Commission is providing guidance that the term "mid-market mark" can be determined through mark-to-model calculations when a liquid market does not exist. In addition, swap dealers and major swap participants can delegate daily mark responsibilities to third party vendors. However, swap dealers and major swap participants will remain responsible for compliance with the rule.

E. Section § 23.432–Clearing Disclosures

1. Proposed § 23.432

The Commission's proposed rule required certain disclosures regarding the counterparty's right to select a DCO and to clear swaps that are not otherwise required to be cleared. For swaps where clearing is mandatory,[478] proposed § 23.432(a) required a swap dealer or major swap participant to notify the counterparty of its right to select the DCO that would clear the swap. For swaps that are not required to be cleared, under proposed § 23.432(b), a swap dealer or major swap participant was required to 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.[479] Neither of these notification provisions applied where the counterparty was a registered swap dealer, major swap participant, security-based swap dealer or major security-based swap

[478] See Section 2(h) of the CEA. (7 U.S.C. 2(h)).

[479] With respect to these proposed disclosure requirements, the Commission noted that, as between the parties, the counterparty is entitled to choose whether and where to clear, but that no DCM or SEF is required to make clearing available through any DCO. In other words, it is up to the parties to take the swap to a DCM or SEF that provides for clearing through the counterparty's preferred DCO. See proposing release, 75 FR at 80646.

participant.[480]

2. Comments

The comments submitted on proposed § 23.432 were directed at issues related to the substantive rules for swaps not required to be cleared and, as such, were beyond the scope of this rulemaking.[481] The only commenters on the disclosure requirement itself stated that they did not object to the proposed rule.[482]

3. Final § 23.432

The Commission has determined to adopt § 23.432 as proposed.

F. Section 23.433–Communications–Fair Dealing

1. Proposed § 23.433

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 established a duty that, consistent with the statutory language, applies to all swap dealer and major swap participant communications with counterparties. As the Commission noted in the proposing release,[483] these principles are well established in the futures and securities markets, particularly through SRO rules.[484] The duty to

[480] Proposing release, 75 FR at 80646.
[481] See Barclays Jan. 11 Letter, at 8 (clearing requirement should not apply to foreign swap transactions); SIFMA/ISDA Feb. 17 Letter, at 24-25; CEF Feb. 22 Letter, at 22 (the Commission should clarify that the election to clear a swap is meant to be exercised at the swap's inception); id. (supporting the proposed clearing disclosure rule, but recommended that the election of the counterparty regarding where to clear that is made at the outset of the transaction should be binding unless both parties agree; to do otherwise might require the swap dealer or major swap participant to transfer a swap from bilateral clearing to central clearing at an economically disadvantageous moment); MetLife Feb. 22 Letter, at 5 (major swap participants should be treated like other customers of a swap dealer, and receive the same rights as other counterparties, including the right to elect where to clear trades).
[482] See COPE Feb. 22 Letter, at 4; CEF Feb. 22 Letter, at 22.
[483] Proposing release, 75 FR at 80646.
[484] 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.

communicate in a fair and balanced manner is one of the primary requirements of the NFA customer communications rule[485] 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 stated that it expects a swap dealer or major swap participant to consider factors such as whether the communication: (1) Provides a sound basis for evaluating the facts with respect to any swap;[486] (2) avoids making exaggerated or unwarranted claims, opinions or forecasts;[487] and (3) balances any statement that refers to the potential opportunities or advantages presented by a swap with statements of corresponding risks.[488] The Commission also stated its expectation that to deal fairly requires the swap dealer or major swap participant to treat counterparties in such a way so as not to unfairly advantage a counterparty or group of counterparties over another. Additionally, communications are subject to the anti-fraud provisions of the CEA and Commission Regulations, as well as any applicable SRO rules.[489]

2. Comments

The Commission received several letters from commenters regarding proposed § 23.433. One commenter found the principles based approach to the rule more appropriate than a prescriptive approach.[490] However, a different commenter expressed concern regarding the rule's lack of detail, stating that it could create uncertainty and risk for swap dealers and major swap

[485] See, e.g., NFA Compliance Rule 2-29(b)(2) and (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).
[486] 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 . . . .").
[487] See, e.g., NFA Compliance Rule 2-29(b)(4)-(5).
[488] Proposing release, 75 FR at 80646.
[489] Id.
[490] CFA/AFR Feb. 22 Letter, at 12. In addition, the commenter recognized the need for future guidance, if necessary, after implementation.

participants.[491] That commenter recommended that the Commission consider using safe harbors containing objective standards as a means to satisfy the statutory requirements.[492] Another commenter urged the Commission to clarify the communications standards by reference to currently prevailing standards, such as FINRA and NFA standards, subject to appropriate modifications to reflect standards for participation in the swaps market.[493] Another commenter requested that major swap participants not be subject to a good faith and fair dealing rule when transacting with swap dealers.[494] It asserted that major swap participants in this particular context are customers of swap dealers and should not be treated as a dealer or quasi-dealer. Others had little or no concern regarding the fair dealing requirement.[495]

3. Final § 23.433

The Commission has determined to adopt § 23.433 as proposed. In addition, the Commission is providing the following guidance regarding the final fair dealing rule. As discussed above regarding § 23.431–Disclosures, the fair dealing rule works in tandem with both the material disclosure and anti-fraud rules to ensure that counterparties receive material information that is balanced and fair at all times.[496] The Commission intends these rules to address the concerns raised by commenters[497] regarding transactions similar to those profiled in the Senate Report.[498] The Senate Report concludes that those transactions, which involved structured CDOs, were

[491] NY City Bar Feb. 22 Letter, at 3.
[492] Id.
[493] FHLBanks Feb. 22 Letter, at 6.
[494] MetLife Feb. 22 Letter, at 4-5.
[495] See COPE Feb. 22 Letter, at 4. Accord, Exelon Feb. 22 Letter, at 3-4 (agreeing that holding swap dealers and major swap participants to standards that require fair dealing is appropriate as long as these principles are properly applied to commodity swap market).
[496] The fair dealing communications rule applies to all communications between a counterparty and a swap dealer or major swap participant, including the daily mark and termination. See Section III.D. of this adopting release for a discussion of § 23.431.
[497] See CFA/AFR Feb. 22 Letter, at 12; Sen. Levin Aug. 29 Letter, at 10-11.
[498] Senate Report, at 376-636.

problematic because they were designed to fail and the disclosures omitted and/or misrepresented the material risks, characteristics, incentives and conflicts of interest. Under all circumstances, and particularly those akin to the Senate Report involving complex swaps, the Commission's fair dealing rule will apply and operate as an independent basis for enforcement proceedings.

The fair dealing rule, like the disclosure rules, is principles based and applies flexibly based on the facts and circumstances of a particular swap. For example, when addressing the risks and characteristics of a swap with features including, but not limited to, caps, collars, floors, knock-ins, knock-outs and range accrual features that increase its complexity, the fair dealing rule requires the swap dealer or major swap participant to provide a sound basis for the counterparty to assess how those features would impact the value of the swap under various market conditions during the life of the swap. In a complex swap, where the risks and characteristics associated with an underlying asset are not readily discoverable by the counterparty upon the exercise of reasonable diligence, the swap dealer or major swap participant is expected, under both the disclosure rule and fair dealing rule, to provide a sound basis for the counterparty to assess the swap by providing information about the risks and characteristics of the underlying asset.[499] The fair dealing rule also will supplement requirements to inform counterparties of material incentives and conflicts of interest that would tend to be adverse to the interests of a counterparty in connection with a swap, particularly in situations like those referenced in the Senate Report. In this regard, a swap dealer or major swap participant will have to follow policies and procedures reasonably designed to ensure that the content and context of its disclosures are fair and complete to allow the counterparty to protect itself and make an informed decision.

[499] Such a requirement is not intended to create, and does not create, any general trading prohibition or general disclosure requirement concerning "inside information." See discussion at fn. 370; see also fn. 452.

In addition, in response to the comments it received, the Commission is confirming that it will look to NFA guidance when interpreting § 23.433 and, as appropriate, will consider providing further guidance, if necessary, after implementation.[500] The Commission concludes that the futures and securities industry familiarity with these precedents considerably mitigates concerns about legal certainty as a result of the principles based rule. Also, in the absence of fraud, the Commission will consider good faith compliance with policies and procedures reasonably designed to comply with the business conduct standards rules as a mitigating factor when exercising its prosecutorial discretion in connection with a violation of the rules. Lastly, the Commission is not exempting major swap participants from the fair communication requirement when they transact with swap dealers. Such an exemption would undermine congressional intent to improve transparency and raise the business conduct standards applicable to the market.

G. Section 23.434–Recommendations to Counterparties–Institutional Suitability

1. Proposed § 23.434

In proposed § 23.434, the Commission exercised its discretionary authority under new Section 4s(h) by proposing 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.[501] More precisely, proposed § 23.434 required a swap dealer or major swap participant to have a reasonable basis to believe that any swap or trading strategy involving

[500] See, e.g., NFA Compliance Rule 2-29 – Communications with the Public and Promotional Material; NFA Interpretative Notice 9041 – Obligations to Customers and Other Market Participants; NFA Interpretive Notice 9043 – NFA Compliance Rule 2-29: Use of Past or Projected Performance; Disclosing Conflicts of Interest for Security Futures Products.
[501] Proposing release, 75 FR at 80647.

swaps that it recommends to a counterparty is suitable for such counterparty.[502] A swap dealer or major swap participant would be required to make this determination based on reasonable due diligence that would include obtaining information 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.[503]

Proposed § 23.434 provided that a swap dealer or major swap participant could fulfill its obligations if the following conditions were satisfied: (1) The swap dealer or major swap participant had a reasonable basis to believe that the counterparty (or a party to whom discretionary authority has been delegated) was capable of evaluating, independently, the risks related to the particular swap or trading strategy recommended; (2) the counterparty (or its discretionary advisor) affirmatively indicated that it was exercising independent judgment in evaluating the recommendations; and (3) the swap dealer or major swap participant had a reasonable basis to believe that the counterparty had the capacity to absorb any potential losses.[504]

Proposed § 23.434 made clear that it would not apply: To any recommendations made to another swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant; where a swap dealer or major swap participant provides information that is general transaction, financial, or market information; or to swap terms in response to a

[502] The proposed rule was proposed based on suitability duties for banks and broker dealers dealing with institutional clients. As such, the proposed rule also implied a general suitability duty such that a swap dealer would have to have a reasonable basis to believe that the recommended swap or swap trading strategy is suitable for at least some counterparties.
[503] Proposing release, 75 FR at 80659.
[504] Id.

competitive bid request from the counterparty. In proposing § 23.434, the Commission explained that 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.[505]

While recognizing that futures market professionals have not been subject to an explicit suitability obligation, the Commission stated that such professionals have long been required to meet a variety of related requirements as part of their NFA-imposed obligations.[506] Further, in proposing § 23.434, the Commission considered that a suitability obligation is a common requirement for professionals in other markets and in other jurisdictions, including the banking and securities markets. Thus, to promote regulatory consistency, the Commission proposed to adopt a suitability obligation for swap dealers and major swap participants, modeled, in part, on existing obligations for banks and broker-dealers dealing with institutional clients.[507]

2. Comments

The Commission received several comments representing a diversity of views on proposed § 23.434. As a general matter, some commenters strongly supported the proposal as an important feature of the system of business conduct standards and directly responsive to the concerns raised by members of Congress regarding conflicts of interest, particularly as between investment banks and their customers.[508] For example, one commenter stated that, for both swap dealers and

[505] Id., at 80647.
[506] See, e.g., NFA Compliance Rule 2-30(c) and (j); see also NFA Interpretive Notice 9004.
[507] Proposing release, 75 FR at 80647.
[508] See, e.g., CFA/AFR Feb. 22 Letter, at 12-13; Better Markets Feb. 22 Letter, at 4-5; CFA/AFR Nov. 3 Letter, at 6-7.

swap advisors, there should be some suitability standards in place so that those entities with the appropriate expertise and capabilities to engage knowledgeably in these transactions are able to do so, while protecting those entities that should not be engaged in these types of transactions.[509] Other commenters, however, believed that the institutional suitability requirement is unnecessary and inappropriate for the swaps market, which is comprised of institutional market participants, not retail investors, and should remain an SRO rule, if at all.[510]

Of specific concern to some commenters was the proposal's inclusion of major swap participants. These commenters stated that, regardless of size, major swap participants cannot be presumed to possess a level of market or product information equal to that of swap dealers. Further, they expressed concern that proposed § 23.434 would force major swap participants into a position of trust and confidence when, in fact, they are transacting with their counterparties on an arm's length basis.[511] These commenters urged the Commission to treat major swap participants like any other customer of a swap dealer.[512]

Several commenters expressed concern with the use of the term "recommendation" in proposed § 23.434.[513] One commenter opined that the term is not defined and, therefore, could be overly broad.[514] Another commenter was concerned that general marketing materials could qualify as a recommendation within the meaning of the proposal.[515] That commenter requested the Commission clarify that such materials, as opposed to the recommendation of specific swaps

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[509] GFOA Feb. 22 Letter, at 2.
[510] See, e.g., Exelon Feb. 22 Letter, at 3; HETCO Feb. 22 Letter, at 1-4; CEF Feb. 22 Letter, at 8-9; SIFMA/ISDA Feb. 17 Letter, at 25; contra CFA/AFR Nov. 3 Letter, at 7.
[511] See, e.g., MFA Feb. 22 Letter, at 2 and 4; MetLife Feb. 22 Letter, at 4-5.
[512] See, e.g., MFA Feb. 22 Letter, at 3; MetLife Feb. 22 Letter, at 4-5; contra CFA/AFR Nov. 3 Letter, at 7.
[513] See, e.g., SIFMA/ISDA Feb. 17 Letter, at 26 ("The Commission's proposal appears to assume that every 'recommendation' is, in essence, a recommendation to the counterparty that the identified transaction is a transaction that the counterparty should execute based on its circumstances. This is far from accurate.").
[514] MFA Feb. 22 Letter, at 3.
[515] FHLBanks Feb. 22 Letter, at 5.

to a customer based on the individual customer's particular circumstances and needs, does not trigger the requirements of proposed § 23.434.[516] Other commenters stated that unless swaps are disclosed in an understandable, disaggregated form, they cannot be suitable.[517] Similarly, a commenter suggested the Commission strengthen or clarify protections against swap dealers recommending swaps that expose the hedger to risks that are greater than those they seek to hedge, either by identifying this as a violation of fraud standards or clarifying that it would be a violation of the suitability and best interests standards.[518] In contrast, one commenter believed that the complexity associated with collective investment vehicles would make it impracticable to carry out suitability and diligence requirements under proposed § 23.434.[519] Similarly, another commenter stated that, without details of the customer's business, staff, or other risks, it would be difficult for the swap dealer or counterparty to make a suitability determination.[520]

Related to the comments regarding the term "recommendation" was the more general concern that proposed § 23.434 would increase costs to, and chill communications and transactions between, swaps market participants.[521] The concern was that the proposal would cut the flow of information and transactional alternatives that fall short of advice and that non-swap dealer and non-major swap participants find beneficial.[522] A related concern was that the term "recommendation" would encompass ordinary interactions, and, therefore, swap dealers would always be subject to an explicit fiduciary duty.[523] According to some commenters, imposing such a fiduciary duty on swap dealers would result in either a blanket prohibition on swap dealers

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[516] Id.
[517] See, e.g., CFA/AFR Feb. 22 Letter, at 12; Better Markets Feb. 22 Letter, at 4-5.
[518] CFA/AFR Feb. 22 Letter, at 20.
[519] AMG-SIFMA Feb. 22 Letter, at 12.
[520] HOOPP Feb. 22 Letter, at 2.
[521] See, e.g., SIFMA/ISDA Feb. 17 Letter, at 26-27; HOOPP Feb. 22 Letter, at 2; Exelon Feb. 22 Letter, at 3.
[522] SIFMA/ISDA Feb. 17 Letter, at 27.
[523] Id.

transacting with ERISA plans or place such plans at a negotiating disadvantage with swap dealers by operation of other requirements that would require the plans to provide their counterparty with financial information to enter into a swap.[524] Regarding costs, some commenters believed that a suitability determination may be challenged in litigation as a possible defense against enforcement of a swap by a swap dealer, and the costs associated with defending such litigation would be passed on to counterparties and would be disproportionate to the benefits expected from proposed § 23.434.[525]

Several commenters suggested that, if the Commission were to adopt a suitability requirement, it could ameliorate some of the costs associated with such a requirement by permitting swap dealers and major swap participants to rely, absent notice of countervailing facts, upon a counterparty's written representations rather than imposing an independent diligence requirement.[526] These commenters contend that such an approach would prevent any suitability requirement from triggering fiduciary or other advisory status except in circumstances where that status reflects the reality of the parties' relationship.[527] In contrast, at least one commenter expressed reservation about the utility of representations because it could subvert the intent of the suitability standard.[528] This commenter believed there was no value in permitting swap dealers and major swap participants to recommend swaps known to be unsuitable just because the customer is willing to enter into the transaction.[529] For this and other reasons, the commenter urged the Commission to require a suitability analysis, properly documented,

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[524] Id.; ABC/CIEBA Feb. 22 Letter, at 7.
[525] See, e.g., FHLBanks June 3 Letter, at 7; VRS Feb. 22 Letter, at 3; HETCO Feb. 22 Letter, at 2; COPE Feb. 22 Letter, at 4.
[526] See, e.g., SIFMA/ISDA Feb. 17 Letter, at 27; ABC/CIEBA Feb. 22 Letter, at 7; but see CFA/AFR Nov. 3 Letter, at 7.
[527] See SIFMA/ISDA Feb. 17 Letter, at 27 fn. 59.
[528] CFA/AFR Feb. 22 Letter, at 13; CFA/AFR Nov. 3 Letter, at 7.
[529] CFA/AFR Feb. 22 Letter, at 13.

whenever the swap dealer or major swap participant is the initiator in recommending the transaction or whenever the swap dealer or major swap participant recommends a customized swap or trading strategy that involves a customized swap.[530]

3. Final § 23.434

The Commission has determined to adopt § 23.434. The final rule text has been changed to harmonize with the SEC's proposed rule and FINRA's final institutional suitability rule.[531] Through these changes, the Commission achieves its proposed regulatory objectives while reducing the cost of compliance associated with reconciliation of the suitability duties imposed by the Commission, the SEC and FINRA.

There are two principal changes from proposed § 23.434. First, major swap participants are excluded from the institutional suitability requirement. Second, the final rule clarifies that the suitability duty requires a swap dealer to (1) understand the swap that it is recommending, and (2) make a determination that the recommended swap is suitable for the specific counterparty. Consistent with the institutional suitability requirements of the proposed rule, however, the swap dealer will still be able to satisfy the counterparty-specific suitability duty by complying with the safe harbor in § 23.434(b) through the exchange of written representations. The Commission also deleted paragraph (c)(2), which excluded from the scope of the rule: (1) Information that is general transaction, financial, or market information; and (2) swap terms in response to a competitive bid request from the counterparty. The Commission has determined that, if a swap dealer were to communicate such information to a counterparty, without more, such communication would not be considered making a "recommendation." As a result, such

[530] Id.

[531] See proposed 17 CFR 240.15Fh-3(f), SEC's proposed rules, 76 FR at 42455; FINRA Rule 2111 (Suitability), 75 FR 71479, Nov. 23, 2010 (Order Approving Proposed Rule Change; File No. SR-FINRA-2010-039).

exclusion in proposed § 23.434 was unnecessary and potentially confusing to the extent that it could be read to contain the only types of information that would be outside the scope of the suitability rule. The Commission agrees with the commenters that stated that major swap participants are unlikely, in the normal course of arm's length transactions, to be making recommendations to counterparties and has removed major swap participants from the final rule. This determination is consistent with Section 4s(h)(4), which does not impose on major swap participants the same "acts as an advisor" to a Special Entity duty as it does on swap dealers.[532]

In response to the comments it received, the Commission is providing additional guidance as to the meaning of the term "recommendation" in the final suitability rule and adding Appendix A to subpart H, which clarifies the term and provides guidance as to compliance with the final rule.[533] Final § 23.434 requires a swap dealer that makes a "recommendation" to a counterparty to have a reasonable basis for believing that the recommended swap or trading strategy involving swaps is suitable for the counterparty. While the determination of whether a swap dealer has made a recommendation that triggers a suitability obligation will turn on the facts and circumstances of the particular situation, there are certain factors the Commission will consider in reaching such a determination. The facts and circumstances determination of whether a communication is a "recommendation" requires an analysis of the content, context, and presentation of the particular communication or set of communications. The determination of whether a "recommendation" has been made, moreover, is an objective rather than a subjective

[532] One commenter disagreed with removing major swap participants from the suitability requirement. The commenter reasoned that, if a major swap participant makes a recommendation, the rule would provide protection for counterparties, but would not otherwise be burdensome if they do not make recommendations. See CFA/AFR Aug. 29 Letter, at 21-25. Notwithstanding the commenter's view, the Commission has determined, in light of the definition of major swap participant and the nature of its business, to remove major swap participants from the suitability requirement.

[533] Appendix A to subpart H provides guidance as to the meaning of the term recommendation as used in § 23.434 and § 23.440(a)–Acts as an Advisor to a Special Entity. The appendix also provides guidance related to the safe harbors for compliance with each final rule.

inquiry. An important factor in this regard is whether, given its content, context, and manner of presentation, a particular communication from a swap dealer to a counterparty reasonably would be viewed as a "call to action," or suggestion that the counterparty enter into a swap.[534] An analysis of the content, context, and manner of presentation of a communication requires examination of the underlying substantive information transmitted to the counterparty and consideration of any other facts and circumstances, such as any accompanying explanatory message from the swap dealer.[535]

Additionally, the more individually tailored the communication to a specific counterparty or a targeted group of counterparties about a swap, group of swaps or trading strategy involving the use of a swap, the greater the likelihood that the communication may be viewed as a "recommendation." For example, a "flip book" or "pitch book" that sets out a customized transaction tailored to the needs or characteristics of a specific counterparty will likely be a recommendation. In contrast, general marketing materials, without more, are unlikely to constitute a recommendation. Further, simply complying with the requirements of the business conduct standards (e.g., verification of ECP or Special Entity status, disclosures of material information, scenario analysis, disclosure of the daily mark, etc.), without more, would not cause a swap dealer to be deemed to have made a recommendation.

This formulation of "recommendation" is consistent with the institutional suitability obligation imposed on federally regulated banks acting as broker-dealers and making recommendations for government securities to institutional customers, FINRA guidance on

[534] Cf. proposing release, 75 FR at 80647 fn. 81 (citing NASD Notice to Members 01-23 (April 2001) and FINRA Proposed Suitability Rule, 75 FR 52562, 52564-69, Aug. 26, 2010).

[535] For example, if a swap dealer transmitted a research report to a counterparty at the counterparty's request, that communication would not be subject to the suitability obligation; whereas, if the same swap dealer transmitted the very same research report with an accompanying message, either oral or written, that the counterparty should act on the report, the analysis would be different.

determining whether a recommendation has been made in the suitability context for broker-dealers recommending securities, and the SEC's proposed rules and the federal securities laws on suitability requirements.[536] Further, DOL confirms that it does not view compliance with the Commission's business conduct standards rules, including the suitability requirement, to cause swap dealers transacting with ERISA plans to become fiduciaries to those plans.[537] The Commission also confirms that compliance with the suitability duty would not cause a swap dealer to owe fiduciary duties to its counterparty, including a Special Entity.

The Commission has considered commenters' statements about the potential costs of proposed § 23.434. With respect to concerns that the suitability requirement could chill communications or spawn vexatious litigation, the Commission notes that the final rule aims to minimize costs by allowing swap dealers to satisfy their due diligence duty "to have or obtain information about the counterparty" including its investment profile, trading objectives, and ability to absorb potential losses by relying on the representations from such counterparty consistent with final § 23.402(d).[538] Furthermore, the Commission is clarifying in this adopting release and in Appendix A to subpart H that, final § 23.434(b) establishes a safe harbor whereby a swap dealer will satisfy its counterparty-specific duty under § 23.434(a)(2) through the exchange of certain written representations between the swap dealer and the counterparty as

[536] See, e.g., 12 CFR 13.4 (Office of the Comptroller of the Currency regulation for banks recommending government securities to customers); FINRA Rule 2111 (Suitability), 75 FR 71479; SEC's proposed rules, 76 FR at 42455.

[537] See Section II.B. of this adopting release for a discussion of "Regulatory Intersections–Department of Labor ERISA Fiduciary Regulations."

[538] The Commission notes, regarding counterparty-specific suitability, that reasonable diligence would include, for example, assessing whether a recommendation would expose a hedger to risks that are greater than those they seek to hedge. See CFA/AFR Feb. 22 Letter, at 20. Reasonable diligence to determine suitability of a bespoke swap might include, as suggested by commenters and depending on the facts and circumstances, consideration of hedge equivalents, evaluations of liquidity, or added price for embedded lines of credit. See Better Markets Feb. 22 Letter, at 4-7; Better Markets June 3 Letter, at 13. Depending on the facts and circumstances, a violation of the suitability duty may also violate other rules, including the anti-fraud and fair dealing rules.

provided in § 23.434(c). The Commission further clarifies the types of representations that would satisfy the requirements of final § 23.402(d) (Reasonable Reliance on Representations) in the context of the final suitability rule in § 23.434.

A swap dealer may rely on representations to obtain information about the counterparty when complying with the counterparty-specific suitability obligation in § 23.434(a)(2). For example, to obtain information about the counterparty's "ability to absorb potential losses associated with the recommended swap or trading strategy," the swap dealer could rely on the counterparty's representation that it has a risk management program and/or hedging policy to manage and monitor its ability to absorb potential losses, and that it has complied in good faith with its policies and procedures for diligent review of and compliance with its risk management program and/or hedging policy.

Alternatively, a swap dealer could satisfy the safe harbor requirements in § 23.434(b) to satisfy the counterparty-specific suitability obligation. Final § 23.434(b)(1) requires the swap dealer to assess whether the counterparty is capable of evaluating, independently, the risks related to a particular swap or swap trading strategy. To make its assessment, the swap dealer may rely on a counterparty's representations as provided in § 23.434(c). Final § 23.434(c)(1) describes the types of representations a swap dealer may rely on with respect to any counterparty other than a Special Entity, and § 23.434(c)(2) describes the types of representations a swap dealer may rely on with respect to a Special Entity. Final § 23.434(c)(1) provides that a swap dealer will satisfy § 23.434(b)(1)'s requirement with respect to a counterparty other than a Special Entity if it receives representations that the counterparty has complied in good faith with its policies and procedures that are reasonably designed to ensure that the persons responsible for evaluating the recommendation and making trading decisions on behalf of the counterparty are

capable of doing so. Final § 23.434(c)(2) provides that a swap dealer will satisfy § 23.434(b)(1)'s requirement with respect to a Special Entity if it receives representations that satisfy the terms of § 23.450(d) regarding a Special Entity's qualified independent representative.[539]

To satisfy the safe harbor in § 23.434(b), the final rule provides that the swap dealer and counterparty must exchange representations that: (1) The counterparty is capable of independently evaluating investment risks with regard to the recommended swap, (2) the counterparty is exercising independent judgment and is not relying on the recommendation of the swap dealer, (3) the swap dealer is acting as a counterparty and is not undertaking to assess the suitability of the swap or trading strategy involving a swap for the customer, and (4) in the case of a counterparty that is a Special Entity, the swap dealer complies with § 23.440 where the recommendation would cause the swap dealer to act as an advisor to a Special Entity within the meaning of § 23.440(a).[540]

The Commission believes that this approach will lower the costs of compliance that would result from a requirement that a swap dealer must always conduct counterparty-specific due diligence while encouraging counterparties that choose to make representations consistent with the final rule to have policies and procedures to ensure that they have their own advisors that are able to assess recommendations and make appropriate determinations as to suitability. To further address commenters' concerns about the potential burden of compliance on swap dealers, the Commission clarifies that there is no duty to look behind such representations in the absence of

[539] See Section IV.C.3.e. at fn. 867 and accompanying text for a discussion of § 23.450(d).

[540] Prong (4) of the safe harbor clarifies that § 23.434's application is broader than § 23.440–Requirements for swap dealers acting as advisors to Special Entities. Final § 23.434 is triggered when a swap dealer recommends any swap or trading strategy that involves a swap to any counterparty. However, § 23.440 is limited to a swap dealer's recommendations (1) to a Special Entity (2) of swaps that are tailored to the particular needs or characteristics of the Special Entity. See Section IV.B.3.a. at fn. 697 and accompanying text. Thus, a swap dealer that recommends a swap to a Special Entity that is tailored to the particular needs or characteristics of the Special Entity may comply with its suitability obligation by satisfying the safe harbor in § 23.434(b); however, the swap dealer must also comply with § 23.440 in such circumstances.

"red flags." In this context, the Commission interprets "red flags" to mean information known by the swap dealer that would cause a reasonable person to question the accuracy of the representation.

Commenters requested that the Commission allow swap dealers to rely on representations made on a relationship basis (i.e., written representations in counterparty relationship documentation) rather than requiring a representation be made on a transaction-by-transaction basis. The Commission agrees and believes this approach addresses the needs that some market participants have to enter into recommended transactions in short time frames. Where such representations are made in counterparty relationship documentation, the documentation must comply with final § 23.402(d) and may be deemed renewed with each recommendation.

The Commission has determined not to adopt suggestions from commenters that it exclude certain classes of "sophisticated" counterparties from the protection of final § 23.434. Nevertheless, with respect to the counterparty-specific suitability duty, the swap dealer will be able to rely on appropriate representations from "sophisticated" counterparties to satisfy the duty. The Commission stresses that the representations relied upon by the swap dealer in all cases must be documented in a manner that allows the Commission to assess compliance with the final suitability rule.

In all cases, to meet the requirements of final § 23.434, a swap dealer must undertake reasonable diligence to understand the swap that it is recommending. In general, what constitutes reasonable diligence will vary depending on, among other things, the complexity of, and risks associated with, the swap or swap trading strategy and the swap dealer's familiarity with the swap or swap trading strategy. At a minimum, a swap dealer's reasonable diligence must provide it with an understanding of the potential risks and rewards associated with the recommended

swap or swap trading strategy. A swap dealer that lacks this understanding would not be able to meet its obligations under § 23.434(a)(1).

These clarifications regarding how the Commission intends to apply the suitability requirement are designed to address many of commenters' statements, including that the Commission should ensure consistency with the approach proposed by the SEC and the long-standing guidance provided by FINRA.[541] In so doing, the Commission states its intention to be guided, but not controlled, by precedent arising under analogous SRO rules.[542]

IV. Final Rules for Swap Dealers and Major Swap Participants Dealing with Special Entities

Swap dealers and major swap participants are also subject to certain business conduct standards rules when dealing with particular counterparties that are defined as Special Entities. This section of the adopting release discusses § 23.401(c)–Definition of the term Special Entity; § 23.440–Requirements for swap dealers acting as advisors to Special Entities; § 23.450–Requirements for swap dealers and major swap participants acting as counterparties to Special Entities; and § 23.451–Political contributions by certain swap dealers.

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

1. Section 23.401–Proposed Definition of "Special Entity"

Section 4s(h)(2)(C) and proposed § 23.401 defined 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; (iv) any governmental plan, as defined in Section 3 of ERISA; or (v) any endowment, including an endowment that is

[541] See SEC's proposed rules, 76 FR at 42415 fn. 133.
[542] See, e.g., NASD Notice to Members 01-23 (April 2001) (discussing what constitutes a "recommendation); see also FINRA Rule 2111 (suitability).

an organization described in Section 501(c)(3) of the Internal Revenue Code of 1986.[543]

2. Comments

a. State and Municipal Special Entities

One commenter requested the Commission clarify whether the proposed definition was intended to include instrumentalities of a State or municipality or a public corporation.[544] The commenter noted that proposed § 23.450(b) (Requirements for a Special Entity's representative) and proposed § 23.451 (Political contributions by certain swap dealers and major swap participants) referenced "municipal entities," which included any agency, authority or instrumentality of a State or political subdivision of a State.[545]

b. Employee Benefit Plans and Governmental Plans

Section 4s(h)(2)(C)(iii) refers to any employee benefit plan "as defined in" Section 3 of ERISA. Section 3 of ERISA, however, defines "employee benefit plan" broadly and also defines several subcategories of employee benefit plans that are excluded from regulation under Title I of ERISA, including "governmental plans," which are referenced in Section 4s(h)(2)(C)(iv).

Some commenters requested that the final rule clarify that prong (iii) of the Special Entity definition only include employee benefit plans that are "subject to," i.e., regulated under, Title I of ERISA.[546] Commenters stated that the "employee benefit plan" prong should be read narrowly and only include those plans "subject to" ERISA because Congress included a separate prong (iv) for "governmental plans" that are "defined in" Section 3 of ERISA, but not "subject to"

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[543] Proposing release, 75 FR at 80649 and 80657.
[544] APGA Feb. 22 Letter, at 2.
[545] Id.; see proposed §§ 23.450(b)(8) and 23.451(a)(3), proposing release, 75 FR at 80660-61.
[546] See, e.g., SIFMA/ISDA Feb. 17 Letter, at 30 fn. 70 (asserting that other than U.S. governmental plans, the Special Entity definition should exclude (1) unfunded plans for highly compensated employees, (2) foreign pension plans, (3) church plans that have elected not to be subject to ERISA, and (4) Section 403(b) plans that accept only employee contributions).

ERISA.[547] Commenters also asserted that the Commission should exclude foreign pension plans from the Special Entity definition[548] and that such an exclusion would be consistent with congressional intent and would avoid conflicts with foreign law.[549]

Other commenters asserted that the Commission should not limit or exclude any governmental plans such as retirement and deferred compensation plans.[550] Another commenter stated that church plans and church benefit boards that are "defined in" Section 3 of ERISA but not "subject to" ERISA should be included within the Special Entity definition.[551] The commenter also asserted that the Commission should avoid legal uncertainty for employee benefit plans that are "defined in" but not "subject to" ERISA, such as church plans and church benefit boards, and permitting such plans to opt in to the Special Entities provisions of the business conduct standards rules would be a preferable approach.[552]

c. Master Trusts

Two commenters asserted that the Commission should clarify that the definition of "Special Entity" should encompass master trusts holding the assets of one or more employee benefit plans of a single employer.[553] Another commenter suggested that the definition apply to any trust that holds the assets of employee benefit plans sponsored by the same employer or related

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[547] SIFMA/ISDA Feb. 17 Letter, at 30; CPPIB Feb. 22 Letter, at 3; OTPP Feb. 22 Letter, at 2.
[548] See SIFMA/ISDA Feb. 17 Letter, at 30; ASF Feb. 22 Letter, at 2-3; OTPP Feb. 22 Letter, at 2; AMG-SIFMA Feb. 22 Letter, at 13 fn. 44; see also Societe Generale Feb. 18 Letter, at 12; Barclays Jan. 11 Letter, at 9 fn. 9.
[549] CPPIB Feb. 22 Letter, at 3-4.
[550] CFA/AFR Feb. 22 Letter, at 14-15; AFSCME Feb. 22 Letter, at 5.
[551] Church Alliance Feb. 22 Letter, at 4-5; Church Alliance Aug. 29 Letter, at 3-4.
[552] Church Alliance Oct. 4 Letter, at 2 (also asserting that a "church benefit board" is an organization described in Section 3(33)(C)(i) of ERISA).
[553] BlackRock Feb. 22 Letter, at 7; SIFMA/ISDA Feb. 17 Letter, at 30; see also Church Alliance Feb. 22 Letter, at 5 ("Church benefit boards may also be likened to a master trust that is established by several multiple-employer pension plans.").

employers.[554] These commenters assert that employers that maintain multiple employee benefit plans often pool their assets into a single trust called a "master trust" for efficiency purposes.[555] The commenters also assert that the Special Entity provisions of the business conduct standards rules should apply with respect to the master trust and not on a plan-by-plan basis, which would be burdensome and negate some efficiencies achieved by a master trust.[556]

d. Endowments

Section 4s(h)(2)(C)(v) refers to "any endowment, including an endowment that is an organization described in Section 501(c)(3)[557] of the Internal Revenue Code of 1986." One commenter recommended the Commission err on the side of inclusiveness and include charitable organizations as Special Entities.[558] Other commenters recommended that the Commission clarify that the endowment prong of the Special Entity definition is limited to when an endowment itself enters into swaps, but does not include non-profit or charitable organizations that enter into swaps, even where such an organization has an endowment.[559] One such commenter asserted that the Commission should clarify that prong (v) does not include non-profit organizations that enter into swaps to hedge operational risks, such as interest rate risk in connection with a bond offering, that is unrelated to its endowment's investment fund.[560] Additionally, one commenter stated that the Special Entity definition should not apply to foreign

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[554] ERIC Feb. 22 Letter, at 2 and 4-5 (asserting that the assets of an employee benefit plan subject to ERISA generally must be held in trust and, although the trust is a separate entity from the plan, the trust exists solely to hold and invest the assets of the plan).
[555] See ERIC Feb. 22 Letter, at 4-5.
[556] See, e.g., ERIC Feb. 22 Letter, at 5.
[557] Section 501(c)(3) of the Internal Revenue Code of 1986 exempts from federal taxes: "Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition . . . or for the prevention of cruelty to children or animals, no part of the net earnings of which inure to the benefit of any private shareholder or individual . . . ." 26 U.S.C. 501(c)(3).
[558] CFA/AFR Feb. 22 Letter, at 14.
[559] SFG Feb. 22 Letter, at 2-3; SIFMA/ISDA Feb. 17 Letter, at 30-31; NACUBO Feb. 22 Letter, at 1 fn. 2.
[560] SFG Feb. 22 Letter, at 2-3.

endowments or foreign entities generally.[561]

e. Collective Investment Vehicles: The "look through" Issue

DOL has a look through test for entities that have ERISA plan investors, such as collective investment vehicles, to determine whether the person operating the entity will be treated as an ERISA fiduciary with respect to the invested plan assets.[562] Collective investment vehicles, such as commodity pools and hedge funds, typically include a variety of investors and may include organizations that fall within the Special Entity definition set forth in Section 4s(h)(2)(C). Because the statutory definition of Special Entity uses ERISA's definition of "employee benefit plan," commenters requested clarification of whether the Commission will apply a "look through" test like DOL's to collective investment vehicles for purposes of the business conduct standards rules.

The Commission also received several comments regarding collective investment vehicles and whether they should be included within the Special Entity definition.[563] The majority of commenters who addressed this issue were opposed to the Commission adopting a DOL-type "look through" test for collective investment vehicles.[564] One commenter asserted that investment vehicles that hold plan assets should not be provided relief from the business conduct standards.[565] Certain commenters asserted that the omission of collective investment vehicles

[561] Barclays Jan. 11 Letter, at 9 fn. 9.
[562] 29 CFR 2510.3-101. If plans subject to ERISA own 25% or more of the assets of a collective investment vehicle, any person who exercises authority or control respecting the management or disposition of the vehicle's underlying assets, and any person who provides investment advice with respect to such assets for a fee, is a fiduciary to the investing ERISA plans.
[563] See, e.g., AMG-SIFMA Feb. 22 Letter, at 12-13; BlackRock Feb. 22 Letter, at 7; ABC/CIEBA Feb. 22 Letter, at 14; ASF Feb. 22 Letter, at 3-6; MFA Feb. 22 Letter, at 6-7; SIFMA/ISDA Feb. 17 Letter, at 29-30; AFSCME Feb. 22 Letter, at 5; Church Alliance Feb. 22 Letter, at 4-5. See also Church Alliance Oct. 4 Letter, at 3-6 (recommending that church benefit boards be allowed to opt in to Special Entity status).
[564] See, e.g., AMG-SIFMA Feb. 22 Letter, at 12-13; BlackRock Feb. 22 Letter, at 7; ABC/CIEBA Feb. 22 Letter, at 14; ASF Feb. 22 Letter, at 3-6; MFA Feb. 22 Letter, at 6-7; SIFMA/ISDA Feb. 17 Letter, at 29-30.
[565] AFSCME Feb. 22 Letter, at 5.

from the definition of Special Entity in the text of the Dodd-Frank Act was determinative of congressional intent.[566] Other commenters pointed out that the statute addressed only direct counterparty relationships and not the indirect collective investment vehicle situation.[567] In addition, it was argued that, because collective investment vehicles include non-ERISA investors, extending the definition would inappropriately cover investors who do not want or need Special Entity protection.[568]

Further, from a pragmatic standpoint, one commenter maintained that it would be highly impractical to discharge heightened duties on the broad range of investors that participate in such vehicles and expressed concern that proposed suitability and diligence requirements would be problematic under a "look through" regime.[569] The commenter suggested that heightened standards for collective investment vehicles would inappropriately subject those vehicles and their investors to increased costs, decreased efficiency and execution delays, and a "look through" provision could limit Special Entities' non-swap investment options.[570] Other commenters believed collective investment vehicle managers would either limit or prohibit investments by Special Entities to avoid limitations on their swap trading activities.[571] Such managers may be concerned that other non-Special Entity investors may redeem or not invest if they believe the fund may be subject to restrictions on trading due to investments by Special Entities.[572]

3. Final § 23.401(c) Special Entity Definitions

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[566] See, e.g., AMG-SIFMA Letter, at 12; ASF Feb. 22 Letter, at 3-6; BlackRock Feb. 22 Letter, at 7.
[567] MFA Feb. 22 Letter, at 6-7; SIFMA/ISDA Feb. 17 Letter, at 29-30; BlackRock Feb. 22 Letter, at 7.
[568] See, e.g., SIFMA/ISDA Feb. 17 Letter, at 30.
[569] AMG-SIFMA Feb. 22 Letter, at 12.
[570] Id., at 13.
[571] See, e.g., ASF Feb. 22 Letter, at 4; AMG-SIFMA Feb. 22 Letter, at 13; MFA Feb. 22 Letter, at 6-7.
[572] See AMG-SIFMA Feb. 22 Letter, at 13.

The Commission has considered the comments and congressional intent, and has determined to clarify the scope of the Special Entity definitions and further refine prongs (ii) and (iii) of Section 4s(h)(2)(C).[573] For prong (ii), the Commission has determined to clarify that the definition of State and political subdivisions of a State includes instrumentalities, agencies or departments of States or political subdivisions of a State. For prong (iii), the Commission has determined to interpret the statute to apply only to employee benefit plans subject to ERISA rather than those defined in ERISA. For plans defined in ERISA but not otherwise covered by the Special Entity definition, the Commission has determined to permit such plans to opt in to the Special Entity protections under subpart H of part 23.

a. Federal Agency

The Commission did not receive any comments on the Federal agency prong (i) of the Special Entity definition, and thus, the Commission is adopting the definition as proposed (renumbered as § 23.401(c)(1)).[574]

b. State and Municipal Special Entities

The Commission has determined to refine prong (ii) of Section 4s(h)(2)(C), State and municipal Special Entities, to clarify that it also includes "any instrumentality, agency, department, or a corporation of or established by" States or political subdivisions of a State (renumbered as § 23.401(c)(2)).[575] This clarification is consistent with the Commission's

[573] In addition to the Commission's discretionary rulemaking authority in Section 4s(h), Section 721(b)(2) of the Dodd-Frank Act provides the Commission discretionary rulemaking authority to define terms included in an amendment to the CEA made by Title VII of the Dodd-Frank Act.

[574] The definition of "swap" excludes "any agreement, contract or transaction a counterparty of which is a Federal Reserve bank, the Federal Government, or a Federal agency that is expressly backed by the full faith and credit of the United States." Section 1a(47)(B)(ix) of the CEA. Accordingly, the Commission expects that Special Entities that are Federal agencies will be a narrow category for purposes of these rules.

[575] In refining prong (ii), the Commission has considered other provisions of the CEA such as the ECP definition for governmental entities, which includes "an instrumentality, agency, or department" of a State or political subdivision of a State. See Section 1a(18)(A)(vii)(III) of the CEA.

modifications to § 23.450(b) (requirements for a Special Entity's representative) and § 23.451 (political contributions by certain swap dealers).[576] The Commission also determined that including instrumentalities, agencies, departments or corporations of or established by States or political subdivisions of a State is consistent with congressional intent to provide heightened protections for institutions backed by taxpayers.[577] In considering commenters' request for clarity on this issue, the Commission views § 23.401(c)(2) to apply broadly to State and local governmental entities that are entrusted with public funds, including public corporations.

c. Employee Benefit Plans and Governmental Plans

As a matter of statutory interpretation, Sections 4s(h)(2)(C)(iii) (employee benefit plans defined in Section 3 of ERISA) and 4s(h)(2)(C)(iv) (governmental plans defined in Section 3 of ERISA) should be construed "to avoid rendering superfluous" the statutory language.[578] Section 3(3) of ERISA defines "employee benefit plan" broadly to encompass plans, funds, or programs established or maintained by an employer or employee organization for the purpose of providing medical benefits or retirement income.[579] Section 3 of ERISA (the definitional section) also defines specific types of employee benefit plans, including governmental plans, which are excluded from regulation under ERISA by Section 4(b) (the coverage section of ERISA).[580]

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[576] See Sections IV.C. and IV.D. of this adopting release for a discussion of §§ 23.450(b)(1)(vii) and 23.451(a)(3), respectively.

[577] See Senator Lincoln floor colloquy stating that the Special Entity provisions in the Dodd-Frank Act "should help protect both tax payers and plan beneficiaries." 156 CONG. REC. S5923 (daily ed. Jul. 15, 2010) (statement of Sen. Lincoln).

[578] Astoria Fed. Sav. & Loan Assn. v. Solimino, 501 U.S. 104, 112 (1991).

[579] See generally 29 U.S.C. 1002(3) ("employee benefit plan" means an employee welfare benefit plan or an employee pension benefit plan); 29 U.S.C. 1002(1) ("employee welfare benefit plan" means a plan, fund, or program established or maintained by an employer or by an employee organization, for the purpose of providing for its participants or their beneficiaries medical, surgical, or hospital care or benefits in the event of sickness, accident, disability, death or unemployment); 29 U.S.C. 1002(2) ("employee pension benefit plan" means any plan, fund, or program established or maintained by an employer or by an employee organization that provides retirement income to employees).

[580] Section 4(b) of ERISA (29 U.S.C. 1003(b)) states that ERISA shall not apply to any employee benefit plan that is (1) a governmental plan (as defined in Section 3(32) of ERISA (29 U.S.C. 1002(32)); (2) a church plan (as defined

Therefore, Section 4s(h)(2)(C)(iii) read literally as any employee benefit plan "defined in" Section 3 of ERISA would render Section 4s(h)(2)(C)(iv) superfluous because a "governmental plan defined in section 3 of [ERISA]" is subsumed by the definition of "employee benefit plan defined in section 3 of [ERISA]."

To resolve this ambiguity, the Commission is refining the definition of "any employee benefit plan defined in section 3 of [ERISA]" in proposed § 23.401 as "any employee benefit plan subject to Title I of [ERISA]" (renumbered as § 23.401(c)(3)). This clarifies that employee benefit plans listed in Section 4(b) of ERISA (29 U.S.C. 1003(b)) are not Special Entities within the meaning of 4s(h)(2)(C)(iii) or § 23.401(c)(3). However, any employee benefit plan that is a governmental plan as defined in Section 3 of ERISA is a Special Entity within the meaning of Section 4s(h)(2)(C)(iv) and § 23.401(c)(4).

This refinement of the definition of "employee benefit plan," however, also excludes other types of employee benefit plans described in Section 4(b) of ERISA, including church plans and public and private foreign pension plans. In response to commenters who support providing protections broadly, including those commenters who assert that "a church plan should be treated as a Special Entity,"[581] the Commission has determined to add a sixth prong to the Special Entity definition. Under the new prong in § 23.401(c)(6), any employee benefit plan defined in Section 3 of ERISA, not otherwise defined as a Special Entity, may elect to be defined as a Special Entity by notifying its swap dealer or major swap participant of its election prior to entering into

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in Section 3(33) of ERISA (29 U.S.C. 1002(33)) with respect to which no election has been made to be subject to ERISA under 26 U.S.C. 410(d); (3) plans maintained solely to comply with workmen's compensation, unemployment compensation, or disability insurance laws; (4) plans maintained outside the United States primarily for the benefit of persons substantially all of whom are nonresident aliens (i.e., foreign pension plans); or (5) excess benefit plans (as defined in Section 3(36) of ERISA (29 U.S.C. 1002(36)) that are unfunded.

[581] Church Alliance Feb. 22 Letter, at 4.

a swap with the particular swap dealer or major swap participant.[582] Therefore, for example, under § 23.401(c)(6), any church plan defined in Section 3(33) of ERISA, including any plan described in Section 3(33)(C)(i), such as a church benefit board, could elect to be defined as a Special Entity.

The Commission has also considered the comments regarding the treatment of a master trust where the master trust holds the assets of more than one ERISA plan, as defined in § 23.401(c)(3), sponsored by a single employer or by a group of employers under common control.[583] In this regard, the Commission clarifies that it would not find a swap dealer or major swap participant to have failed to comply with the requirements of subpart H of part 23 of the Commission's Regulations with respect to an ERISA plan, if it otherwise complied with such requirements with respect to a master trust that holds the assets of such ERISA plan. The Commission understands that a single employer or a group of employers under common control may sponsor multiple ERISA plans that are combined into a master trust to achieve economies of scale and other efficiencies. In such cases, the Commission does not believe that any individual ERISA plan within the master trust would receive any additional protection if the swap dealer or major swap participant had to separately comply with requirements of subpart H of part 23 with respect to each ERISA plan whose assets are held in the master trust.

d. Endowment

The Commission agrees with commenters that the Special Entity prong with respect to

[582] This construction is similar to that of Section 4(b)(2) of ERISA, which excludes church plans unless the church plan has elected to be subject to ERISA. (29 U.S.C. 1003(b)(2)).

[583] See generally Section 403(a) of ERISA (in general, "assets of an employee benefit plan shall be held in trust by one or more trustees") (29 U.S.C. 1103(a)); see also DOL Regulation 29 CFR 2520.103-1(e) (requiring the plan administrator of a Plan which participates in a master trust to file an annual report on IRS Form 5500 in accordance with the instructions for the form relating to master trusts); see also IRS Form 5500 Instructions, at 9 ("For reporting purposes, a 'master trust' is a trust . . . in which the assets of more than one plan sponsored by a single employer or by a group of employers under common control are held.").

endowments is limited to the endowment itself. Therefore, the endowment prong of the Special Entity definition under Section 4s(h)(2)(C)(v) and § 23.401(c)(5) applies with respect to an endowment that is the counterparty to a swap with respect to its investment funds. The definition would not extend to counterparties that are charitable organizations generally. Additionally, where a charitable organization enters into a swap as a counterparty, the Special Entity definition would not apply where the organization's endowment is contractually or otherwise legally obligated to make payments on the swap. The Commission believes that this determination is consistent with a plain reading of the statute and is consistent with the Commission's determination regarding Special Entities and collective investment vehicles. Finally, the statute does not distinguish between foreign and domestic counterparties in Section 4s(h). Therefore, the Commission has determined that prong (v) of Section 4s(h)(2)(C) and § 23.401(c)(5) will apply to any endowment, whether foreign or domestic.

e. Collective Investment Vehicles: The "look through" Issue

The Commission has determined as a matter of statutory interpretation of Section 4s(h) that the definition of Special Entity does not include collective investment vehicles that have Special Entity participants. While DOL rules "look through" collective investment vehicles to determine whether the managers and advisors of those vehicles that received plan assets should be subject to ERISA's fiduciary rules, there is no indication that Congress intended the Commission to "look through" collective investment vehicles to apply the Dodd-Frank Act Special Entity protections.[584] Given that the statutory definition of Special Entity does not mention collective investment vehicles, the Commission is not convinced that extending the Dodd-Frank Act definition of Special Entities to collective investment vehicles based on a DOL-type look

[584] However, nothing in the Dodd-Frank Act or the business conduct standards rules would affect the application of the ERISA look-through requirements.

through test is appropriate or necessary.[585]

Moreover, collective investment vehicles that trade swaps, known as commodity pools,[586] generally are operated by CPOs and traded by CTAs, which some courts have held owe a fiduciary duty to the pool and pool participants.[587] Therefore, treating collective investment vehicles as Special Entities if they receive investment funds from Special Entities would not materially enhance the protections afforded to such pool participants, but likely would create administrative burdens for swap dealers and major swap participants seeking to determine those pool participants' Special Entity status.

B. Section 23.440–Requirements for Swap Dealers Acting as Advisors to Special Entities

1. Proposed § 23.440

Proposed § 23.440 follows the statutory framework in Section 4s(h)(4)(B) of the CEA, which imposes a duty on any swap dealer that "acts as an advisor to a Special Entity" to "act in the best interests of the Special Entity." Section 4s(h)(4)(C) also requires any swap dealer that "acts as an advisor to a Special Entity" to "make reasonable efforts to obtain such information as is necessary to make a reasonable determination that any swap recommended by the swap dealer is in the best interests of the Special Entity . . . ." The terms "act as an advisor to a Special Entity," "best interests," "make reasonable efforts" and "recommended" are not defined in the statute.

Proposed § 23.440(a) defined the term "acts as an advisor to a Special Entity" and stated the

[585] The Commission clarifies, however, that this analysis is not intended to apply with respect to a master trust that holds the assets of more than one ERISA plan, as defined in § 23.401(c)(3), which includes a master trust in which the assets of more than one plan sponsored by a single employer or by a group of employers under common control are held. This determination is based on the language of Section 4s(h) of the CEA and ERISA's treatment of master trusts as subject to regulation under ERISA, and is consistent with the unanimous position of the comments received. Thus, the Commission would consider such a master trust to be a Special Entity within the meaning of § 23.401(c)(3).

[586] Section 1a(10) of the CEA (7 U.S.C. 1a(10)).

[587] See, e.g., Commodity Trend Serv., Inc. v. CFTC, 233 F.3d 981 (7th Cir. 2000); Savage v. CFTC, 548 F.2d 192 (7th Cir. 1977).

term "shall include where a swap dealer recommends a swap or trading strategy that involves the use of swaps to a Special Entity."[588] Under proposed § 23.440(a)(1)-(2), the term does 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 a Special Entity.[589] The Commission also discussed the meaning of the term "recommendation" in the preamble to proposed § 23.434–Recommendations to counterparties–institutional suitability.[590]

Proposed § 23.440(b)(1) restated the statutory duty to "act in the best interests" but did not define the term "best interests."[591] The proposing release clarified that the meaning of the term would be informed by "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 "best interests" 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 . . . ."[592] The proposing release also stated that best interests principles would impose affirmative duties "to employ reasonable care that any recommendation

[588] Proposing release, 75 FR at 80650 and 80659.
[589] The exclusions in proposed § 23.440(a)(1)-(2) for general transaction, financial or market information and swap terms in response to a competitive bid request are consistent with the exclusions in proposed § 23.434(c)(2)–Recommendations to counterparties-institutional suitability. Proposing release, 75 FR at 80647-48 and 80659.
[590] In the proposing release, the Commission stated that whether a recommendation has been made depends on the facts and circumstances of the particular case, and includes 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, 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. Proposing release, 75 FR at 80647. See id. at 80647 and fn. 81 (citing SRO guidance – NASD Notice to Members 01-23 (April 2001) – interpreting the meaning of the term "recommendation" in the context of a securities suitability obligation). See Sections III.G. and IV.B. of this adopting release for a discussion of final §§ 23.434 and 23.440, respectively, and Appendix A to subpart H of part 23 for clarification of the term "recommendation."
[591] Proposing release, 75 FR at 80650 and 80659.
[592] Id., at 80650 fn. 98 (citing similar language in SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191-94 (1963)).

made to a Special Entity is designed to further the purposes of the Special Entity."[593]

The proposing release explained that the statutory language in Sections 4s(h)(4) and (5) and congressional intent guided the proposal. The proposal would permit a swap dealer to both recommend a swap to a Special Entity, prompting the duty to act in the best interests, and then enter into the same swap with the Special Entity as a counterparty if the Special Entity had a representative independent of the swap dealer on which it could rely.[594] Finally, the proposing release stated that Sections 4s(h)(4) and (5) of the CEA and proposed rules §§ 23.440 and 23.450, together, were "intended to allow existing business relationships to continue, albeit subject to the new, higher statutory standards of care."[595]

The proposed rule restated the duty in Section 4s(h)(4)(C) that "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 recommend by the swap dealer is in the best interests of the Special Entity."[596] The statute also states that "such information" includes information relating to (1) the financial status, (2) the tax status, and (3) the investment or financing objectives of the Special Entity.[597] The statute also grants the Commission discretionary authority to prescribe additional types of information to satisfy the "reasonable efforts" and "best interests" standards.[598] As a result, the Commission proposed that the swap dealer also be required to make reasonable efforts to obtain the following information: (1) The authority of the Special Entity to enter into a swap; (2) the experience of the Special Entity with respect to entering into swaps; (3) whether the Special Entity has a representative as provided in

[593] Id.
[594] Id., at 80650 fn. 99 (citing 156 CONG. REC. S5923 (daily ed. Jul. 15, 2010) (statement of Sen. Lincoln)).
[595] Id., at 80650.
[596] Proposed § 23.440(b)(2); proposing release, 75 FR at 80659-60.
[597] Section 4s(h)(4)(C)(i)-(iii) of the CEA.
[598] Section 4s(h)(4)(C)(iv) of the CEA.

proposed § 23.450(b); (4) whether the Special Entity has the financial capability to withstand potential market-related changes in the value of the swap; and (5) such other information as is relevant to the particular facts and circumstances of the Special Entity.[599]

Proposed § 23.440(c) allowed a swap dealer to rely on the Special Entity's written representations to satisfy its duty to "make reasonable efforts to obtain information" under proposed § 23.440(b). The proposed rule required a swap dealer to have 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.[600] The representations had to be sufficiently detailed.[601]

2. Comments

The Commission received a significant number of comments regarding proposed § 23.440. The commenters raised a range of issues, including: What types of activities should fall within the scope of the rule; the definitions of the terms "act as an advisor to a Special Entity" and "best interests"; whether Special Entities should be allowed to opt out of the protections; safe harbors for compliance; intersections with the CTA, ERISA fiduciary, investment adviser, and municipal advisor statutory and regulatory provisions; and the potential costs and benefits to swap dealers and Special Entities. The Commission also received late-filed comments comparing its proposed approach with the SEC's proposed approach to "acts as an advisor to a Special Entity" for SBS Dealers.

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[599] Proposing release, 75 FR at 80650.
[600] Id., at 80660.
[601] See proposed § 23.440(c)(2) requiring representations to be sufficiently detailed for the swap dealer to reasonably conclude that the Special Entity is (1) capable of evaluating independently the material risk inherent in the recommendation, (2) exercising independent judgment in evaluating the recommendation, and (3) capable of absorbing potential losses related to the recommended swap. Proposing release, 75 FR at 80660. The criteria in paragraph (c)(2) parallel and were modeled on the three criteria in § 23.434(b)(1)-Recommendations to counterparties–institutional suitability. Id., at 80659.

A few commenters supported the Commission's proposed interpretation of Section 4s(h)(4)(B)-(C) and proposed § 23.440.[602] The overwhelming majority of commenters, however, raised concerns with the proposed rule and requested that the Commission further clarify the meaning of "acts as an advisor to a Special Entity."[603]

a. Scope of the Proposed "Acts as an Advisor to a Special Entity" and "Recommendation" Definitions

Commenters generally discussed the following issues: (1) Congressional intent regarding the meaning of "acts as an advisor to a Special Entity"; (2) the definition of "advice" or "recommendation"; (3) whether activities other than advice or recommendations would trigger application of proposed § 23.440; (4) whether compliance with other business conduct standards would trigger proposed § 23.440; and (5) whether to permit an opt out or create a safe harbor for swap dealers dealing with Special Entities that meet certain criteria.

The Commission received several comments discussing whether proposed § 23.440 was consistent with congressional intent and Section 4s(h)(4). Some commenters stated that "recommendations" were an appropriate trigger for proposed § 23.440 and consistent with congressional intent.[604] Other commenters stated that proposed § 23.440 was inconsistent with or went beyond congressional intent.[605] One commenter stated that Congress sought to establish a

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[602] See, e.g., CFA/AFR Feb. 22 Letter, at 15-16; AFSCME Feb. 22 Letter, at 2-5; CFA/AFR Nov. 3 Letter, at 1.

[603] See, e.g., APGA Feb. 22 Letter, at 3-5; APPA/LPPC Feb. 22 Letter, at 3; CalSTRS Feb. 28 Letter, at 3-5; CEF Feb. 22 Letter, at 16; GFOA Feb. 22 Letter, at 1-2; HOOPP Feb. 22 Letter, at 2-3; NACUBO Feb. 22 Letter, at 2-4; Ropes & Gray Feb. 22 Letter, at 2-3; Russell Feb. 18 Letter, at 1; SIFMA/ISDA Feb. 17 Letter, at 31-35; ERIC Feb. 22 Letter, at 13-16; SWIB Feb. 22 Letter, at 2-4; Texas VLB Feb. 22 Letter, at 1-2; and U. Tex. System Feb. 22 Letter, at 1-3.

[604] See, e.g., AFSCME Feb. 22 Letter, at 2-3; CFA/AFR Feb. 22 Letter, at 14-15 and 19 (the goal of the statute was to ensure that swap dealers would act in the best interest of more vulnerable counterparties when providing advice and making recommendations).

[605] See, e.g., VRS Feb. 22 Letter, at 5 (Congress did not intend for the Commission to impose duties on a relationship that is potentially principal-to-principal); SIFMA/ISDA Feb. 17 Letter, at 4 (Congress intended parties to a swap to clarify the nature of their relationship, and not to transform the nature of their relationship, noting the

clear, bright line between swap dealers that are advisors under Section 4s(h)(4) and those that are merely counterparties under Section 4s(h)(5).[606] Other commenters asserted that the proposed rule imposed a fiduciary status on swap dealers, a result that Congress expressly rejected in the legislative history of the Dodd-Frank Act.[607]

Several commenters stated that the Commission's description of "recommendation" in the proposed rule was too broad and would inappropriately limit communications between swap dealers and Special Entities.[608] Similarly, some commenters stated that the rule creates a very low bar for tripping the "best interests" standard and would often apply in the normal course of interactions between swap dealers and Special Entities.[609] Commenters asserted that a swap dealer that prepares a term sheet and recommends a swap for consideration is not necessarily providing advice as to whether or not to enter into the transaction.[610] Another commenter asserted that the term "recommends" has the potential to be vastly expansive and should not extend to marketing activities.[611] A number of commenters asserted that the enumerated exclusions from the term "acts as an advisor to a Special Entity" are too narrow and overlook

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provision in 4s(h)(5)(A)(ii) that requires a swap dealer that offers to enter or enters into a swap with a Special Entity to disclose its capacity before initiation of the transaction); APPA/LPPC Feb. 22 Letter, at 3 (the Dodd-Frank Act does not mandate a "recommendation" standard for the acts as an advisor provision); Ropes & Gray Feb. 22 Letter, at 2 (the statute should be triggered when the dealer assumes a status, rather than simply performing a single act, and the phrase "acts as an advisor" intends a more formal relationship than providing advice); CalSTRS Feb. 28 Letter, at 4 (impairing Special Entities' access to derivatives markets was contrary to congressional intent).

[606] SIFMA/ISDA Feb. 17 Letter, at 4 fn. 11.

[607] See BlackRock Feb. 22 Letter, at 2; AMG-SIFMA Feb. 22 Letter, at 6 fn. 16.

[608] See, e.g., SIFMA/ISDA Feb. 17 Letter, at 2; SWIB Feb. 22 Letter, at 2-4; NACUBO Feb. 22 Letter, at 2; U. Tex. System Feb. 22 Letter, at 1-2.

[609] See, e.g., U. Tex. System Feb. 22 Letter, at 2; Russell Feb. 18 Letter, at 1; GFOA Feb. 22 Letter, at 1-2; AMG-SIFMA Feb. 22 Letter, at 3; ERIC Feb. 22 Letter, at 15; ABC/CIEBA Feb. 22 Letter, at 7; SIFMA/ISDA Feb. 17 Letter, at 33 (providing specific information while negotiating a swap should not constitute advising others); cf. CFA/AFR Feb. 22 Letter, at 19-20.

[610] SIFMA/ISDA Feb. 17 Letter, at 33; cf. Russell Feb. 18 Letter, at 1.

[611] Ropes & Gray Feb. 22 Letter, at 2-3.

circumstances that should not give rise to an advisory relationship.[612]

Several commenters have stated that the Commission should clearly define activities that are recommendations or provide an alternative that clearly establishes when a swap dealer acts as an advisor to a Special Entity.[613] Commenters stated the Commission should issue guidance to clearly define when a swap dealer will be classified as an "advisor" to avoid inadvertently triggering that status.[614] Other commenters stated that the proposed rule uses subjective criteria and is unworkable.[615]

Commenters also suggested that the definition of "advice" or "recommendations" should be limited to communications that are individualized or tailored to the recipient. One commenter suggested that the "acts as an advisor to a Special Entity" definition should be limited to individualized advice based on the particular needs of the Special Entity.[616] Another commenter suggested the Commission adopt a definition of advice as "recommendations related to a swap or a swap trading strategy that are made to meet the objectives or needs of a specific counterparty after taking into account the counterparty's specific circumstances."[617] Another commenter stated that the definition of "recommendation" should turn on whether the swap dealer suggested or indicated a particular preferred course of action.[618]

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[612] See, e.g., AFSCME Feb. 22 Letter, at 3; NACUBO Feb. 22 Letter, at 2; U. Tex. System Feb. 22 Letter, at 2; Ropes & Gray Feb. 22 Letter, at 2-3; cf. SWIB Feb. 22 Letter, at 2-3 (the exclusion is too narrow because Special Entities do not always issue competitive bid requests); Texas VLB Feb. 22 Letter, at 2.
[613] See ERIC Feb. 22 Letter, at 2; CEF Feb. 22 Letter, at 17; AGPA Feb. 22 Letter, at 4; Ropes & Gray Feb. 22 Letter, at 3; Russell Feb. 18 Letter, at 1.
[614] See ERIC Feb. 22 Letter, at 15; CEF Feb. 22 Letter, at 17.
[615] See Russell Feb. 18 Letter, at 1; VRS Feb. 22 Letter, at 5; cf. Ropes & Gray Feb. 22 Letter, at 3 (a bright line test would be more appropriate than a facts-and-circumstances approach to a rule focused on the existence of a specific relationship).
[616] SIFMA/ISDA Feb. 17 Letter, at 31-32.
[617] CFA/AFR Feb. 22 Letter, at 19-20; cf. SWIB Feb. 22 Letter, at 2-3 (a swap dealer should not be acting as an advisor where it provides research and recommendations that are not specifically designed for the specific Special Entity).
[618] APGA Feb. 22 Letter, at 4 (a "recommendation" should mean a firm indication by the swap dealer of a particular preferred transaction, swap or market strategy).

Commenters also proposed alternatives to determining when a swap dealer "acts as an advisor to a Special Entity." Some commenters requested the Commission specifically exclude certain activities from the meaning of "advice" or "recommendation."[619] Commenters also suggested the Commission should look to principles of agency to determine whether a swap dealer is acting as an advisor.[620]

Commenters asserted that broad application of the term "recommends" in proposed § 23.440, which imposes a best interests duty on a swap dealer, will chill normal commercial communications, restrict customary commercial interactions, and generally reduce market information shared between swap dealers and Special Entities.[621] Commenters asserted that swap dealers will decline to propose transactions, provide term sheets or transaction-specific information tailored to the Special Entity, and will be discouraged from providing education, suggestions, or other information with respect to a current or potential transaction that is customarily provided in the normal course of the business relationship.[622]

Commenters asserted that swap dealers provide valuable information, but the broad application of the term "recommends" will preclude Special Entities from receiving this

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[619] See CEF Feb. 22 Letter, at 17 ("recommending" a swap should not apply to the negotiation or the marketing of a swap); APGA Feb. 22 Letter, at 5 (providing market color and alerting a Special Entity to a possible strategy or to new products that are being offered, even when based upon knowledge of the Special Entity's hedge positions or market strategy, should not constitute making a recommendation that causes a swap dealer to be deemed an advisor to a Special Entity); SIFMA/ISDA Feb. 17 Letter, at 33-34.

[620] See CEF Feb. 22 Letter, at 16; Ropes & Gray Feb. 22 Letter, at 2 (providing advice is a narrower category than making a mere recommendation; therefore, "acting as an advisor" should require acknowledged agency, in which the Special Entity places trust, confidence, or reliance on the swap dealer); but cf. AFSCME Feb. 22 Letter, at 3 (many non-swap dealer market participants often assume that the swap dealer is a trusted advisor and is accountable for its advice).

[621] See SIFMA/ISDA Feb. 17 Letter, at 22; APGA Feb. 22 Letter, at 3; APPA/LPPC Feb. 22 Letter, at 3; NACUBO Feb. 22 Letter, at 2; COPE Feb. 22 Letter, at 2; U. Tex. System Feb. 22 Letter, at 2; VRS Feb. 22 Letter, at 5; Ohio STRS Feb. 18 Letter, at 2-3; MHFA Feb. 22 Letter, at 2; Russell Feb. 18 Letter, at 1; BlackRock Feb. 22 Letter, at 5; AMG-SIFMA Feb. 22 Letter, at 3.

[622] See, e.g., SIFMA/ISDA Feb. 17 Letter, at 6 and 33; VRS Feb. 22 Letter, at 5; U. Tex. System Feb. 22 Letter, at 2; MHFA Feb. 22 Letter, at 2; Russell Feb. 18 Letter, at 1; APPA/LPPC Feb. 22 Letter, at 3; Ohio STRS Feb. 18 Letter, at 2-3; BlackRock Feb. 22 Letter, at 5; AMG-SIFMA Feb. 22 Letter, at 3; Texas VLB Feb. 22 Letter, at 1; NACUBO Feb. 22 Letter, at 2; AMG-SIFMA Feb. 22 Letter, at 3.

information. One commenter asserted that such communications serve an important informational function; even where the prospective counterparty's last inclination would be to follow guidance from the swap dealer, such communications can indicate where the dealer might be willing to execute before negotiation and the types of trades that are being circulated in the marketplace.[623] Other commenters added that swap dealers provide valuable information that could not easily be obtained elsewhere, and informal and course-of-business communications where market ideas and structures are presented and discussed is invaluable.[624] Other commenters asserted that the broad application of the term "recommends" will make compliance burdensome for swap dealers and will increase costs.[625] Commenters requested the Commission clarify whether activities or conduct other than making a recommendation would cause a swap dealer to "act as an advisor to a Special Entity" within the meaning of § 23.440, because language in the proposing release was ambiguous.[626] Several commenters raised concerns that compliance with other business conduct rules could cause a swap dealer to act as an advisor. Commenters identified the following examples: Providing tailored disclosures, scenario analyses, daily marks, assessing the qualifications of a Special Entity's independent representative, the general provisions of proposed § 23.402, and verification of counterparty

[623] Ropes & Gray Feb. 22 Letter, at 3

[624] U. Tex. System Feb. 22 Letter, at 2; APPA/LPPC Feb. 22 Letter, at 3, APGA Feb. 22 Letter, at 4; SWIB Feb. 22 Letter, at 3; Texas VLB Feb. 22 Letter, at 3; SFG Feb. 22 Letter, at 3; MHFA Feb. 22 Letter, at 3; ERIC Feb. 22 Letter, at 15.

[625] COPE Feb. 22 Letter, at 2-3 (swap dealers may be forced to require personnel to read from an approved script to avoid violations; such compliance will require more compliance personnel and raise swap dealer costs); Ropes & Gray Feb. 22 Letter, at 3 (compliance with the proposed rule would require the swap dealer to make difficult distinctions between general information and specific trade data).

[626] CalSTRS Feb. 28 Letter, at 3 and 5; ERIC Feb. 22 Letter, at 3, 14 and 16; see proposing release, 75 FR at 80650 ("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.").

eligibility.[627]

Several commenters discussed whether the Commission should permit the intention of the parties, rather than a functional test, to determine whether a swap dealer "acts as an advisor to a Special Entity."[628] One commenter asserted that it would be impossible under the proposed rules for a swap dealer to confirm to a Special Entity counterparty that it was acting only as a counterparty and not acting as an advisor.[629] Several commenters supported an approach to permit the Special Entity and swap dealer to agree that the swap dealer is not acting as an advisor, and, therefore, not subject to proposed § 23.440.[630] Another commenter stated that permitting the swap dealer and Special Entity to determine whether the swap dealer "acts as an advisor to the Special Entity" is consistent with the business conduct standards requirement for a swap dealer to "disclose to the Special Entity in writing the capacity in which the swap dealer is acting."[631] By contrast, however, one commenter opposed an approach that would permit a swap dealer to avoid any obligation for giving advice where it discloses that it is not impartial and has an interest in the transaction being recommended.[632]

Many commenters suggested that the Commission consider whether the Special Entity relied

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[627] See SIFMA/ISDA Feb. 17 Letter, at 4 and 32; AFSCME Feb. 22 Letter, at 3; NACUBO Feb. 22 Letter, at 3; U. Tex. System Feb. 22 Letter, at 2-3; SWIB Feb. 22 Letter, at 3; CalPERS Feb. 18 Letter, at 3 fn. 4; BlackRock Feb. 22 Letter, at 6; ERIC Feb. 22 Letter, at 15-16; ABC/CIEBA Feb. 22 Letter, at 7.

[628] See, e.g., SIFMA/ISDA Feb. 17 Letter, at 5; Ropes & Gray Feb. 22 Letter, at 2; NACUBO Feb. 22 Letter, at 2-3; U. Tex. System Feb. 22 Letter, at 2 and 3; CEF Feb. 22 Letter, at 16; VRS Feb. 22 Letter, at 5; CalSTRS Feb. 28 Letter, at 3; MHFA Feb. 22 Letter, at 2; Russell Feb. 18 Letter, at 1; ERIC Feb. 22 Letter, at 2; ABC/CIEBA Feb. 22 Letter, at 7; ABA/ABC Feb. 22 Letter, at 2; Davis & Harman Mar. 25 Letter, at 4; Rep. Smith July 25 Letter, at 2.

[629] SIFMA/ISDA Feb. 17 Letter, at 5.

[630] See Ropes & Gray Feb. 22 Letter, at 2; NACUBO Feb. 22 Letter, at 2-3; CEF Feb. 22 Letter, at 16; VRS Feb. 22 Letter, at 5; CalSTRS Feb. 28 Letter, at 3; MHFA Feb. 22 Letter, at 2; Russell Feb. 18 Letter, at 1; ERIC Feb. 22 Letter, at 2; ABC/CIEBA Feb. 22 Letter, at 7; ABA/ABC Feb. 22 Letter, at 2; Davis & Harman Mar. 25 Letter, at 4; Rep. Smith July 25 Letter, at 2; cf. U. Tex. System Feb. 22 Letter, at 2-3 (a swap dealer should not be an advisor if (1) any swap dealer communications that would otherwise be deemed a recommendation were only made in response to the Special Entity's solicitation for information, and (2) the Special Entity certifies to the swap dealer that an advisory relationship does not arise).

[631] VRS Feb. 22 Letter, at 5; see Section 4s(h)(5)(A)(ii) of the CEA; proposing release, proposed § 23.450(f), 75 FR at 80661.

[632] AFSCME Feb. 22 Letter, at 4.

or depended on the swap dealer's advice or recommendations to determine whether a swap dealer "acts as an advisor to a Special Entity."[633] Commenters suggested a swap dealer should be deemed to "act as an advisor to a Special Entity" only where the advice will serve as a primary basis for the Special Entity's decision to take or refrain from taking a particular action.[634] One commenter asserted that "[i]mposing a 'best interests' duty based only on recommendations in the context of particular transactions would effectively overturn . . . longstanding [Commission] precedent."[635]

Commenters suggested that the Commission permit Special Entities of a certain size or sophistication be exempted or permitted to opt out of the protections under Section 4s(h)(4)(B)-(C) and proposed § 23.440. Commenters suggested that Special Entities be permitted to represent to a swap dealer that an advisory relationship is not intended if the Special Entity meets a minimum threshold of assets under management, net financial assets, debt outstanding, or frequency of executing swaps.[636] Commenters also asserted that the business conduct standards protections generally, and proposed § 23.440 in particular, do not provide any benefit to

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[633] Ropes & Gray Feb. 22 Letter, at 2 (the definition of "acts as an advisor" should require acknowledged agency in which the Special Entity places trust, confidence, or reliance on the swap dealer); SIFMA/ISDA Feb. 17 Letter, at 31-32 fn. 76; APGA Feb. 22 Letter, at 4; ATA Feb. 22 Letter, at 5; AMG-SIFMA Feb. 22 Letter, at 3; ERIC Feb. 22 Letter, at 16.

[634] SIFMA/ISDA Feb. 17 Letter, at 31-32; APGA Feb. 22 Letter, at 4; ATA Feb. 22 Letter, at 5; AMG-SIFMA Feb. 22 Letter, at 3; cf. DOL's current fiduciary regulation, which deems a person that renders investment advice to an ERISA plan a "fiduciary" where "the advice will serve as a primary basis for investment decisions with respect to plan assets." 29 CFR 2510.3–21(c); supra fn. 34.

[635] SIFMA/ISDA Feb. 17 Letter, at 32 fn. 76 (asserting that Commission precedent recognized "the nature of the overall relationship between the customer and advisor–and the customer's dependence on the advisor–that gives rise to a fiduciary relationship") citing In re Jack Savage, [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,139 (CFTC Mar. 1, 1976).

[636] NACUBO Feb. 22 Letter, at 2-4; U. Tex. System Feb. 22 Letter, at 3; cf. VRS Feb. 22 Letter, at 4 (the Commission should exempt transactions between swap dealers and Special Entities that qualify as "qualified institutional buyers" as defined in Rule 144A under the Securities Act); CEF Feb. 22 Letter, at 5; SIFMA/ISDA Feb. 17 Letter, at 3 fn. 17. (17 CFR 230.144A). Rule 144A exempts from certain federal securities law protections certain entities that own and invest on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the entity.

sophisticated Special Entities.[637] Additionally, one commenter suggested that the final rule should provide that a swap dealer is never an advisor to an ERISA plan.[638]

Many commenters suggested that the Commission create a safe harbor for compliance with proposed § 23.440 if the Special Entity is separately represented by a qualified independent representative as prescribed under Section 4s(h)(5) and proposed § 23.450.[639] Several commenters suggested different refinements for such a safe harbor, for example, if (1) the communications are in response to the advisor's standing solicitation for information, and (2) the advisor certifies to the swap dealer that no advisory relationship is intended.[640] Other commenters suggested the safe harbor should apply if the Special Entity is represented by a sophisticated, professional advisor such as a bank, registered investment adviser, insurance company, qualified professional asset manager[641] ("QPAM"), or in-house asset manager[642] ("INHAM").[643] Alternatively, the Special Entity's fiduciary could agree to the safe harbor if it is in the Special Entity's best interests, for example, where the Special Entity has the ability to solicit bids and trade with multiple counterparties.[644]

Following the release of SEC's proposed business conduct standards for SBS Entities, the Commission received several comment letters addressing, among other things, a comparison of

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[637] See, e.g., CEF Feb. 22 Letter, at 16; VRS Feb. 22 Letter, at 4.
[638] ERIC Feb. 22 Letter, at 2.
[639] SIFMA/ISDA Feb. 17 Letter, at 31; Ropes & Gray Feb. 22 Letter, at 2; NACUBO Feb. 22 Letter, at 4; CEF Feb. 22 Letter, at 16; APPA/LPPC Feb. 22 Letter, at 3; APGA Feb. 22 Letter, at 5; SWIB Feb. 22 Letter, at 5; CalPERS Feb. 18 Letter, at 4; CalSTRS Feb. 28 Letter, at 3; SFG Feb. 22 Letter, at 1; BlackRock Feb. 22 Letter, at 5; AMG-SIFMA Feb. 22 Letter, at 2 and 5; ERIC Feb. 22 Letter, at 3 and 15; ABC/CIEBA Feb. 22 Letter, at 7; contra CFA/AFR Nov. 3 Letter, at 3.
[640] NACUBO Feb. 22 Letter, at 4.
[641] A qualified professional asset manager is defined in DOL prohibited transaction exemption 84-14 as a bank, insurance company, or registered investment adviser that meets certain capital, net worth, or assets under management tests. DOL QPAM PTE 84-14, 75 FR 38837.
[642] An in-house asset manager is defined in DOL prohibited transaction exemption 96-23, 61 FR 15975, Apr. 10, 1996 ("DOL In-House Asset Manager PTE 96-23"), as a wholly-owned subsidiary of an ERISA plan sponsor that is a registered investment adviser that meets certain assets under management tests.
[643] SIFMA/ISDA Feb. 17 Letter, at 31; BlackRock Feb. 22 Letter, at 5; ABC/CIEBA Feb. 22 Letter, at 7.
[644] CalSTRS Feb. 28 Letter, at 4.

SEC's proposed § 240.15Fh-2(a) and § 240.15Fh-4,[645] Special Requirements for SBS Dealers Acting as Advisors to Special Entities, and the Commission's proposed § 23.440,[646] Requirements for Swap Dealers Acting as Advisors to Special Entities.

The Commission's proposed § 23.440(a) and the SEC's proposed § 240.15Fh-2(a) both define a swap dealer or SBS Dealer, respectively, that recommends a swap, security-based swap or a trading strategy that uses a swap or security-based swap to a Special Entity to be "acting as an advisor to a Special Entity." Under the Commission's proposed § 23.440, a swap dealer that meets the definition of "acts as an advisor to a Special Entity" then has a duty to act in the best interests of the Special Entity. Under the SEC's proposed § 240.15h-2(a), a SBS Dealer that recommends a security-based swap or trading strategy involving the use of a security-based swap meets the definition of "acts as an advisor to a Special Entity," unless (1) the Special Entity represents in writing that: (i) It will not rely on recommendations provided by the SBS Dealer; and (ii) it will rely on advice from a qualified independent representative as defined in § 240.15Fh-5(a);[647] (2) the SBS dealer has a reasonable basis to believe that the Special Entity is advised by a qualified independent representative as defined in § 240.15Fh-5(a); and (3) the SBS Dealer discloses that it is not undertaking to act in the best interests of the Special Entity. Under the proposal, an SBS Dealer that exchanges the required representations with the Special Entity would not have a duty to act in the best interests of the Special Entity when making a recommendation.

[645] SEC's proposed rules, 76 FR at 42423-25, 42454, and 42456-57.
[646] Proposing release, 75 FR at 80650-51 and 80659-60.
[647] SEC's proposed rules, 76 FR at 42425-27 and 42457. SEC proposed § 240.15Fh-5(a) is the parallel rule to the Commission's proposed § 23.450–Requirements for swap dealers and major swap participants acting as counterparties to Special Entities. Both proposed rules further describe the duty for a swap dealer, major swap participant, or SBS Entity to have a reasonable basis to believe that a Special Entity has a qualified independent representative that meets certain statutory criteria described in Section 4s(h)(5) of the CEA or Section 15F(h)(5) of the Exchange Act.

The Commission received comment letters in support of [648] and against[649] the SEC approach. The supporters generally asserted that the SEC's proposed rules represent workable solutions to some of the industry's concerns over the adverse consequences of the Commission's proposed rules.[650] Commenters opposed to the SEC's approach generally asserted that it was inconsistent with congressional intent and would permit an SBS Entity to provide advice that may not be in the best interests of the Special Entity without accountability.[651] Another commenter asserted that the SEC's approach would result in Special Entities signing away their right to the "best interests" protection as a condition of doing business.[652]

b. Meaning of "Best Interests"

Several commenters raised issues concerning the duty to act in the best interests of the Special Entity imposed under Section 4s(h)(4) and § 23.440. Issues raised by commenters generally include: (1) Whether a "best interests" duty imposes a fiduciary duty; (2) whether imposing a "best interests" duty will improperly encourage Special Entities to rely on the swap dealer; (3) the meaning of the term "best interests"; (4) whether a "best interests" duty also imposes specific disclosure obligations; and (5) whether swap dealers will continue to transact with Special Entities if they are subject to a "best interests" duty.

The Commission sought comment on a number of questions regarding proposed § 23.440, including whether swap dealers should be subject to an explicit fiduciary duty when acting as an advisor to a Special Entity.[653] Some commenters cited the legislative history to support the view

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[648] See, e.g., FIA/ISDA/SIFMA Aug. 26 Letter, at 4-5; BlackRock Aug. 29 Letter, at 2 and 7; ABC Aug. 29 Letter, at 2 and 6-8.
[649] Better Markets Aug. 29 Letter, at 2 and 14-15; CFA/AFR Aug. 29 Letter, at 1-2, 9, 13 and 26-29.
[650] See, e.g., BlackRock Aug. 29 Letter, at 2.
[651] Better Markets Aug. 29 Letter, at 15; see also CFA/AFR Aug. 29 Letter, at 26-29.
[652] CFA/AFR Aug. 29 Letter, at 26; CFA/AFR Nov. 3 Letter, at 2.
[653] Proposing release, 75 FR at 80651.

that Congress rejected an express fiduciary duty for swap dealers entering into a swap with a Special Entity.[654] A number of commenters assert that a "best interests" duty creates a fiduciary relationship,[655] or could give rise to fiduciary duties under other bodies of law including the common law, state pension laws, the CEA, the Advisers Act, and ERISA.[656] Commenters also asserted that the inherent conflicts of interest in a counterparty relationship are incompatible with a fiduciary duty.[657] Similarly, another commenter asked the Commission to clarify that complying with §§ 23.440 and 23.450 do not cause a swap dealer to be a fiduciary under any other body of law, including the securities laws or common law.[658]

The Commission also sought comment in the proposing release on whether to define "best interests," and if so, what should the definition be.[659] Some commenters stated that the best interests duty should be removed from the final rules.[660] One commenter suggested that the Commission revise the "best interests" standard to require only a duty of fair dealing and not import a fiduciary duty.[661] Another commenter asserted that a "best interests" standard of care is appropriate where a swap dealer provides advice tailored to the Special Entity's position; however, the standard would be inappropriate if the definition of "advice" was not sufficiently

[654] SIFMA/ISDA Feb. 17 Letter, at 4 (citing a Senate version of H.R. 4173); but cf. CFA/AFR Feb. 22 Letter, at 15 (asserting that the original Senate version imposed a fiduciary duty on all interactions between swap dealers and Special Entities that was ultimately an unworkable approach. However, the legislative history provides an insight into congressional intent that the "best interests" standard of care should be broadly applied).
[655] Ohio STRS Feb. 18 Letter, at 2; CPPIB Feb. 22 Letter, at 3; AMG-SIFMA Feb. 22 Letter, at 4 and 6; SIFMA/ISDA Feb. 17 Letter, at 6; NACUBO Feb. 22 Letter, at 2; Calhoun Feb. 22 Letter, at 2-3.
[656] SIFMA/ISDA Feb. 17 Letter, at 6; CalSTRS Feb. 28 Letter, at 3; AMG-SIFMA Feb. 22 Letter, at 4; Comm. Cap. Mkts. May 3 Letter, at 3.
[657] SIFMA/ISDA Feb. 17 Letter, at 6; CalSTRS Feb. 28 Letter, at 4.
[658] ERIC Feb. 22 Letter, at 4; cf. BlackRock Feb. 22 Letter, at 5 (recommending the Commission should specify that proposed § 23.440 is not intended to cause a swap dealer to be considered an ERISA fiduciary).
[659] Proposing release, 75 FR at 80651.
[660] BlackRock Feb. 22 Letter, at 5; Calhoun Feb. 22 Letter, at 2-3; cf. CalSTRS Feb. 28 Letter, at 3 (asserting that the term "best interests" is vague).
[661] AMG-SIFMA Feb. 22 Letter, at 6.

narrowed.[662]

Other commenters supported the proposed "best interests" standard and suggested that the Commission should clarify that a "best interests" duty is a higher standard than a suitability obligation.[663] The commenter also requested that the Commission clarify that certain practices should be identified as inherent violations of the best interests standard, including (1) designing swaps with features that expose the Special Entity to risks that are greater than those it intends to hedge, and (2) recommending customized swaps when the Special Entity could attain the same results at a lower risk-adjusted cost using standardized swaps.[664]

Other commenters discussed the scope of the duty. A commenter asserted, in the context of trading with a municipality, a swap dealer that demanded additional collateral could arguably violate its best interests duty because obtaining collateral is in the interest of the swap dealer and not the municipality.[665] The commenter also stated that the Commission should clarify the scope of the "best interests" standard and "distinguish advice that is fiduciary in nature from advice rendered in the context of soliciting, structuring or executing a particular transaction."[666] Conversely, another commenter asserted that customization by its very nature implies that the swap has been designed with the particular needs of the counterparty in mind, and, therefore, there is no benefit to allowing swap dealers to avoid regulatory duties when recommending

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[662] SWIB Feb. 22 Letter, at 3.
[663] CFA/AFR Feb. 22 Letter, at 15.
[664] Id.
[665] SIFMA/ISDA Feb. 17 Letter, at 6 fn. 19.
[666] SIFMA/ISDA Feb. 17 Letter, at 32 fn. 74 (asserting that such a distinction exists in other legal contexts, for example, a broker that provides advice on particular occasions does not trigger an ongoing duty to advise in the future and monitor all data potentially relevant to a customer's investment) (citing de Kwiatkowski v. Bears Stearns & Co., Inc., 306 F.3d 1293, 1302 (2d Cir. 2003); see id. (asserting that the Advisers Act generally does not apply to a person whose only advice consists of advising an issuer how to structure its financing) (citing SEC Staff Legal Bulletin No. 11 (Sept. 2000) and SEC no-action letter to David A. Kekich, The Arkad Company, 1992 WL 75601 (available Mar. 19, 1992)).

customized swaps.[667]

Some commenters raised concerns that the "best interests" duty will inappropriately encourage a Special Entity to rely on a swap dealer. Commenters claim that reliance could create confusion regarding the parties' respective responsibilities and could inappropriately increase dependence on the swap dealer and discourage counterparties from conducting their own investigations and taking responsibility for their own decisions and conduct.[668] Conversely, other commenters stated that applying the "best interests" duty to recommendations would strike a reasonable balance by limiting the duty to instances in which Special Entities relied on the swap dealer and the standard should be scalable depending on the degree of reliance.[669]

The Commission listed three questions in the proposing release requesting comment on whether a "best interests" duty should require additional specific disclosures regarding (1) conflicts of interest, (2) the profit the swap dealer expects to make on swaps it enters into with the Special Entity, and (3) any positions the swap dealer holds from which it may profit should the swap in question move against the Special Entity.[670] Most commenters discussed material incentives and conflicts of interest generally in the context of proposed § 23.431(a)(3);[671] however, some commenters discussed the Commission's request for comment in the context of a "best interests" duty.

One commenter asserted that a swap dealer should provide conflict of interest disclosures that go beyond the issue of compensation and third-party payments when dealing with a Special

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[667] CFA/AFR Feb. 22 Letter, at 13 (discussing customized swaps with respect to a suitability duty).
[668] See, e.g., SIFMA/ISDA Feb. 17 Letter, at 2.
[669] CFA/AFR Feb. 22 Letter, at 5 and 15; cf. AFSCME Feb. 22 Letter, at 3 (asserting that non-swap dealers will often assume that a swap dealer that represents itself as a "trusted advisor" will be accountable for the advice it provides).
[670] Proposing release, 75 FR at 80651.
[671] See Section III.D.3.d. of this adopting release for a discussion of § 23.431(a)(3).

Entity and consider the full range of conflicts that may exist that are relevant to a particular recommendation.[672] The commenter also stated that it is not necessary to require a swap dealer in all instances to disclose its pre-existing positions; however, disclosure should be required if those positions create a material conflict of interest.[673]

Some commenters opposed requiring a swap dealer to disclose their profit or anticipated profit in connection with a particular swap.[674] Commenters also opposed requirements for swap dealers to disclose pre-existing positions to any counterparty because swap dealers may choose not to enter into swaps with Special Entities if they are required to disclose proprietary positions.[675]

The Commission also requested comment on whether proposed § 23.440 would preclude swap dealers from continuing their current practice of both recommending and entering into swaps with Special Entities.[676] One commenter asserted that Special Entities would retain their ability to engage in transactions with swap dealers as counterparties.[677] Conversely, several commenters asserted that a duty to act in the "best interests" is incompatible with a counterparty

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[672] CFA/AFR Feb. 22 Letter, at 16 (asserting a swap dealer must disclose if a swap is designed so that the dealer will profit if the transaction fails for the Special Entity); see id. (when recommending customized swaps, a swap dealer should be required to break out the pricing of the components of the swap, including the profit).

[673] CFA/AFR Feb. 22 Letter, at 7 (asserting that an example of such a material conflict would be where the swap dealer was taking a major short position in a type of swap that it was also recommending a Special Entity take a long position, therefore the swap dealer should be required to disclose that fact and its reasons for believing the counter position is nonetheless in the best interests of the Special Entity).

[674] SIFMA/ISDA Feb. 17 Letter, at 22 (asserting that such disclosure is not required by the statute and is inconsistent with congressional intent as Congress rejected such a requirement when enacting the Dodd-Frank Act); CEF Feb. 22 Letter, at 21.

[675] See SWIB Feb. 22 Letter, at 4; SIFMA/ISDA Feb. 17 Letter, at 14-15 (opposing the disclosure of pre-existing positions because it could allow a counterparty to discern confidential information of the swap dealer's other clients, the disclosure is potentially misleading, the requirement would discourage swap dealers from providing liquidity, and compliance would be difficult when considering whether disclosure is required for non-standardized swaps whose relation to a pre-existing position of a recommended swap is a matter of degree).

[676] Proposing release, 75 FR at 80651.

[677] CFA/AFR Feb. 22 Letter, at 17; CFA/AFR Nov. 3 Letter, at 3.

relationship.[678] These commenters asserted that there are several problems for a swap dealer that both acts as a counterparty and is required to act in the best interests of its counterparty in the same transaction, including that: (1) The duty of care is fundamentally at odds with an arm's length counterparty relationship, (2) it would result in an unresolvable conflict, and (3) the parties' interests are by definition adverse.[679]

Several commenters asserted that a "best interests" duty will discourage or prevent swap dealers from transacting with Special Entities.[680] Commenters also asserted that a duty to act in the "best interests" of a Special Entity will increase burdens, compliance costs and liability exposure to swap dealers, and the additional costs and risks will be passed on to Special Entities through increased pricing.[681] Thus, several commenters asserted that the proposed rules could increase costs for Special Entities, preclude them from hedging their risks, and do not provide corresponding benefits to Special Entities.[682]

c. Comments on § 23.440(b)(2)–Duty to Make Reasonable Efforts

The Commission sought comment in the proposing release on whether to prescribe additional information that would be relevant to a swap dealer's "reasonable efforts" and "best interests" duties under the proposed rule.[683] One commenter suggested that the Commission should clarify

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[678] SWIB Feb. 22 Letter, at 4; GFOA Feb. 22 Letter, at 2; Calhoun Feb. 22 Letter, at 2; ABC/CIEBA Feb. 22 Letter, at 7; ABA/ABC Feb. 22 Letter, at 2.

[679] SWIB Feb. 22 Letter, at 4; GFOA Feb. 22 Letter, at 2; ABC/CIEBA Feb. 22 Letter, at 7; contra CFA/AFR Nov. 3 Letter, at 3.

[680] See SIFMA/ISDA Feb. 17 Letter, at 5-6; Ohio STRS Feb. 18 Letter, at 2; CalSTRS Feb. 28 Letter, at 4; AMG-SIFMA Feb. 22 Letter, at 4; SWIB Feb. 22 Letter, at 4; CalPERS Feb. 18 Letter, at 3-4; VRS Feb. 22 Letter, at 3; OTPP Feb. 22 Letter, at 3; GFOA Feb. 22 Letter, at 2; BlackRock Feb. 22 Letter, at 5; ERIC Feb. 22 Letter, at 2; ABC/CIEBA Feb. 22 Letter, at 2; Texas VLB Feb. 22 Letter, at 1; NACUBO Feb. 22 Letter, at 2-3; HOOPP Feb. 22 Letter, at 2.

[681] See, e.g., CEF Feb. 22 Letter, at 16; CalPERS Feb. 18 Letter, at 4; Ropes & Gray Feb. 22 Letter, at 2; COPE Feb. 22 Letter, at 2; VRS Feb. 22 Letter, at 3; BDA Feb. 22 Letter, at 2; AMG-SIFMA Feb. 22 Letter, at 4.

[682] See CEF Feb. 22 Letter, at 16; APGA Feb. 22 Letter, at 1; ETA May 4 Letter, at 8; CalPERS Feb. 18 Letter, at 4; SWIB Feb. 22 Letter, at 3; VRS Feb. 22 Letter, at 4; CalSTRS Feb. 28 Letter, at 2 and 4; OTPP Feb. 22 Letter, at 3; ERIC Feb. 22 Letter, at 2.

[683] Proposing release, 75 FR at 80651.

whether there is certain information without which the swap dealer could not make a recommendation. The commenter also suggested that where a swap dealer makes a recommendation based on limited information, any disclosures about the limitations should be made to the board of the Special Entity and not simply to the investment officer.[684] The commenter agreed that there should be a mechanism to allow a Special Entity to discuss various options with a swap dealer without divulging confidential information.[685] The commenter warned, however, that an overly broad interpretation of proposed § 23.440(c) could undercut the protections of the best interests duty.[686]

Another commenter opposed requirements for swap dealers to seek extensive information about a Special Entity, including information for the swap dealer to reasonably conclude that the Special Entity has the financial capability to withstand potential market-related changes in the value of the swap.[687] The commenter asserted that if the Special Entity had to provide financial information as a prerequisite to enter into a swap, such a requirement would disadvantage the Special Entity and give swap dealers an informational advantage in negotiations.[688] Other commenters asserted that the pre-execution duties to make reasonable efforts would require a swap dealer to undertake extensive diligence and obtain detailed representations.[689] One commenter added that such requirements would significantly increase costs, delay execution, and leave Special Entities to pay more for swaps and expose them to extended periods

[684] CFA/AFR Feb. 22 Letter, at 17.
[685] Id., at 16.
[686] Id. (asserting that some Special Entities may have incentives to evade the restrictions of their charters to hide the extent to which they are underfunded and, therefore, the Commission should ensure that the regulation does not provide a means for Special Entities to use swaps to assume unreasonably high investment risks to seek higher returns).
[687] ABC/CIEBA Feb. 22 Letter, at 7-8.
[688] Id.
[689] SIFMA/ISDA Feb. 17 Letter, at 6-7; Ohio STRS Feb. 18 Letter, at 2; BlackRock Feb. 22 Letter, at 5-6; ETA May 4 Letter, at 8.

of market risk.[690] The commenter also requested that the Commission permit a swap dealer to rely on representations of the Special Entity to meet both its duty to act in the best interests and its obligation to make reasonable efforts to obtain necessary information.[691] Other commenters asked the Commission to provide greater clarity as to what constitutes "a reasonable basis to believe that the representations are reliable."[692] The commenters suggest that representations from the Special Entity's authorized employee or independent representative should be conclusive unless the swap dealer has actual knowledge that such representations are untrue.[693] Other commenters stated that the proposing release did not provide estimates of the costs of the proposed rule to Special Entities, and that the additional costs and burdens do not have corresponding benefits.[694]

3. Final § 23.440

Considering the comments, statutory construction and legislative history, the Commission has determined to adopt § 23.440 with certain modifications. Final § 23.440(a) defines the term "acts as an advisor to a Special Entity" to mean "when the swap dealer recommends a swap or trading strategy involving a swap that is tailored to the particular needs or characteristics of the Special Entity." Final § 23.440(b) provides two safe harbors from the definition of "acts as an advisor to a Special Entity" for particular types of conduct: (1) Communications between a swap dealer and an ERISA plan that has an ERISA fiduciary;[695] and (2) communications to any Special Entity (including a Special Entity that is an ERISA plan) or its representative that do not

[690] SIFMA/ISDA Feb. 17 Letter, at 6-7 (asserting such requirements would reduce or eliminate swap transactions for Special Entities if the information gathering is required on a trade-by-trade basis).
[691] Id., at 35.
[692] APPA/LPPC Feb. 22 Letter, at 3; APGA Feb. 22 Letter, at 5.
[693] Id.
[694] BlackRock Feb. 22 Letter, at 5-6; ETA May 4 Letter, at 8.
[695] An ERISA "fiduciary" is defined in Section 3(21) of ERISA (29 U.S.C. 1002(21)) and DOL Regulations at 29 CFR 2510.3-21.

express an opinion as to whether the Special Entity should enter into a recommended swap or trading strategy involving a swap that is tailored to the particular needs or characteristics of the Special Entity.[696] Qualifying for either safe harbor requires an exchange of specified representations in writing by the swap dealer and Special Entity.

The final rule adopts the statutory "best interests" duty for swap dealers acting as advisors to Special Entities and "reasonable efforts" duty for swap dealers to make a determination that any swap or swap trading strategy is in the best interests of the Special Entity. The final rule allows a swap dealer to rely on the written representations of the Special Entity to satisfy its "reasonable efforts" duty. Such representations can be made on a relationship basis in counterparty relationship documentation rather than on a transaction basis, where appropriate. This adopting release and Appendix A to subpart H provide guidance for compliance with the second safe harbor in § 23.440(b)(2).

a. Acts as an Advisor to a Special Entity

The Commission has determined that a swap dealer will act as an advisor to a Special Entity when it recommends a swap or swap trading strategy that is tailored to the particular needs or characteristics of the Special Entity. This approach differs from proposed § 23.440 in two significant ways. First, the type of recommendation that will prompt the "best interests" duty in the final rule is limited to recommendations of bespoke swaps,[697] i.e., swaps that are tailored to

[696] Swap dealers that choose to operate within the safe harbor would be permitted to recommend tailored swaps to a Special Entity, provided that the swap dealer does not express an opinion as to whether the Special Entity should enter into the particular swap or swap trading strategy. Therefore, the safe harbor carves out from the term "acts as an advisor to a Special Entity" recommendations that are trade ideas or alternatives, but does not carve out subjective opinions as to whether the Special Entity should enter into a particular bespoke swap or swap trading strategy.

[697] Unlike § 23.440, the suitability rule § 23.434 covers recommendations regarding any type of swap or trading strategy involving a swap and is not limited to recommendations of bespoke swaps.

the particular needs or characteristics of the Special Entity.[698]

Second, in response to commenters' concerns, the Commission clarified in the discussion of the institutional suitability rule, § 23.434, the types of communications that will be considered recommendations.[699] These two changes clarify the circumstances that would cause a swap dealer to act as an advisor to a Special Entity, consistent with the statutory framework and considering the comments.[700]

In addition, the Commission has determined to provide two safe harbors to the rule – one that will apply only to ERISA plans and another that would apply to all Special Entities (including a Special Entity that is an ERISA plan). These safe harbors reflect several considerations,

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[698] Whether a swap is tailored to the particular needs or characteristics of the Special Entity will depend on the particular facts and circumstances. Swaps with terms that are tailored or customized to a specific Special Entity's needs or objectives, or swaps with terms that are designed for a targeted group of Special Entities that share common characteristics, e.g., school districts, are likely to be viewed as tailored to the particular needs or characteristics of the Special Entity. Generally, however, the Commission would not view a swap that is "made available for trading" on a DCM or SEF, as provided in Section 2(h)(8) of the CEA, as tailored to the particular needs or characteristics of the Special Entity. See Section III.D.3.b. at fn. 394 for a discussion of final § 23.431(b)'s requirement to provide scenario analysis when requested by the counterparty for any swap not "made available for trading" on a DCM or SEF; see also Proposed Rules, Trade Execution Requirements, 76 FR at 58191; Proposed Rules, Process to Make a Swap Available to Trade, 76 FR 77728.

[699] The facts and circumstances determination of whether a communication is a "recommendation" requires an analysis of the content, context, and presentation of the particular communication or set of communications. The determination of whether a "recommendation" has been made is an objective rather than a subjective inquiry. An important factor in this regard is whether, given its content, context, and manner of presentation, a particular communication from a swap dealer to a counterparty reasonably would be viewed as a "call to action," or suggestion that the counterparty enter into a swap. An analysis of the content, context, and manner of presentation of a communication requires examination of the underlying substantive information transmitted to the counterparty and consideration of any other facts and circumstances, such as any accompanying explanatory message from the swap dealer. Additionally, the more individually tailored the communication to a specific counterparty or a targeted group of counterparties about a swap, group of swaps or trading strategy involving the use of a swap, the greater the likelihood that the communication may be viewed as a "recommendation." See Section III.G. of this adopting release for a discussion of the suitability obligation under § 23.434.

[700] See, e.g., CFA/AFR Feb. 22 Letter, at 20 ("an appropriate definition of advice might be: 'recommendations related to a swap or a swap trading strategy that are made to meet the objectives or needs of a specific counterparty after taking into account the counterparty's specific circumstances'"); CFA/AFR Nov. 3 Letter, at 2; SIFMA/ISDA Feb. 17 Letter, at 32 (advice is "individualized based on the particular needs of the Special Entity"); cf. SWIB Feb. 22 Letter, at 2-3; see also APGA Feb. 22 Letter, at 4 ("a 'recommendation' which would trigger the advisor obligations should mean a firm indication by the swap dealer of a particular preferred transaction, swap, or market strategy"); id. (A presentation offering information concerning new products or services or new market strategies, without advancing a particular course of action, should not be considered advice); SIFMA/ISDA Feb. 17 Letter, at 33 ("in preparing a term sheet, recommending a swap for consideration by a counterparty, and in other similar conduct, [a swap dealer] may well not be providing advice as to the advisability of entering into the relevant swap transaction").

including comments describing the benefits of a free flow of information between a swap dealer and Special Entity, clear congressional intent to raise the standard of care for swap dealers that transact with Special Entities, and the implications of the "best interests" duty for swap dealers and Special Entities.

First, under § 23.440(b)(1), a swap dealer will not be acting as an advisor to a Special Entity that is an ERISA plan if: (1) The ERISA plan represents in writing that it has an ERISA fiduciary; (2) the ERISA fiduciary represents in writing that it will not rely on recommendations provided by the swap dealer; and (3) the ERISA plan represents in writing that (A) it will comply in good faith with written policies and procedures reasonably designed to ensure that any recommendation the Special Entity receives from the swap dealer materially affecting a swap transaction is evaluated by a fiduciary before the transaction occurs, or (B) any recommendation the Special Entity receives from the swap dealer materially affecting a swap transaction will be evaluated by a fiduciary before that transaction occurs. In reaching this determination, the Commission has considered the comments, the comprehensive federal regulatory scheme that applies to ERISA fiduciaries, and the importance of harmonizing the Dodd-Frank Act requirements with ERISA to avoid unintended consequences.[701] Therefore, § 23.440(b)(1) both harmonizes the federal regulatory regimes and ensures appropriate protections for ERISA plans.

Second, under § 23.440(b)(2), a swap dealer will not be "acting as an advisor" to any Special

[701] The Commission has considered commenters' suggestions that different categories of Special Entities should not be treated differently. See, e.g., CalSTRS Feb. 28 Letter, at 2 fn. 1. The Commission disagrees. Congress has established a comprehensive federal regulatory framework for ERISA plans, but has not done so for other Special Entities, which are subject to a wide range of state and local laws. Therefore, the Commission believes it is appropriate and consistent with congressional intent to harmonize regulation under the Dodd-Frank Act and CEA with ERISA requirements. Such harmonization avoids unintended consequences while maintaining protections for ERISA plans. With respect to other Special Entities, the Commission has considered commenters concerns and has provided compliance mechanisms under the final rules to address potential costs without undermining the benefits Congress intended.

Entity (including a Special Entity that is an ERISA plan)[702] if: (1) The swap dealer does not express an opinion as to whether the Special Entity should enter into a recommended swap or swap trading strategy that is tailored to the particular needs or characteristics of the Special Entity; (2) the Special Entity represents in writing that it will not rely on the swap dealer's recommendations and will rely on advice from a qualified independent representative within the meaning of § 23.450; and (3) the swap dealer discloses that it is not undertaking to act in the best interests of the Special Entity. The Commission believes that this will provide greater clarity to the respective roles of the parties, and because a swap dealer must refrain from making statements or otherwise expressing an opinion to meet the safe harbor's requirements, the provision also provides meaningful protections to Special Entities.

Appendix A to subpart H provides additional guidance to market participants that choose to operate within the safe harbor. If a swap dealer complies with the terms of the safe harbor, it can be assured that the following types of communications, for example, would not be subject to the best interests duty: (1) Providing information that is general transaction, financial, educational, or market information; (2) offering a swap or trading strategy involving a swap, including swaps that are tailored to the needs or characteristics of a Special Entity; (3) providing a term sheet, including terms for swaps that are tailored to the needs or characteristics of a Special Entity; (4) responding to a request for a quote from a Special Entity; (5) providing trading ideas for swaps or swap trading strategies, including swaps that are tailored to the needs or characteristics of a Special Entity; and (6) providing marketing materials upon request or on an unsolicited basis about swaps or swap trading strategies, including swaps that are tailored to the needs or characteristics of a Special Entity. The list is illustrative and not exhaustive. It is intended to

[702] When dealing with an ERISA plan, a swap dealer may comply with either or both safe harbors under § 23.440(b)(1) and (b)(2).

provide guidance to market participants. The safe harbor in § 23.440(b)(2) allows a wide range of communications and interactions between swap dealers and Special Entities without invoking the "best interests" duty, provided that the swap dealer does not express its own subjective opinion to the Special Entity or its representative as to whether the Special Entity should enter into the swap or trading strategy that is customized or tailored to the Special Entity's needs or circumstances and the appropriate representations and disclosures are exchanged. The Commission notes, however, that depending on the facts and circumstances, some of the examples on the list in Appendix A could be a "recommendation" that would trigger a suitability obligation under § 23.434. However, the Commission has determined that such activities would not, by themselves, prompt the "best interests" duty in § 23.440 provided that the parties comply with the other requirements of § 23.440(b)(2).

The safe harbor draws a clear distinction between the activities that will and will not cause a swap dealer to be acting as an advisor to a Special Entity. Thus, a swap dealer that wishes to avoid engaging in activities that trigger a "best interests" duty must appropriately manage its communications. To clarify the type of communications that they will make under the safe harbor, the Commission expects that swap dealers may specifically represent that they will not express an opinion as to whether the Special Entity should enter into a recommended swap or trading strategy, and that for such advice the Special Entity should consult its own advisor. Nothing in the final rule would preclude such a representation from being included in counterparty relationship documentation. However, such a representation would not act as a safe harbor under the rule where, contrary to the representation, the swap dealer does express an opinion to the Special Entity as to whether it should enter into a recommended swap or trading strategy.

The safe harbor permits a swap dealer to engage in a wide variety of discussions and communications with a Special Entity about individually tailored swaps and trading strategies, including the advantages or disadvantages of different swaps or trading strategies, without invoking the "best interests" duty. All of the swap dealer's communications, however, must be made in a fair and balanced manner based on principles of fair dealing and good faith in compliance with § 23.433. Furthermore, where the communications are "recommendations," the swap dealer must comply with the suitability obligations under § 23.434.

Some commenters requested that the Commission clarify whether activities other than those described in § 23.440 would cause a swap dealer to act as an advisor to a Special Entity. The Commission has determined that a swap dealer will only "act as an advisor to a Special Entity" as provided in final § 23.440(a). Similarly, in response to commenters, the Commission confirms that compliance with the requirements of Section 4s(h) and the Commission's business conduct standards rules in subpart H of part 23, will not, by itself, cause a swap dealer to "act as an advisor to a Special Entity" within the meaning of § 23.440.

b. Commenters' Alternative Approaches

The Commission considered comments asserting that Sections 4s(h)(4) and 4s(h)(5) of the CEA are mutually exclusive provisions and 4s(h)(4) should not apply where a swap dealer acts as a counterparty to a Special Entity. Similarly, the Commission considered comments requesting that the Commission provide a safe harbor to § 23.440 that would allow a swap dealer to avoid "acting as an advisor to a Special Entity" where the Special Entity is advised by a qualified independent representative. The Commission disagrees with commenters' statutory interpretation and declines to provide a safe harbor for all communications between a swap dealer and Special Entity provided that the Special Entity is advised by a qualified independent

representative. A plain reading of Section 4s(h) does not provide that a swap dealer acting as a counterparty to a Special Entity may avoid Section 4s(h)(4)'s provisions.[703] The Commission also believes that it would be inconsistent with the statutory language to allow a swap dealer to avoid Section 4s(h)(4)'s requirements when it provides subjective advice to a Special Entity, simply because the Special Entity has a representative on which it is relying. Such an interpretation of the statute would essentially render Section 4s(h)(4) a nullity and grant swap dealers unfettered discretion to provide subjective advice. Such a result would be inconsistent with congressional intent to raise standards for the protection of Special Entities.

Many commenters suggested that a swap dealer should only be deemed to "act as an advisor" based on mutual agreement between the swap dealer and Special Entity. The Commission declines to adopt such an approach because it would be inconsistent with the statute. Section 4s(h)(4) is self-effectuating and by its terms does not delegate the determination to the parties. The statute establishes an advisor test based on conduct–"acting" as an advisor–not agreement. If the parties were permitted to agree that a swap dealer was not acting as an advisor subject to a "best interests" duty, irrespective of the swap dealer's conduct, the rule would essentially immunize swap dealers from complying with the obligations imposed by the statute when acting as an advisor. A statutory protection would not be meaningful if the default position were that protection only applies where the entity regulated by the provision, the swap dealer, agrees to be regulated.

Commenters also suggest that the Commission should look to whether the Special Entity

[703] Legislative history supports that 4s(h)(4) and 4s(h)(5) are not mutually exclusive. "[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).

relied on the swap dealer's advice or recommendations or whether such communications were the primary basis for the Special Entity's trading decision to determine whether the swap dealer acted as an advisor. The Commission declines to adopt such a standard. Final § 23.440 creates an objective test that analyzes the swap dealer's communications. Such a standard is appropriate considering that the business conduct standards rules regulate the swap dealer's conduct. The commenters' suggestion would shift the inquiry from an analysis of the swap dealer's conduct to an analysis of whether the Special Entity actually relied on the swap dealer.[704] Such a shift would not achieve the purposes of the statue and would create uncertainty.

Commenters also suggested that the Commission adopt rules that permit sophisticated Special Entities to opt out of the protections provided in Section 4s(h)(4) and § 23.440. Neither the statute nor legislative history distinguishes between sophisticated and unsophisticated Special Entities. Congress intended to provide heightened protections to Special Entities, and the Commission is not convinced that there is an objective proxy for sophistication with respect to participants in the swaps markets.[705] Therefore, the Commission has determined not to permit Special Entities to opt out of the protections of the statute and the rules. Instead, the Commission has adopted clear, objective criteria for a swap dealer to determine whether it is acting as an advisor to a Special Entity, subject to a "best interests" duty, or operating within the safe harbors

[704] One commenter asserted that Commission precedent recognizes that dependence or reliance is necessary to give rise to an advisory relationship. SIFMA/ISDA Feb. 17 Letter, at 32 fn. 76 (citing In re Jack Savage, [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,139 (CFTC Mar. 1, 1976)). The Commission disagrees that Savage can be applied so broadly. In Savage, the Commission denied a newsletter publisher's commodity trading advisor registration application. Although the Commission acknowledges in Savage that the duties attendant to an advisory relationship exist where a customer may rely on a commodity trading advisor's advice, reliance is not a required element for the creation of an advisory status nor the duties that flow from it. The fact that a customer does not rely would have no bearing on a regulatory action. An advisory relationship and related duties do not arise by the subjective understanding of the customer but by operation of law. A person becomes a commodity trading advisor when advising others for compensation or profit as to the value or advisability of trading in a commodity for future delivery or swap, among others. Once the advice is rendered for compensation or profit, regardless of the customer's reliance, the advisor owes the duties attendant to such advice.

[705] See Section III.A.1. of this adopting release for a discussion of "Opt in or Opt out for Certain Classes of Counterparties."

provided in the rule.

Those commenters that advocated an opt out regime, a qualified independent representative safe harbor, or to limit application of the rule were primarily concerned that a broad application of the definition of "acts as an advisor to a Special Entity" and that potential new costs or liability could chill communications between swap dealers and Special Entities, raise hedging costs for Special Entities, or reduce the number of swap dealers that would be willing counterparties to Special Entities. The Commission believes that the final rule appropriately addresses these concerns. Under the final rule a swap dealer can appropriately manage its communications to its counterparties and can take reasonable steps to avoid "act[ing] as an advisor to a Special Entity." Thus, the Commission believes that § 23.440 is designed appropriately to mitigate costs associated with the statutory requirements and the rule. The rule also achieves the intended regulatory protections by either (1) limiting the types of communications from the swap dealer that could have the greatest potential to mislead a Special Entity, or (2) where the swap dealer "acts as an advisor," subjecting such communications to the "best interests" standard of care.

c. Best Interests

The final rule (renumbered as § 23.440(c)(1)) adopts the statutory "best interests" duty for swap dealers acting as advisors to Special Entities and "reasonable efforts" duty for swap dealers making a determination that the swap or swap trading strategy is in the best interests of the Special Entity. The Commission has determined not to define the term "best interests," but rather to provide further guidance as to the meaning of the term and the scope of the duty.

The Commission has considered commenters' views and the legislative history[706] in regard to whether Section 4s(h)(4) imposes a fiduciary duty. The Commission has determined that the "best interests" duty under Section 4s(h)(4) is not a fiduciary duty. Additionally, the Commission does not view the business conduct standards statutory provisions or rules in subpart H of part 23 to impose a fiduciary duty on a swap dealer with respect to any other party.

Whether a recommended swap is in the "best interests" of the Special Entity will turn on the facts and circumstances of the particular recommendation and particular Special Entity. However, the Commission will consider a swap dealer that "acts as an advisor to a Special Entity" to have complied with its duty under final § 23.440(c)(1) where the swap dealer (1) complies with final § 23.440(c)(2) to make a reasonable effort to obtain necessary information, (2) acts in good faith and makes full and fair disclosure of all material facts and conflicts of interest with respect to the recommended swap,[707] and (3) employs reasonable care that any recommendation made to a Special Entity is designed to further the Special Entity's stated objectives.[708]

For a recommendation of a swap to be in the best interests of the Special Entity, the swap does not need to be the "best" of all possible alternatives that might hypothetically exist, but

[706] In the Senate bill, the business conduct standards provision stated "a swap dealer that provides advice regarding, or offers to enter into, or enters into a swap with [a Special Entity] shall have a fiduciary duty to the [Special Entity]." Restoring American Financial Stability Act of 2010, H.R. 4173, Section 731 (May 20, 2010) (Public Print version as passed in the Senate of the United States May 27 (legislative day, May 26, 2010) (proposed amendments to Section 4s(h)(2)(A) and (B) of the CEA), available at http://www.gpo.gov). The House and Senate Conference Committee did not adopt the fiduciary duty language and instead adopted the following: "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." See Section 4s(h)(4)(B) of the CEA.

[707] Where a swap dealer "acts as an advisor to a Special Entity," the nature and content of the conflicts of interest disclosures will depend on the facts and circumstances of the particular swap dealer–Special Entity relationship and the recommended swap or trading strategy. See Section III.D. of this adopting release for a discussion of § 23.431–Disclosures of material information, including whether a swap dealer is required to disclose that it is trying to move a particular position off its books at Section III.D.3.d.

[708] A swap dealer would be expected to evaluate the "best interests" in accordance with reasonably designed policies and procedures and document how it arrived at a "reasonable determination" that a recommended swap is in the best interests of the Special Entity.

should be assessed in comparison to other swaps, such as swaps offered by the swap dealer or "made available for trading" on a SEF or DCM.[709] To be in the best interests of a Special Entity, the recommended bespoke swap would have to further the Special Entity's hedging, investing or other stated objectives. Additionally, whether a recommended swap is in the best interests of the Special Entity will be analyzed based on information known to the swap dealer (after it has employed its reasonable efforts required under Section 4s(h)(4)(C) and final § 23.440(c)(2)) at the time the recommendation is made. The "best interests" duty does not prohibit a swap dealer from negotiating swap terms in its own interests,[710] nor does it prohibit a swap dealer from making a reasonable profit from a recommended transaction.[711] Depending on the facts and circumstances, the "best interests" duty also does not require an ongoing obligation to act in the best interests of the Special Entity.[712] For example, a swap dealer would be able to exercise its rights under the terms and conditions of the swap when determining whether to make additional collateral calls in response to the Special Entity's deteriorating credit rating, whether or not such collateral calls would be, from the Special Entity's perspective, in the Special Entity's "best interests."

d. Commenters' Alternative "Best Interests" Approaches

The Commission declines some commenters' suggestions that the Commission delete the

[709] See Section IV.B.3.a. at fn. 698 for a discussion of Section 2(h)(8) and swaps "made available for trading" on a DCM or SEF; see also Section III.D.3.b. for a related discussion of swaps "made available for trading" for scenario analysis disclosures under final § 23.431(b) at fn. 394 and accompanying text at fn. 405.

[710] For example, the swap dealer may negotiate appropriate provisions relating to collateral calls and termination rights to manage its risks related to the swap.

[711] Some commenters suggested that a swap dealer that "acts as an advisor to a Special Entity" should be required to break out the pricing components of the swap, including the profit. See, e.g., CFA/AFR Feb. 22 Letter, at 16. The Commission declines to require any particular disclosures under this principles based standard. Whether such disclosure would be required to comply with the duty to act in the best interests of the Special Entity will depend on the facts and circumstances of the particular recommended swap or trading strategy.

[712] However, whenever the swap dealer engages in activity that would cause it to be acting as an advisor to the Special Entity, the best interests duty would be prompted. For example, if a swap dealer acted as an advisor in connection with a material amendment to, or termination of, a swap, the "best interests" duty would apply.

best interests duty or interpret best interests to be a fair dealing standard. Such an approach is inconsistent with the statute which uses the terms, "fair dealing" and "best interests," in different provisions, indicating that they impose different duties.[713] Another commenter requested that the Commission identify certain practices as inherent violations of the "best interests" duty including where a swap dealer designs a swap with features that expose the Special Entity to risks that are greater than those they intend to hedge. In the Commission's view, a swap dealer that "acts as an advisor to a Special Entity" could not recommend a swap or trading strategy that is inconsistent with the Special Entity's stated objectives. Where a swap dealer that is acting as an advisor concludes that the stated objectives are inconsistent with the Special Entity's best interests, the swap dealer would be expected to so inform the Special Entity and its independent representative.

The Commission has considered commenters' assertions that a Special Entity may be less likely to undertake its own due diligence when dealing with a swap dealer that is subject to the "best interests" duty. The Commission, however, believes that final § 23.440 appropriately clarifies the duties and roles of the parties consistent with congressional intent. The Commission also notes that prior to entering into any swap with a swap dealer, a Special Entity will have a qualified independent representative that will evaluate the swap dealer's advice in light of the Special Entity's "best interests."

e. Final § 23.440(c)(2)–Duty to Make Reasonable Efforts

Consistent with Section 4s(h)(4)(C), proposed § 23.440(b)(2) (renumbered as § 23.440(c)(2)) required a swap dealer that "acts as an advisor to a Special Entity" to make reasonable efforts to obtain information necessary to make a reasonable determination that any recommended swap or

[713] Compare Section 4s(h)(3)(C) ("duty for a swap dealer . . . to communicate in a fair and balanced manner based on principles of fair dealing and good faith") with Section 4s(h)(4)(B) ("a duty to act in the best interests").

trading strategy involving a swap is in the best interests of the Special Entity.[714] The proposed rule listed eight specific types of information that the swap dealer must make reasonable efforts to obtain and consider when making a determination that a recommendation is in the best interests of the Special Entity.[715] The Commission has determined to delete two of the listed types of information, proposed § 23.440(b)(2)(i)[716] and (vi).[717] Additionally, the Commission is refining the criteria in proposed § 23.440(b)(2)(iv)[718] and (vii)[719] (renumbered as § 23.440(c)(2)(iii) and (v)). These changes are for clarification only and do not substantively change the rule.

The Commission also clarifies how a swap dealer can satisfy its best interests duty where a Special Entity does not provide complete information with respect to the criteria in final § 23.440(c)(2). Commenters have asserted that Special Entities may be 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. Nothing in the rule is intended to disadvantage a Special Entity in its negotiations with a swap dealer or require it to disclose proprietary information.

However, to comply with its "best interests" duty where the Special Entity does not provide complete information, the swap dealer must make clear to the Special Entity that the

[714] Proposing release, 75 FR at 80650 and 80659-60.
[715] Id., at 80659-60.
[716] Under proposed § 23.440(b)(2)(i), a swap dealer would have to make reasonable efforts to obtain such information regarding "the authority of the Special Entity to enter into a swap." Id., at 80660. The Commission has determined that the regulatory objective intended by this provision is already achieved in final § 23.402(b)–Know your counterparty.
[717] Under proposed § 23.440(b)(2)(vi), a swap dealer would have to make reasonable efforts to obtain such information regarding "whether the Special Entity has an independent representative that meets the criteria enumerated in [proposed] § 23.450(b)." Id., at 80660. The Commission has determined that this would be duplicative of the requirements in § 23.450.
[718] Id., at 80660. The provision as adopted clarifies that a Special Entity's objectives in using swaps may be broader than investment or financing needs.
[719] Id., at 80660. The provision as adopted clarifies that the intent of the provision concerns changes in market conditions.

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. The Commission has also considered comments suggesting that disclosures about a recommendation's limitations should be made to the board of the Special Entity and not to the investment officer.[720] The Commission agrees that the best practice for a swap dealer that "acts as an advisor to a Special Entity" within the meaning of § 23.440(a) would be to ensure that disclosures about the limitations of its recommendation are communicated to the governing board or to a person or persons occupying a similar status or performing similar functions.

Furthermore, where a swap dealer's reasonable efforts to obtain necessary information results in limited or incomplete information, the swap dealer must assess whether it is able to make a reasonable determination that a particular recommendation is in the "best interests" of the Special Entity. For example, a fundamental requirement to making a determination that a recommendation is in the best interests is to understand the objectives of the Special Entity with respect to the swap. If, after the swap dealer makes reasonable efforts to obtain information about the Special Entity's objectives, the Special Entity does not provide sufficient information to the swap dealer, then the swap dealer would be unable to make a determination that a recommendation is in the best interests of the Special Entity. Therefore, a swap dealer that "acts as an advisor to a Special Entity" would have to refrain from making a recommendation to the Special Entity in such circumstances.

A commenter asserted that any mechanism to allow a Special Entity to avoid divulging confidential information should not be interpreted so broadly as to undercut the protections of a

[720] See CFA/AFR Feb. 22 Letter, at 17.

best interests duty or permit Special Entities to engage in swaps with unreasonably high risk.[721] The Commission has considered the comment and has determined that the rule is designed to provide appropriate protections to Special Entities.

f. Final § 23.440(d)–Reasonable Reliance on Representations

Proposed § 23.440(c) (renumbered as § 23.440(d)) permitted a swap dealer to rely on written representations of the Special Entity to satisfy its obligation to "make reasonable efforts" to obtain necessary information. However, the proposed rule listed additional criteria that a swap dealer would have to consider to determine that the representations were reliable.[722] The Commission has determined to delete from the final rule text the additional criteria that a swap dealer would be expected to consider. Commenters found the proposed rule text confusing and unworkable.[723] In light of the comments, the Commission has determined to provide additional guidance as to when a swap dealer would not be able to rely on written representations.

A swap dealer would be able to rely on representations unless it had information that would cause a reasonable person to question the accuracy of the representation.[724] The Commission

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[721] Id., at 16.

[722] See proposed § 23.440(c)(1)-(3), proposing release, 75 FR at 80660 ("(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).").

[723] See, e.g., BlackRock Feb. 22 Letter, at 6.

[724] The Commission's determination is consistent with several commenters' suggestions. See, e.g., SIFMA/ISDA Feb. 17 Letter, at 36 ("[swap dealers] should be permitted to rely on a written representation . . . that the counterparty and/or its representative satisfies the standards . . . absent actual 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."); ABC/CIEBA Feb. 22 Letter, at 10-11 fn. 3 (asserting the Commission should adopt a standard used under Rule 144A of the federal securities laws, which would not impose a duty to inquire further "unless circumstances existed giving reason to question the veracity of a certification"); AMG-SIFMA Feb. 22 Letter, at 10-11 ("A swap dealer or [major swap participant] should be able to rely on an investment adviser's representation unless the swap dealer or [major swap participant] has information to the contrary."); Comm. Cap. Mkts. May 3 Letter, at 2 ("The dealer should be required to probe beyond that representation only if it has reason to believe that the Special Entity's

declines to adopt other commenters' suggestion that a swap dealer or major swap participant be permitted to rely on representations unless it had actual knowledge that the representations were untrue. The Commission has determined that an actual knowledge standard may inappropriately encourage the swap dealer to ignore red flags. The Commission also confirms that such representations, where appropriate, can be contained in counterparty relationship documentation consistent with § 23.402(d) to avoid transaction-by-transaction compliance.[725]

C. Section 23.450–Requirements for Swap Dealers and Major Swap Participants Acting as Counterparties to Special Entities

1. Proposed § 23.450

Proposed § 23.450 followed the statutory language in Section 4s(h)(5) of the CEA, which requires swap dealers and major swap participants[726] that offer to enter or enter into swaps with Special Entities[727] to comply with any duty established by the Commission that they have a reasonable basis to believe that the Special Entity has an independent representative that meets

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representations with respect to its independent representative are inaccurate."); BlackRock Feb. 22 Letter, at 3 ("The CFTC should specifically permit the [swap dealer] to rely, absent notice of facts that would require further inquiry.").

[725] As the Commission stated in the proposing release, such representations can be included in counterparty relationship documentation 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 if the representations continue to be accurate and relevant with respect to the subsequent swaps. Proposing release, 75 FR at 80641-42.

[726] 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 proposed to apply the counterparty requirements to major swap participants as well as to swap dealers. Proposing release, 75 FR at 80651 fn. 104.

[727] The Commission interpreted the statute as imposing this duty on swap dealers and major swap participants in connection with swaps entered into with all categories of Special Entities. 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). The Commission's interpretation is consistent with legislative history. 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."). Proposing release, 75 FR at 80651 fn. 106 and 108.

certain enumerated criteria. The enumerated criteria include that a Special Entity representative: (1) Has sufficient knowledge to evaluate the transaction and risks; (2) is not subject to a statutory disqualification;[728] (3) is independent of the swap dealer or major swap participant;[729] (4) undertakes a duty to act in the best interests of the Special Entity it represents;[730] (5) makes appropriate and timely disclosures to the Special Entity;[731] (6) evaluates, consistent with any guidelines provided by the Special Entity, fair pricing and the appropriateness of the swap;[732] (7) in the case of employee benefit plans subject to ERISA, is a fiduciary as defined in Section 3 of ERISA (29 U.S.C. 1002);[733] and (8) in the case of a municipal entity as defined in proposed

[728] To guide swap dealers and major swap participants, the proposed rule defined "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. Proposing release, 75 FR at 80651.

[729] The proposed rule clarified that "independent" as it relates to a representative of a Special Entity means independent of the swap dealer or major swap participant, not independent of the Special Entity. Proposing release, 75 FR at 80652 fn. 113 and 115.

[730] The Commission did not define "best interests" in this context, but noted the scope of the duty would be related to the nature of the relationship between the independent representative and the Special Entity, and established principles in case law would inform the meaning of the term on a case-by-case basis. 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 entering into the transaction. Proposing release, 75 FR at 80652.

[731] The proposed rule refined the criterion under Section 4s(h)(5)(A)(i)(V), "appropriate disclosures" to mean "appropriate and timely disclosures." Proposing release, 75 FR at 80652.

[732] The proposed rule refined the statutory language to provide that the representative "evaluate[], consistent with any guidelines provided by the Special Entity, [the] fair pricing and . . . appropriateness of the swap." Swap dealers and major swap participants could 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 or major swap participant 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 also would consider whether the 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. This approach was applied to in-house independent representatives as well. Proposing release, 75 FR at 80652-53.

[733] Notwithstanding comments from ERISA plans and their fiduciaries, the Commission determined that independent representatives of plans subject to ERISA would have to meet all the independent representative criteria in Section 4s(h)(5)(A). The Commission sought further comment on this interpretation of the statute. Proposing release, 75 FR at 80653 fn. 122.

§ 23.451, is subject to restrictions on certain political contributions imposed by the Commission, the SEC or an SRO subject to the jurisdiction of the Commission or the SEC.[734]

The proposed rule set out several factors to be considered by swap dealers and major swap participants in determining whether the Special Entity's representative satisfies the enumerated criteria, including (1) the nature of the Special Entity-representative relationship; (2) the representative's ability to make hedging or trading decisions; (3) the use of consultants or, with respect to employee benefit plans subject to ERISA, use of a Qualified Professional Asset Manager[735] or In-House Asset Manager;[736] (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.[737]

The proposed rule provided that a representative would be deemed to be independent if: (1) It was 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 was no "principal relationship" between the representative and the swap dealer or major swap participant within

[734] Criterion 8–restrictions on certain political contributions–is not in the statutory text under Section 4s(h)(5)(A)(i)(I)-(VII). The Commission proposed this criterion using its discretionary authority under Section 4s(h)(5)(B). The requirement would not apply to in-house independent representatives of a municipal entity following the definition of "municipal advisor" in Section 15B of the Exchange Act (15 U.S.C. 78o-4), which excludes employees of a municipal entity. For examples of pay-to-play rules, see, e.g., SEC Rule 206(4)-5 under the Advisers Act (17 CFR 275.206(4)-5) ("SEC Advisers Act Rule 206(4)-5"); MSRB Rule G-37: Political Contributions and Prohibitions on Municipal Securities Business. The Commission proposed to impose comparable requirements on swap dealers and major swap participants that act as counterparties to Special Entities in proposed § 23.451. The Commission stated in the proposing release that it would propose comparable requirements on registered CTAs when they advise municipal entities in a separate release. Proposing release, 75 FR at 80653 fn. 125.

[735] See DOL QPAM PTE 84-14, 75 FR 38837.

[736] See DOL In-House Asset Manager PTE 96-23, 61 FR 15975; Proposed Amendment to PTE 96-23, 75 FR 33642, June 14, 2010.

[737] Proposing release, 75 FR at 80651; see also id., at 80660-61 (proposed § 23.450(d)(2)).

the meaning of § 3.1(a)[738] of the Commission's Regulations; and (3) the representative did not have a material business relationship with the swap dealer or major swap participant.[739] 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.[740] The proposed rule defined 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.[741]

To address concerns that the statute places undue influence in the hands of the swap dealer or major swap participant by allowing it to control who qualifies as an independent representative of a Special Entity, the proposed rule provided that negative determinations be reviewed by the swap dealer's or major swap participant's chief compliance officer.[742] Under the proposed rule, if a swap dealer or major swap participant determined that an independent representative did not meet the enumerated criteria, 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.[743] Such review would ensure that the swap dealer or major

[738] 17 CFR 3.1(a).
[739] Proposing release, 75 FR at 80652.
[740] Id.
[741] Id.
[742] Id., at 80653.
[743] Id.

swap participant had a substantial, unbiased basis for the determination.[744]

Proposed § 23.450(f) also required, as provided in Section 4s(h)(5)(A)(ii), that swap dealers and major swap participants disclose in writing to Special Entities the capacity in which they are acting before initiation of a swap transaction. In addition, 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.[745]

Finally proposed § 23.450(g) stated that the rule 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.[746]

2. Comments

The Commission received many comments on the various aspects of proposed § 23.450. The Commission has grouped the comments by the following issues: (1) Types of Special Entities that should be included in final § 23.450; (2) duty to assess the qualifications of a Special Entity's representative; (3) representative qualifications;[747] (4) reasonable reliance on representations; (5) unqualified representatives; and (6) disclosure of capacity.

a. Types of Special Entities Included in Section 4s(h)(5)(A)(i)

Several commenters asserted that Section 4s(h)(5)(A)(i) only applies to the governmental Special Entities that are described in Section 1a(18)(A)(vii)(I) and (II) of the CEA, contrary to

[744] Id.
[745] For example, the Commission stated that when the swap dealer acts both as an advisor and a counterparty to the Special Entity, or when firms act both as underwriters in a bond offering and counterparties in swaps used to hedge such financing, a swap dealer's duties to the Special Entity would vary depending on the capacities in which it is operating. Id., at 80653.
[746] Proposed § 23.450(g) is informed by the statutory language in Section 4s(h)(7) of the CEA.
[747] The comments related to representative qualifications address the following issues: (1) Regulated advisors; (2) independence; (3) best interests, disclosures, fair pricing and appropriateness; and (4) employee benefit plans subject to ERISA.

the approach taken in proposed § 23.450.[748] Commenters also asserted that it is unclear whether the Commission has the authority to apply the rule to swaps with ERISA plans, governmental plans, and endowments.[749] Some commenters urged the Commission to resolve any ambiguity in the statutory language by applying the final rule only to the State and municipal Special Entities defined in Section 4s(h)(C)(2)(ii).[750] One commenter stated that if the final rule is applied to ERISA plans, then such plans should only be subject to subclause (VII) of Section 4s(h)(5)(A)(i),[751] which requires a Special Entity that is an employee benefit plan subject to ERISA to have an independent representative that "is a fiduciary as defined in Section 3 of [ERISA]."[752] Commenters asserted that requirements for ERISA fiduciaries are comparable to those required in subclauses (I)-(VI) of Section 4s(h)(5)(A)(i), rendering the protections of Section 4s(h)(5) and proposed § 23.450 unnecessary, and potentially harmful.[753] Conversely, one commenter opposed any carve-outs for ERISA plans and stated the Special Entity provisions are not served by deferring to ERISA's regulatory regime.[754]

b. Duty to Assess the Qualifications of a Special Entity's Representative

Commenters asserted that proposed § 23.450 will allow a swap dealer or major swap participant to veto a Special Entity's decision to select a particular representative,[755] and will unduly limit a Special Entity's choice regarding its own advisor.[756] Commenters also assert that

[748] See, e.g., Ropes & Gray Feb. 22 Letter, at 4-5; CalPERS Feb. 18 Letter, at 5; ABC/CIEBA Feb. 22 Letter, at 2-3 and 8; ERIC Feb. 22 Letter, at 6-7; Davis & Harman Mar. 25 Letter, at 2.
[749] See, e.g., Ropes & Gray Feb. 22 Letter, at 4-5; CalPERS Feb. 18 Letter, at 5; ABC/CIEBA Feb. 22 Letter, at 8.
[750] See, e.g., Ropes & Gray Feb. 22 Letter, at 4-5; CalPERS Feb. 18 Letter, at 5; ERIC Feb. 22 Letter, at 6-7.
[751] ABC/CIEBA Feb. 22 Letter, at 9 fn. 1; ABC Aug. 29 Letter, at 9.
[752] Section 4s(h)(5)(A)(i)(VII).
[753] See, e.g., ERIC Feb. 22 Letter, at 6-9.
[754] AFSCME Feb. 22 Letter, at 5.
[755] ABA/ABC Feb. 22 Letter, at 2; Davis & Harman Mar. 25 Letter, at 2-3; Rep. Smith July 25 Letter, at 2; ABC/CIEBA June 3 Letter, at 5-6;
[756] See, e.g., SIFMA/ISDA Feb. 17 Letter, at 36; ABC/CIEBA Feb. 22 Letter, at 9; CEF Feb. 22 Letter, at 23; Calhoun Feb. 22 Letter, at 5.

proposed § 23.450 inappropriately gives additional leverage to a swap dealer or major swap participant dealing with Special Entities, undermines the representative's ability or willingness to negotiate, and may be used to pressure Special Entities to share otherwise confidential information.[757] Furthermore, commenters assert that the duty under the proposed rule is intrusive, creates an inherent conflict of interest, and undermines the Special Entity's own selection process.[758] Other commenters asserted that proposed § 23.450 will not benefit Special Entities and will make dealing with swap dealers more costly and problematic.[759] Conversely, one commenter asserted that proposed § 23.450 created a reasonable and workable approach that is consistent with congressional intent.[760]

Commenters also asserted that proposed § 23.450 may conflict with current law under ERISA or with DOL's proposed fiduciary rule. The commenters asserted that proposed § 23.450 requires a swap dealer or major swap participant to review the qualifications of the Special Entity's representative which could be considered providing advice as to the selection of the Special Entity's advisor. Commenters asserted this could make the swap dealer or major swap participant a fiduciary to an ERISA plan under ERISA and DOL's existing regulations[761] or under DOL's proposed fiduciary rule.[762]

Commenters also asserted that proposed § 23.450 may conflict with DOL's QPAM prohibited transaction exemption.[763] The QPAM exemption sets out several conditions an ERISA

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[757] ABC/CIEBA Feb. 22 Letter, at 9; ABA/ABC Feb. 22 Letter, at 2; AMG-SIFMA Feb. 22 Letter, at 10.
[758] See, e.g., BlackRock Feb. 22 Letter, at 3; CalPERS Feb. 18 Letter, at 3; Cityview Feb. 22 Submission; Texas VLB Feb. 22 Letter, at 2; GFOA Feb. 22 Letter, at 1.
[759] See, e.g., ASF Feb. 22 Letter, at 5; GFOA Feb. 22 Letter, at 1.
[760] CFA/AFR Feb. 22 Letter, at 17.
[761] ABA/ABC Feb. 22 Letter, at 1; Davis & Harman Mar. 25 Letter, at 1; ERIC Feb. 22 Letter, at 9; MFA Feb. 22 Letter, at 6-7 fn. 13; ABC/CIEBA June 3 Letter, at 2.
[762] SIFMA/ISDA Feb. 17 Letter, at 39; ABC/CIEBA Feb. 22 Letter, at 5; ABA/ABC Feb. 22 Letter, at 1; Davis & Harman Mar. 25 Letter, at 1; ERIC Feb. 22 Letter, at 9; ABC/CIEBA June 3 Letter, at 2.
[763] See DOL QPAM PTE 84-14, 75 FR 38837.

fiduciary must satisfy to be a "qualified professional asset manager" within the meaning of the exemption. According to commenters, proposed § 23.450 permits a swap dealer or major swap participant to veto or implicitly cause the Special Entity to replace its advisor which may render the QPAM exemption unavailable to ERISA plans and their ERISA fiduciaries.[764]

c. Representative Qualifications

i. Regulated Advisors

Several commenters recommended that the Commission deem representatives that have a particular regulatory status to meet some or all of independent representative criteria in proposed § 23.450(b). Several commenters suggested that banks, investment advisers, insurance companies, QPAMs, and INHAMs[765] be deemed to meet the statutory criteria.[766] Commenters also stated that requirements under ERISA should automatically qualify an ERISA plan's fiduciary under the proposed criteria.[767] Other commenters asserted that municipal advisors,[768] fiduciaries to governmental plans,[769] and employees of a Special Entity should be deemed to satisfy the enumerated criteria.[770]

Several commenters requested that the Commission or an SRO develop a voluntary certification and proficiency examination program for independent representatives. The commenters proposed that the Commission should permit a swap dealer or major swap participant to conclude that any certified representative would automatically satisfy the criteria in

[764] SIFMA/ISDA Feb. 17 Letter, at 39; ABC/CIEBA June 3 Letter, at 5.
[765] Cf. DOL In-House Asset Manager PTE 96-23, 61 FR 15975.
[766] See SIFMA/ISDA Feb. 17 Letter, at 36; ERIC Feb. 22 Letter, at 2 and 12; AMG-SIFMA Feb. 22 Letter, at 2; BlackRock Feb. 22 Letter, at 3.
[767] See, e.g., ERIC Feb. 22 Letter, at 6-9.
[768] SIFMA/ISDA Feb. 17 Letter, at 36; Texas VLB Feb. 22 Letter, at 2.
[769] CalSTRS Feb. 28 Letter, at 3.
[770] APGA Feb. 22 Letter, at 6-7.

proposed § 23.450(b).[771] Conversely, one commenter asserted that representations and warranties from the representative should not amount to a waiver of compliance for a swap dealer.[772]

ii. Independence

The proposing release clarified that the Special Entity's representative must be "independent" of the swap dealer or major swap participant; however, the representative does not have to be independent of the Special Entity.[773] Several commenters agreed with the Commission's proposed interpretation.[774] Commenters also requested that the Commission clarify that an independent representative may be an employee, officer, agent, associate, trustee, director, subsidiary, or affiliate, such as an INHAM.[775]

The Commission received comments concerning the proposed independence test in general and specifically regarding the "material business relationship" prong. Some commenters recommended that the Commission delete the "material business relationship" requirement.[776] Alternatively, commenters suggested the Commission consider other existing standards which, according to the commenters, would be more workable such as ownership[777] or affiliate tests.[778] Commenters stated that the Commission's proposed standard was unnecessarily duplicative of or not harmonized with other independence standards under the federal securities laws and

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[771] See, e.g., CalPERS Feb. 18 Letter, at 5-6; CalPERS Aug. 29 Letter, 4-6; SWIB Feb. 22 Letter, at 4; CEF Feb. 22 Letter, at 23; Cityview Feb. 22 Submission; Riverside Feb. 22 Letter, at 1-2; SFG Feb. 22 Letter, at 1; CFA/AFR Aug. 29 Letter, at 23; CFA/AFR Nov. 3 Letter, at 5.
[772] AFSCME Feb. 22 Letter, at 6.
[773] Proposing release, 75 FR at 80652 fn. 113.
[774] See CFA/AFR Feb. 22 Letter, at 17; ERIC Feb. 22 Letter, at 3 and 9; APPA/LPPC Feb. 22 Letter, at 2; NACUBO Feb. 22 Letter, at 4; U. Tex. System Feb. 22 Letter, at 3-4; APGA Feb. 22 Letter, at 6.
[775] See, e.g., NACUBO Feb. 22 Letter, at 4; U. Tex. System Feb. 22 Letter, at 3-4; ERIC Feb. 22 Letter, at 9. Cf. DOL In-House Asset Manager PTE 96-23, 61 FR 15975.
[776] See, e.g., AMG-SIFMA Feb. 22 Letter, at 11-12; SIFMA/ISDA Feb. 17 Letter, at 38; contra CFA/AFR Feb. 22 Letter, at 17 ("the proposed standard generally provides the appropriate level of independence").
[777] See, e.g., AMG-SIFMA Feb. 22 Letter, at 11-12, fn. 38 (recommending the Commission consider "standards of ownership" such as those in DOL's QPAM exemption); see also DOL QPAM PTE 84-14, 75 FR 38837.
[778] See, e.g., SIFMA/ISDA Feb. 17 Letter, at 37-38 ("the Commission should adopt one of several other well-established and workable tests of independence (such as excluding all 'affiliates,' as . . . defined under . . . the CEA)"); BlackRock Feb. 22 Letter, at 4.

ERISA.[779] Commenters also asserted that the final regulation should permit a swap dealer or major swap participant to conclude that a plan's representative is "independent" if the representative is an ERISA fiduciary,[780] or at a minimum, if the representative is an ERISA fiduciary that is also a regulated entity such as a QPAM.[781]

Commenters also assert that the proposed "material business relationship" standard is unclear, vague and overly broad, and swap dealers will refrain from transacting with Special Entities without further clarifications.[782] These commenters stated that the "material business relationship" standard may inappropriately preclude many qualified asset managers from acting as independent representatives.[783] According to the commenters, many asset managers have multiple relationships with financial services firms that have swap dealer affiliates, and a requirement to survey all business relationships to determine whether and what compensation was paid would be very burdensome, require the development of costly new recordkeeping systems not currently in place, and provide little or no benefit to Special Entities.[784] The

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[779] See, e.g., SIFMA/ISDA Feb. 17 Letter, at 38; ABC/CIEBA Feb. 22 Letter, at 11; ERIC Feb. 22 Letter, at 11-12; AMG-SIFMA Feb. 22 Letter, at 2; BlackRock Feb. 22 Letter, at 4.

[780] ERIC Feb. 22 Letter, at 6 and 8; ABC/CIEBA Feb. 22 Letter, at 11 ("we urge the CFTC to provide that a 'major [sic] business relationship' does not exist if the relationship between the dealer or [major swap participant] and the [ERISA] Plan . . . would not give rise to a prohibited transaction under ERISA"); ABC Aug. 29 Letter, at 14.

[781] See, e.g., BlackRock Feb. 22 Letter, at 4; FIA/ISDA/SIFMA Aug. 29 Letter, at 20; AMG-SIFMA Feb. 22 Letter, at 11-12 fn. 38; see also DOL QPAM PTE 84-14, Part (VI)(a), 75 FR at 38843 (a QPAM must be a bank, savings and loan association, insurance company, or registered investment adviser).

[782] See, e.g., SIFMA/ISDA Feb. 17 Letter, at 38 ("the proposing standard is so broad and vague that [swap dealers] wary of the consequence of misinterpreting its requirements will likely simply abstain from affected trades"); APPA/LPPC Feb. 22 Letter, at 5 (the "standard is both broad and somewhat vague . . . and dealers may be reluctant to take on the potential liability related to this determination"); AMG-SIFMA Feb. 22 Letter, at 11; BlackRock Feb. 22 Letter, at 11.

[783] SIFMA/ISDA Feb. 17 Letter, at 38; ABC/CIEBA Feb. 22 Letter, at 11; AMG-SIFMA Feb. 22 Letter, at 11; BlackRock Feb. 22 Letter, at 4 fn. 9, but see CFA/AFR Nov. 3 Letter, at 3-4.

[784] BlackRock Feb. 22 Letter, at 4 ("an asset manager may trade securities through the broker affiliate of the swap dealer; use an affiliated broker dealer as distributor/underwriter for mutual funds managed by the asset manager; or license an index from an affiliate of the dealer"); SIFMA/ISDA Feb. 17 Letter, at 38 (a swap dealer's "affiliated broker-dealer [that] is the underwriter for mutual funds managed by the investment adviser" should not constitute a "material business relationship"); ABC/CIEBA Feb. 22 Letter, at 11 (requiring representatives to determine all compensation received from a swap dealer in connection with all other transactions worldwide would impose staggering administrative burdens and is likely impracticable); AMG-SIFMA Feb. 22 Letter, at 11 (large investment

commenters also assert that the "material business relationship" standard reduces Special Entities' choices for qualified representatives and increases costs for representatives and Special Entities.[785] A number of commenters also requested that the Commission clarify that the disclosure requirement is limited to compensation received in connection with the relevant swap transaction.[786] Conversely, one commenter asserted the rule should require disclosure of all business relationships.[787]

The proposed definition of "material business relationship" also excluded payment of fees by the swap dealer or major swap participant to the Special Entity's representative at the written direction of the Special Entity for services provided in connection with the swap.[788] Some commenters expressed concerns that the exclusion could be used for abuse or would undermine the independence of their advice.[789] These commenters stated the exclusion should be deleted and such practices should be prohibited.[790]

The proposed definition of "material business relationship" also stated that the term is subject to a one-year look back, including any compensation received within one year of an offer to enter into the swap.[791] Some commenters recommended that the Commission extend the relevant

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advisers are affiliated with banks and broker-dealers that would also be, or be affiliated with, swap dealers and would be precluded from entering into trades with many swap dealers on behalf of their customers).

[785] SIFMA/ISDA Feb. 17 Letter, at 38; AMG-SIFMA Feb. 22 Letter, at 11; BlackRock Feb. 22 Letter, at 4; APPA/LPPC Feb. 22 Letter, at 5.

[786] ABC/CIEBA Feb. 22 Letter, at 11; SIFMA/ISDA Feb. 17 Letter, at 38 (disclosure should not be required where a swap dealer in its capacity as broker provided soft dollar research unrelated to any swap transaction to a Special Entity's investment adviser); BlackRock Feb. 22 Letter, at 4; APPA/LPPC Feb. 22 Letter, at 5; CEF Feb. 22 Letter, at 23.

[787] Better Markets Feb. 22 Letter, at 8 (asserting swap dealers have provided advantageous allocations of securities in public offerings to influence advisors that should be disclosed).

[788] Proposing release, 75 FR at 80652 and 80660.

[789] CFA/AFR Feb. 22 Letter, at 17; Better Markets Feb. 22 Letter, at 4 and 8; Calhoun Feb. 22 Letter, at 2; see also CFA/AFR Nov. 3 Letter, at 4; but cf. APPA/LPPC Feb. 22 Letter, at 5 (limiting such arrangements may make it difficult for governmental entities to find qualified swap advisors).

[790] Better Markets Feb. 22 Letter, at 7-8; Better Markets June 3 Letter, at 13; Calhoun Feb. 22 Letter, at 3.

[791] Proposed § 23.450(a)(3), proposing release, 75 FR at 80652 and 80660.

time period.[792] Conversely, another commenter stated that a one-year look back would be problematic in instances where corporate identities change through corporate transactions or consolidations.[793]

Under proposed § 23.450(c)(3), the Special Entity may agree in writing that any compensation the representative received from the swap dealer or major swap participant does not constitute a "material business relationship."[794] One commenter requested that the Commission clarify that the disclosure of any such compensation is made to the Special Entity's board and the written agreement comes from the board.[795] Other commenters asserted that a Special Entity may be reluctant to make a determination that a relationship was not a "material business relationship" because the Special Entity could be held liable if the determination is later deemed inaccurate.[796]

Following the release of the SEC's proposed business conduct standards for SBS Entities, the Commission received comment letters addressing harmonization of the agencies' independence tests.[797] Some commenters requested that both agencies adopt the Commission's proposed approach with "minor adjustments."[798] Other commenters supported the SEC's associated person and gross revenue tests[799] and requested that the agencies coordinate the independence tests.[800]

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[792] CFA/AFR Aug. 29 Letter, at 33; Better Markets Feb. 22 Letter, at 8.
[793] BlackRock Aug. 29 Letter, at 6 (asserting that DOL eliminated a one-year look back rule in the QPAM Exemption in response to industry concerns regarding the workability in light of consolidation and changes in the financial services industry).
[794] Proposing release, 75 FR at 80660.
[795] CFA/AFR Feb. 22 Letter, at 17; CFA/AFR Nov. 3 Letter, at 4.
[796] APPA/LPPC Feb. 22 Letter, at 5; AMG-SIFMA Feb. 22 Letter, at 4.
[797] The SEC proposed that a Special Entity's representative would be "independent" of an SBS Entity if the representative does not have a relationship with the SBS Entity, whether compensatory or otherwise, that reasonably could affect the independent judgment or decision-making of the representative. The SEC's proposal, however, would consider a representative deemed to be independent of the SBS Entity if, within one year, the representative was not an associated person of the SBS Entity and had not received more than ten percent of its gross revenues from the SBS Entity. SEC's proposed rules, 76 FR at 42426.
[798] See, e.g., CFA/AFR Aug. 29 Letter, at 33.
[799] See, e.g., FIA/ISDA/SIFMA Aug. 26 Letter, at 6.

iii. Best Interests, Disclosures, Fair Pricing and Appropriateness

Section 4s(h)(5) and proposed § 23.450(b) would require a swap dealer or major swap participant to have a reasonable basis to believe that a Special Entity's representative (1) undertakes a duty to act in the Special Entity's "best interests"; (2) makes appropriate disclosures; and (3) will provide written representations regarding fair pricing and appropriateness of the transaction.[801] To assess the "best interests" criterion, the Commission proposed by example that a swap dealer or major swap participant would be able to rely, absent red flags, on duties established by appropriate legal arrangements between Special Entities and their independent representatives.[802] One commenter requested that the Commission clarify that a swap dealer or major swap participant could also rely on an employment relationship to satisfy the "best interests" duty, disclosure obligation, and duty to evaluate fair pricing and appropriateness of the swap.[803] Other commenters similarly stated that legal obligations under ERISA or state law would require the fiduciary to an ERISA plan or governmental plan to comply with a best interests duty, disclosure obligations, and a duty to evaluate fair pricing and appropriateness.[804]

iv. Employee Benefit Plans Subject to ERISA

The Commission sought comment on whether the statutory representative criteria under Section 4s(h)(5)(A)(i)(I)-(VI) were duplicative or inconsistent with ERISA's fiduciary

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[800] See, e.g., FIA/ISDA/SIFMA Sept. 14 Letter, at passim; see also SIFMA/ISDA Feb. 17 Letter, at 37-38.
[801] Section 4s(h)(5)(A)(i)(IV)-(VI) of the CEA and proposed § 23.450(b)(4)-(6); proposing release, 75 FR at 80652-53 and 80660.
[802] Proposing release, 75 FR at 80652-53. Such legal arrangements could include, for example, a contract between a pension plan and a plan fiduciary that required the fiduciary to evaluate, consistent with any guidelines provided by the Special Entity, fair pricing and the appropriateness of the swap.
[803] APGA Feb. 22 Letter, at 6; cf. CFA/AFR Aug. 29 Letter, at 34 (asserting that a representative that is subject to separate legal requirements, such as an investment adviser or ERISA fiduciary, could be presumed to satisfy the "best interests" criterion).
[804] See, e.g., ERIC Feb. 22 Letter, at 8-9; CalSTRS Feb. 28 Letter, at 3.

requirements.[805] Commenters asserted that ERISA imposes comparable requirements to the statute and proposed § 23.450(b)(1)-(6), and the rule adds administrative costs without corresponding benefits.[806]

Another commenter stated that it was unclear whether the criteria in Section 4s(h)(5)(A)(i)(I)-(VI) apply to governmental plans that are defined in but not subject to ERISA. The commenter requested that the Commission clarify that a governmental plan's representative does not need to satisfy the first six criteria if it is represented by a fiduciary under state or local law.[807]

d. Reasonable Reliance on Representations

Proposed § 23.450(d) permitted a swap dealer or major swap participant[808] to rely on Special Entity representations to satisfy its duty to assess the qualifications of the Special Entity's independent representative, if the representations were reliable and sufficiently detailed.[809] Several commenters expressed concern with the language in proposed § 23.450(d)(1) that would require the swap dealer or major swap participant to "consider the facts and circumstances of a particular Special Entity-representative relationship, assessed in the context of a particular transaction."[810] Similarly, several commenters expressed concern with the language in proposed

[805] Proposing release, 75 FR at 80653.
[806] SIFMA/ISDA Feb. 17 Letter, at 36-37; ERIC Feb. 22 Letter, at 2 and 6-9 (asserting that ERISA imposes "duties that are similar, but more exacting," with respect to the knowledge requirement, statutory disqualification, independence, best interests, disclosures, and fair pricing and appropriateness); ABC/CIEBA June 3 Letter, at 6.
[807] CalSTRS Feb. 28 Letter, at 6.
[808] Two commenters noted that the rule text of proposed § 23.450(d) provided that a swap dealer may rely on written representations but was silent as to whether major swap participants could rely. See SIFMA/ISDA Feb. 17 Letter, at 36 fn. 85; ABC/CIEBA Feb. 22 Letter, at 9 fn. 2. The Commission intended this provision to be available to both swap dealers and major swap participants and expressly references both in final § 23.450(e).
[809] Proposing release, 75 FR at 80660.
[810] SIFMA/ISDA Feb. 17 Letter, at 35-36; ABC/CIEBA Feb. 22 Letter, at 9; BlackRock Feb. 22 Letter, at 3; proposing release, 75 FR at 80660.

§ 23.450(d)(2) that would require the representations to be "sufficiently detailed."[811] Conversely, one commenter supported the Commission's approach and requested that the Commission require record retention that would permit the Commission to determine compliance.[812]

A majority of commenters asserted that proposed § 23.450(d) would require extensive and burdensome transaction-by-transaction diligence that would significantly delay execution and increase costs for swap dealers, major swap participants and Special Entities.[813] Commenters also asserted that the conditions for reliance, which include a nonexclusive list of seven factors under proposed § 23.450(d)(2), were unnecessarily complex and could cause swap dealers or major swap participants to overreach in their requests for information.[814] Many commenters requested that the Commission permit swap dealers and major swap participants to rely on representations from the Special Entity or the independent representative that simply repeat the enumerated criteria in proposed § 23.450(b).[815] Commenters also requested that the Commission permit representations to be made on a relationship basis and only updated periodically[816] or upon a material change such as a change in the Special Entity's representative.[817] Another commenter stated that to avoid giving the swap dealer or major swap participant unfair leverage when dealing with Special Entities, the required representations must be unambiguous, and

[811] Id.
[812] CFA/AFR Feb. 22 Letter, at 6; CFA/AFR Nov. 3 Letter, at 5.
[813] See, e.g., SIFMA/ISDA Feb. 17 Letter, at 35-36; ABC/CIEBA Feb. 22 Letter, at 9-10; BlackRock Feb. 22 Letter, at 3; ABA/ABC Feb. 22 Letter, at 2-3; AMG-SIFMA Feb. 22 Letter, at 9; SWIB Feb. 22 Letter, at 4-5; Ropes & Gray Feb. 22 Letter, at 3-4; APPA/LPPC Feb. 22 Letter, at 4.
[814] See, e.g., Ropes & Gray Feb. 22 Letter, at 3-4; APPA/LPPC Feb. 22 Letter, at 4; SIFMA/ISDA Feb. 17 Letter, at 35-36; ABC/CIEBA Feb. 22 Letter, at 9-10.
[815] SIFMA/ISDA Feb. 17 Letter, at 35-36; ABC/CIEBA Feb. 22 Letter, at 10; SWIB Feb. 22 Letter, at 4-5; CEF Feb. 22 Letter, at 16 and 23; VRS Feb. 22 Letter, at 5; APPA/LPPC Feb. 22 Letter, at 4; Comm. Cap. Mkts. May 3 Letter, at 2; Comm. Cap. Mkts. Aug. 29 Letter, at 2-3.
[816] Ropes & Gray Feb. 22 Letter, at 4.
[817] APGA Feb. 22 Letter, at 6-7.

determinations of accuracy must be within the sole judgment of the Special Entity.[818]

A number of commenters also discussed the circumstances in which a swap dealer or major swap participant could rely on a representation without further inquiry. Some commenters suggested the Commission permit a swap dealer or major swap participant to rely if it did not have actual knowledge that the representations were incorrect.[819] Conversely, some commenters suggested the Commission permit reliance unless the swap dealer or major swap participant knows of facts that reasonably should put it on notice that would trigger a duty to inquire further.[820] Two commenters requested that the Commission clarify that the exchange of representations will not give any party any additional rescission, early termination, or monetary compensation rights.[821]

e. Unqualified Representatives

Proposed § 23.450(e) provided that any swap dealer or major swap participant that determines a Special Entity's representative does not meet the relevant criteria must submit a written record of the basis of its determination to the chief compliance officer for review that the determination was unbiased. Two commenters asserted that the proposed rule does not provide meaningful protection to Special Entities from a swap dealer or major swap participant that abuses its discretion.[822] Another commenter recommended the Commission require the swap dealer or major swap participant to submit the written record to the Commission in addition to

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[818] CalPERS Oct. 4 Letter, at 1.

[819] See, e.g., ABC/CIEBA Feb. 22 Letter, at 10-11; Davis & Harman Mar. 25 Letter, at 5-6; APGA Feb. 22 Letter, at 6; SIFMA/ISDA Feb. 17 Letter, at 36; contra CFA/AFR Nov. 3 Letter, at 5.

[820] See, e.g., SIFMA/ISDA Feb. 17 Letter, at 36 ("[swap dealers] should be permitted to rely on a written representation . . . that the counterparty and/or its representative satisfies the standards . . . absent actual 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."); see also supra fn. 724. Contra CFA/AFR Nov. 3 Letter, at 5.

[821] ABC/CIEBA Feb. 22 Letter, at 12-13 (asserting that a swap dealer faced with a highly volatile market and disadvantageous swap position could claim that a Special Entity provided inaccurate representations to avoid its obligations); AMG-SIFMA Feb. 22 Letter, at 10.

[822] ABC/CIEBA Feb. 22 Letter, at 9; CalPERS Feb. 18 Letter, at 3.

the chief compliance officer.[823] A commenter also asserted the Commission should require the written determination be made to the trading supervisor rather than the chief compliance officer.[824]

A commenter requested that the Commission confirm that the swap dealer or major swap participant would not have any liability to the Special Entity or its representative as a result of its good faith determination that the representative was not qualified.[825]

f. Disclosure of Capacity

Proposed § 23.450(f) requires a swap dealer or major swap participant to disclose to the Special Entity the capacity in which it is acting in connection with the swap and, if in more than one capacity, to disclose the material differences between such capacities in connection with the swap and any other financial transaction or service involving the Special Entity. Two commenters requested that the Commission clarify that required disclosures of other capacities be limited only to those capacities in connection with the swap.[826] Commenters also requested the Commission clarify the meaning of "before the initiation of a swap" and to confirm that such disclosures could be made in a master agreement.[827] One commenter asserted that ERISA plans typically have many different types of relationships with swap dealers, and listing all such relationships prior to each transaction would impose significant burdens and not provide meaningful information to an ERISA plan.[828]

g. Transaction Costs and Risks

Commenters asserted that compliance with proposed § 23.450 would be burdensome, costly,

[823] CFA/AFR Feb. 22 Letter, at 18.
[824] SIFMA/ISDA Feb. 17 Letter, at 38-39.
[825] Id.
[826] SIFMA/ISDA Feb. 17 Letter, at 39; ABC/CIEBA Feb. 22 Letter, at 11-12.
[827] See, e.g., SIFMA/ISDA Feb. 17 Letter, at 39; ABC/CIEBA Feb. 22 Letter, at 11-12; APGA Feb. 22 Letter, at 7.
[828] ABC/CIEBA Feb. 22 Letter, at 12.

or impractical.[829] Commenters also stated that the proposed rule may expose swap dealers and major swap participants to new litigation risks from Special Entities and representatives.[830] Commenters asserted that swap dealers and major swap participants will either pass additional risk and compliance costs onto Special Entities or refuse to transact with Special Entities altogether, and such results are ultimately harmful to Special Entities and outweigh any benefits.[831]

3. Final § 23.450

Based on consideration of the comments, the Commission has determined to adopt proposed § 23.450 with several changes. The principal changes include, first, under § 23.450(b)(2), a representative of an ERISA plan will have to meet only one criterion to qualify under the section: That it is a fiduciary as defined in Section 3 of ERISA (29 U.S.C. 1002).[832] Second, under § 23.450(d)(1) certain counterparty representations will be deemed to provide a reasonable basis for a swap dealer or major swap participant to believe that a representative of a Special Entity, other than an ERISA plan, meets the enumerated criteria in § 23.450(b).[833] Third, under

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[829] See, e.g., ABC/CIEA Feb. 22 Letter, at 3; ERIC Feb. 22 Letter, at 9; CalSTRS Feb. 28 Letter, at 2 and 6; MFA Feb. 22 Letter, at 2; CalPERS Feb. 18 Letter, at 3-4; CEF Feb. 22 Letter, at 16; HOOPP Feb. 22 Letter, at 2.

[830] See, e.g., ABC/CIEBA Feb. 22 Letter, at 9-10; SIFMA/ISDA Feb. 17 Letter, at 39; VRS Feb. 22 Letter, at 3; HOOPP Feb. 22 Letter, at 2; CEF Feb. 22 Letter, at 16.

[831] See, e.g., ABC/CIEBA Feb. 22 Letter, at 9-10; ERIC Feb. 22 Letter, at 9-10; CalSTRS Feb. 28 Letter, at 2 and 6; MFA Feb. 22 Letter, at 2; CalPERS Feb. 18 Letter, at 3-4; CEF Feb. 22 Letter, at 16; HOOPP Feb. 22 Letter, at 2.

[832] Section 23.450(b)(2) provides: "Any swap dealer or major swap participant that offers to enter or enters into a swap with a Special Entity as defined in § 23.401(c)(3) shall have a reasonable basis to believe that the Special Entity has a representative that is a fiduciary as defined in Section 3 of [ERISA] (29 U.S.C. 1002)." A swap dealer or major swap participant will have a reasonable basis to believe that an ERISA plan has a qualified independent representative under § 23.450(b)(2) if it receives a representation in writing identifying the representative and stating that the representative is a fiduciary as defined in Section 3 of ERISA (29 U.S.C. 1002) as provided in § 23.450(d)(2).

[833] Section 23.450(d)(1) provides: Safe Harbor. (1) A swap dealer or major swap participant shall be deemed to have a reasonable basis to believe that the Special Entity, other than a Special Entity defined in § 23.401(c)(3), has a representative that satisfies the applicable requirements of paragraph (b)(1) of this section provided that: (i) The Special Entity represents in writing to the swap dealer or major swap participant that it has complied in good faith with written policies and procedures reasonably designed to ensure that it has selected a representative that satisfies the applicable requirements of paragraph (b) of this section, and that such policies and procedures provide for ongoing monitoring of the performance of such representative consistent with the requirements of paragraph (b) of

§ 23.450(c) compliance with certain criteria will be deemed to establish that a representative is "independent" of the swap dealer or major swap participant within the meaning of § 23.450(b)(1)(iii).[834] The following discussion addresses comments on proposed § 23.450 and the changes in final § 23.450.

a. Types of Special Entities Included in Section 4s(h)(5)(A)(i)

The Commission has determined based on the statutory framework and legislative intent that final § 23.450, like the proposed rule, shall apply to swaps offered or entered into with all types of Special Entities. The Commission declines to adopt commenters' position that the rule be limited to the entities described under Section 1a(18)(A)(vii)(I) and (II).[835] The Commission also disagrees with commenters' assertion that the Commission does not have the authority to apply the rule to swaps with all types of Special Entities.

Requiring swap dealers or major swap participants to comply with § 23.450 when dealing

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this section; and (ii) The representative represents in writing to the Special Entity and swap dealer or major swap participant that the representative: (A) Has policies and procedures reasonably designed to ensure that it satisfies the applicable requirements of paragraph (b) of this section; (B) Meets the independence test in paragraph (c) of this section; and (C) Is legally obligated to comply with the applicable requirements of paragraph (b) of this section by agreement, condition of employment, law, rule, regulation, or other enforceable duty.

[834] Section 23.450(c) provides: Independent. For purposes of paragraph (b)(1)(iii) 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 of representing the Special Entity in connection with the swap, 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; (3) The representative: (i) Provides timely and effective disclosures to the Special Entity of all material conflicts of interest that could reasonably affect the judgment or decision making of the representative with respect to its obligations to the Special Entity; and(ii) Complies with policies and procedures reasonably designed to manage and mitigate such material conflicts of interest; (4) The representative is not directly or indirectly, through one or more persons, controlled by, in control of, or under common control with the swap dealer or major swap participant; and (5) The swap dealer or major swap participant did not refer, recommend, or introduce the representative to the Special Entity within one year of the representative's representation of the Special Entity in connection with the swap.

[835] The Commission is persuaded, however, that with respect to ERISA plans, the swap dealer or major swap participant need only assess whether the plan representative is a fiduciary as defined in Section 3 of ERISA (29 U.S.C. 1002) as provided in Section 4s(h)(5)(A)(VII). See Section IV.C.3.d. for a discussion of qualification criteria for independent representatives.

with all types of Special Entities resolves the ambiguities in the statutory text.[836] The determination is also consistent with the legislative history[837] and the clear statutory intent to raise the standard of care for swap dealers and major swap participants dealing with Special Entities, generally. Finally, Section 4s(h)(5)(B) provides the Commission with discretionary rulemaking authority to 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 the CEA. The Commission believes that ensuring all Special Entities have a sufficiently knowledgeable and independent representative that is capable of providing disinterested, expert advice is an essential component of the statutory framework that Congress established for Special Entities.[838]

b. ERISA Plan Representatives that are ERISA Fiduciaries

The Commission has considered the statutory language in Section 4s(h)(5) and issues raised by commenters[839] and is persuaded that, for transactions with an ERISA plan under final § 23.450, swap dealers and major swap participants need only have a reasonable basis to believe that an ERISA plan representative is an ERISA fiduciary. This interpretation of Section 4s(h)(5) of the CEA is informed by the comprehensive federal regulatory scheme that applies to plans subject to regulation under ERISA, the importance of harmonizing the Dodd-Frank Act requirements with ERISA to avoid unintended consequences, and the Commission's view that ERISA plans will continue to benefit from the many other protections under subpart H of part 23

[836] See fn. 727 discussing the ambiguities in Section 4s(h)(5) of the CEA as to whether the duty is intended to apply with respect to all types of Special Entity counterparties or just a sub-group.
[837] 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.").
[838] For ERISA plans, the Commission has determined that the statute deems a fiduciary as defined in Section 3 of ERISA (29 U.S.C. 1002) to be a qualified independent representative within the meaning of Section 4s(h)(5)(A).
[839] See, e.g., SIFMA/ISDA Feb. 17 Letter, at 36-37; ERIC Feb. 22 Letter, at 2 and 6; ABC/CIEBA June 3 Letter, at 6.

of the Commission's rules. The Commission declines to opine on commenters claims that requirement's under ERISA for plan fiduciaries are comparable,[840] or not,[841] to those criteria in subclauses (I)-(VI) of Section 4s(h)(5)(A)(i). That is more appropriately addressed by DOL, the primary regulator of ERISA plans.

Thus, the Commission is adopting proposed § 23.450(b)(7) (renumbered as § 23.450(b)(2)) as a separate provision that applies only with respect to ERISA plans as defined in § 23.401(c)(3). A swap dealer or major swap participant that offers or enters into a swap with an ERISA plan need only have a reasonable basis to believe that the ERISA plan's representative is an ERISA fiduciary.

c. Duty to Assess the Qualifications of a Special Entity's Representative

The Commission has determined to clarify the final rule text to address commenters' concerns that a swap dealer or major swap participant could use the statutory framework prescribed for assessing the qualifications of a Special Entity representative to overreach in requesting information from the Special Entity or to otherwise gain a negotiating advantage. Thus, the Commission has added § 23.450(d), which states that a swap dealer or major swap participant shall have a reasonable basis to believe a Special Entity's chosen representative complies with all criteria under § 23.450 where the swap dealer or major swap participant receives certain representations from the Special Entity and its representative.[842] The representations under § 23.450(d) may be made, as appropriate, on a relationship basis in counterparty relationship documentation consistent with §§ 23.402(d) and 23.450(e). Finally, § 23.450(f) requires a swap dealer or major swap participant's chief compliance officer to review

[840] See, e.g., ERIC Feb. 22 Letter, at 6-9.
[841] AFSCME Feb. 22 Letter, at 5.
[842] Section 23.450(d) supra fn. 833. See also Section IV.C.3.e. of this adopting release for a discussion of § 23.450(d).

any determination that the swap dealer or major swap participant does not have a reasonable basis to believe that a Special Entity's representative meets the criteria in § 23.450. The chief compliance officer's review must ensure that there is a substantial, unbiased basis for the determination.

d. Representative Qualifications

i. Regulated Entities and Suggested Certification Regime

The Commission declines commenters' suggestion that a swap dealer or major swap participant be permitted to conclude that a Special Entity's representative is per se qualified because it has a particular status such as CTA, bank, investment adviser, insurance company, municipal advisor, state law pension fiduciary, or is an employee of the Special Entity.[843] The statutory language does not reference any "status" other than a fiduciary as defined in ERISA. As a result the Commission is not inclined to conclude that regulatory status alone is a sufficient proxy for the enumerated criteria in Section 4s(h)(5)(A).

The Commission is continuing to consider commenters' suggestion that the Commission or an SRO develop a voluntary certification and proficiency examination program for independent representatives that would permit a swap dealer or major swap participant to rely on such certification as satisfying the enumerated criteria.[844] In this regard, the Commission notes, that it has begun informal consultations with the staffs of the SEC, NFA, and MSRB to harmonize regulatory requirements for municipal advisors and CTAs that advise municipalities on swaps.

[843] The Commission's determination that ERISA plan representatives that are ERISA fiduciaries will meet the requirements of the rule is premised on the statutory language referencing the comprehensive Federal regulatory scheme under ERISA. See also Section IV.C.3.b. of this adopting release for a discussion of representatives of ERISA plans.

[844] The Commission is considering both legal and practical issues raised by commenters' certification proposal. See, e.g., Section 4o(2) of the CEA makes it unlawful for any CTA or commodity pool operator registered under the CEA to "represent or imply in any manner whatsoever that such person has been sponsored, recommended, or approved by the United States or any agency or officer thereof." From a practical standpoint, the proposal would depend on resources committed by an SRO or private certification board.

The Commission intends to continue to explore whether such efforts could be incorporated into a broader application for the independent representatives of all Special Entities.

In the meantime, however, the Commission believes that final § 23.450 provides a manageable approach for qualifying Special Entity representatives that addresses the commenters' concerns about the role of swap dealers and major swap participants under the statutory framework and proposed § 23.450. The Commission has clarified the means of compliance for a swap dealer or major swap participant, including compliance through representations made on a relationship basis, as appropriate. Furthermore, the Commission is adopting an alternative means of compliance under § 23.450(d)[845] with clear, objective criteria that will permit a swap dealer or major swap participant to form a reasonable basis to believe that a Special Entity's representative meets the relevant criteria, without undue influence on the selection process.

ii. Sufficiently Knowledgeable

The Commission requested comment on whether there are other qualifications that should be considered regarding whether an independent representative has sufficient knowledge to evaluate the transaction and risks.[846] The Commission did not receive comments addressing any additional qualifications other than a representative that holds a particular regulatory, state law, or employment status.[847] Therefore, the Commission is adopting § 23.450(b)(1) as proposed (renumbered as § 23.450(b)(1)(i)).

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[845] See Section IV.C.3.e. of this adopting release for a discussion of § 23.450(d) (under § 23.450(d), as adopted, a swap dealer or major swap participant shall have a reasonable basis to believe a Special Entity's chosen representative complies with all criteria under § 23.450 where the swap dealer or major swap participant receives certain representations from the Special Entity and its representative).

[846] Proposing release, 75 FR at 80653.

[847] The Commission separately addressed comments regarding a Special Entity's representative that holds a particular regulatory, state law or employment status. See Section IV.C.3.d.i. of this adopting release.

The Commission has determined to delete from the final rule text the list of factors that a swap dealer or major swap participant would be expected to consider in determining whether an independent representative meets the enumerated criteria in the proposed rule.[848] Commenters found the proposed rule text confusing and unworkable.[849] In light of the comments, the Commission has determined that such considerations are more appropriate as guidance regarding whether a representative is sufficiently knowledgeable, and would be relevant where the Special Entity did not provide the representations specified in § 23.450(d) for establishing the qualifications of a representative.

Where a swap dealer or major swap participant is required to undertake due diligence to assess whether it has a reasonable basis to believe that a representative has sufficient knowledge to evaluate the transaction and risks, it should consider: (1) The representative's capability to make hedging or trading decisions, and the resources available to the representative to make informed decisions; (2) the use by the representative of one or more consultants; (3) 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; (4) the representative's ability to understand the economic features of the swap involved; (5) the representative's ability to evaluate how market developments would affect the swap; and (6) the complexity of the swap or swaps involved. Additional considerations may also include the

[848] The proposed rule set out several factors to be considered by swap dealers and major swap participants in determining whether the Special Entity's representative satisfies certain of the enumerated criteria, including (1) the nature of the Special Entity-representative relationship; (2) the representative's ability to make hedging or trading decisions; (3) the use of consultants or, with respect to employee benefit plans subject to ERISA, use of a QPAM or INHAM; (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. These criteria will serve as guidance to swap dealers and major swap participants required to undertake due diligence to assess the sophistication of a Special Entity's representative.

[849] See, e.g., ABC/CIEBA Feb. 22 Letter, at 3.

representative's ability to analyze the credit risk, market risk, and other relevant risks posed by a particular swap and its ability to determine the appropriate methodologies used to evaluate relevant risks and the information which must be collected to do so. The listed considerations are illustrative guidance.[850]

iii. Statutory Disqualification

The Commission did not receive any comments regarding this criterion under proposed § 23.450(b)(2); therefore, the Commission adopts § 23.450(b)(2) (renumbered as § 23.450(b)(1)(ii)) and the definition of "statutory disqualification" in § 23.450(a)(3) as proposed with respect to Special Entities other than ERISA plans. The Commission also clarifies that a representative must satisfy the criterion regardless of whether it is registered or is required to register with the Commission, such as an employee of the Special Entity.

iv. Independence

The Commission proposed a three prong test to determine whether the Special Entity representative was "independent" of the swap dealer or major swap participant. A representative would be deemed to be independent if: (1) It was not, within one year, an associated person of the swap dealer or major swap participant (proposed § 23.450(c)(1)); (2) there was no "principal relationship" between the representative and the swap dealer or major swap participant (proposed § 23.450(a)(2) and (c)(2)); and (3) the representative did not have a "material business relationship" with the swap dealer or major swap participant (proposed § 23.450(a)(1) and (c)(3)).[851]

[850] The Commission does not intend to imply that each consideration is necessarily a prerequisite for a swap dealer or major swap participant to form a reasonable basis to believe the representative is sufficiently knowledgeable. For example, an employee of a Special Entity, in some cases, may not use one or more third party consultants. However, this would not mean, in and of itself, that the representative is not sufficiently knowledgeable.

[851] Proposing release, 75 FR at 80651-52 and 80660.

a. Associated Person

The Commission is adopting the "associated person" prong in proposed § 23.450(c)(1) and clarifies that "within one year" means "within one year of representing the Special Entity in connection with the swap." The Commission clarifies that where the Special Entity's representative is an entity, the representative could still satisfy the "associated person prong" in final § 23.450(c)(1) if the representative had an employee that was an associated person of the swap dealer or major swap participant within the preceding twelve months ("restricted associated person").[852] To satisfy the "associated person" prong in this situation, a Special Entity's representative must comply with policies and procedures reasonably designed to manage and mitigate the conflict. Such policies and procedures, for example, should impose compensation restrictions to avoid having the restricted associated person benefit from the Special Entity's transactions with the swap dealer or major swap participant and provide for informational barriers, as appropriate, between any restricted associated person and those employees that directly provide advice, make trading decisions or otherwise manage and supervise the Special Entity's account with respect to swaps with the swap dealer or major swap participant.

b. Principal Relationship

The Commission is also adopting the "principal relationship" prong of the proposed independence test with one clarification. Section 23.450(a)(2) (renumbered as § 23.450(a)(1)) is amended to clarify that the term "principal," with respect to any swap dealer, major swap participant, or Special Entity's representative, means any person listed in § 3.1(a)(1)-(3) as

[852] The definition of "associated person of a swap dealer or major swap participant" under Section 1a(4) of the CEA (7 U.S.C. 1a(4)) is limited by its terms to natural persons. Section 1a(4) states in relevant part that the term "means a person who is associated with a swap dealer or major swap participant as a partner, officer, employee, or agent (or any person occupying a similar status or performing similar function) in any capacity that involves–(i) the solicitation or acceptance of swaps; or (ii) the supervision of any person or persons so engaged."

opposed to a person defined in § 3.1(a).

c. Material Business Relationship

Proposed § 23.450(a)(1) defined "material business relationship" as any relationship, whether compensatory or otherwise, that could reasonably affect the independent judgment or decision making of the representative. The Commission has determined to delete the "material business relationship" prong of the independence test in proposed § 23.450(a)(1) and (c)(3) and to substitute the following three criteria that were encompassed within the definition.

First, under § 23.450(c)(3), to be deemed "independent," a representative must (1) provide timely and effective disclosures of all material conflicts of interest that could reasonably affect the judgment or decision making of the representative with respect to its obligations to the Special Entity, and (2) comply with policies and procedures reasonably designed to manage and mitigate all such material conflicts of interest. In the Commission's view, to be "timely and effective" the disclosures would be have to be sufficient to permit the Special Entity to assess the conflict of interest and take steps to mitigate any materially adverse effect on the Special Entity that could be created by the conflict. In determining whether a conflict of interest exists, a representative would be expected to review its relationships with the swap dealer or major swap participant and their affiliates, including lines of business in which the representative will solicit business on an ongoing basis.[853] Additionally, where applicable, the representative should review relationships of its principals and employees who could reasonably affect the judgment or decision making of the representative with respect to its obligations to the Special Entity. The representative must also manage and mitigate its material conflicts of interest to avoid having a

[853] For example, a representative may have separate lines of business in which it provides services to swap dealers, major swap participants, or their affiliates. The representative should consider whether such ongoing relationships where it has an interest in maintaining existing business or soliciting future business could reasonably affect its judgment or decision making with respect to its obligations to the Special Entity.

materially adverse effect on the Special Entity. A representative should establish and comply in good faith with written policies and procedures that identify, manage and mitigate material conflicts of interest including, where appropriate, those arising from (1) compensation or incentives for employees that carry out the representative's obligations to the Special Entity, and (2) lines of business, functions and types of activities conducted by the representative for the swap dealer or major swap participant.[854]

Second, the Commission has added § 23.450(c)(4) to the independence test to clarify that a representative may not, directly or indirectly, control, be controlled by, or be under common control with the swap dealer or major swap participant. This provision is consistent with the "principal relationship" prong and clarifies that a representative would not be deemed "independent" where there is indirect control through one or more persons or common control with the swap dealer or major swap participant.

Finally, the Commission is adopting § 23.450(c)(5), which clarifies that a representative will not be deemed independent if the swap dealer or major swap participant refers, recommends, or introduces the representative to the Special Entity within one year of the representative's representation of the Special Entity in connection with the swap. The Commission believes a

[854] Similarly, the Special Entity and representative should consider the basis upon which the representative will be compensated by the Special Entity to ensure that the representative's compensation is not contingent upon executing, for example, a particular swap, or a swap with a particular dealer or major swap participant. The Commission understands based on industry practice that representative fees are sometimes paid at the time of execution of the swap by the swap dealer or major swap participant at the direction of the Special Entity for services provided by the representative in connection with the swap. In the proposed rule, the Commission recognized that such transfer of payment on behalf of the Special Entity would not necessarily be a material conflict of interest between the representative and the swap dealer or major swap participant. See proposed definition of material business relationship in proposed § 23.450(a)(1). Proposing release, 75 FR at 80660. However, Special Entities and representatives must ensure that the compensation arrangement does not undermine the independence and "best interests" duty of the representative as a result of the contingent nature of the fee arrangement. As a nonexclusive example, where a representative's compensation is contingent on execution by the Special Entity of a specific transaction with a specific swap dealer, the representative will have a material conflict of interest and will not be incentivized to act in the best interests of the Special Entity. Special Entities should ensure that the fee arrangements with their representatives do not compromise the independence of the representative, create conflicts of interest or otherwise undermine the quality of the advice provided by the representative.

Special Entity should retain a representative without input from the swap dealer or major swap participant. If a swap dealer or major swap participant is asked by a Special Entity for a name or list of names of potential representatives, the swap dealer or major swap participant would be expected either to decline to answer or direct the Special Entity to, for example, an independently maintained repository of business listings such as a list of registrants with a relevant SRO, a trade association unaffiliated with the swap dealer or major swap participant, or a widely-available independent publication that provides industry contact information.

The Commission has considered the comments and believes that deleting the "material business relationship" prong and substituting the enumerated criteria in § 23.450(c) resolves commenters' primary issues about clarity and workability. In addition, the reformulation of the treatment of ERISA plans under § 23.450(b)(2) eliminates any potential conflict with the independence test under ERISA.[855] The final rule also resolves commenters' concern that the standard would inappropriately preclude qualified asset managers with complex business relationships with swap dealers or major swap participants from acting as Special Entity representatives. Furthermore, any added costs associated with the duty to disclose and mitigate material conflicts of interest will only be incremental because many third party independent representatives will already be subject to similar or identical disclosure obligations by virtue of being a CTA, investment adviser, municipal advisor, or other fiduciary to the Special Entity. The Commission has also determined that a conflicts disclosure regime paired with an obligation to manage and mitigate conflicts appropriately balances the statutory independence criterion with any associated costs.

v. Duty to Act in the Best Interests

[855] See Section IV.C.3.b. of this adopting release.

The Commission agrees with commenters that a swap dealer or major swap participant could rely[856] on evidence of legal arrangements between the Special Entity and its representative that the representative is obligated to act in the best interests of the Special Entity, including by contract, an employment agreement, or requirements under state or federal law.[857] Having considered the comments, the Commission is adopting § 23.450(b)(4) as proposed (renumbered as § 23.450(b)(1)(iv)).

As more fully discussed in connection with § 23.440, the Commission has determined that a best interests duty under §§ 23.440 and 23.450 will be the duty to act in good faith, make full and fair disclosure of all material facts and conflicts of interest, and to employ reasonable care to advance the Special Entity's stated objectives.[858]

vi. Appropriate and Timely Disclosures

The Commission also agrees with commenters and confirms that a swap dealer or major swap participant could rely on appropriate legal arrangements between a Special Entity and its representative to form a reasonable basis to believe the representative makes appropriate and timely disclosures. Therefore, the Commission is adopting § 23.450(b)(5) as proposed (renumbered as § 23.450(b)(1)(v)).[859]

The Commission expects that "appropriate disclosures" will be assessed in the context of the

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[856] In making the representations specified in § 23.450(d) for establishing the qualifications of a representative Special Entities are encouraged to ensure that their policies and procedures are sufficiently robust to evaluate the effectiveness and enforceability of the obligations of the representative to act in the best interests of the Special Entity, to make appropriate and timely disclosures, and to evaluate the appropriateness and pricing of any swaps entered into by the Special Entity.

[857] This is also consistent with proposed § 23.450(d)(2)(i), which stated that relevant considerations for a swap dealer or major swap participant include: "The nature of the relationship between the Special Entity and the representative and the duties of the representative, including the obligation to act in the best interests of the Special Entity." As with proposed § 23.450(d)(2)(ii)-(vii), the Commission has decided to delete proposed § 23.450(d)(2)(i) and adopt it as guidance.

[858] Section IV.B.3.c. of this adopting release.

[859] See supra, fn. 856.

Special Entity-representative relationship. For example, a third party advisor would be expected to disclose all compensation it receives, directly or indirectly, with respect to the swap, and it would be expected to disclose all material conflicts of interest. Disclosures should also include all fees and compensation structures in a manner that is clearly understandable to the Special Entity.[860] A representative that is a Special Entity's employee would be expected to disclose material information not otherwise known to a Special Entity through the employment relationship such as any material compensation the representative receives from a third party or where the representative trades for its own account in the same or a related market. The Commission also expects that a representative would timely disclose to the Special Entity (or to appropriate supervisors in the case of an employee), where appropriate, unexpected gains or losses, unforeseen changes in the market place, compliance irregularities or violations, and other material information.[861]

vii. Fair Pricing and Appropriateness

Section 4s(h)(5)(A)(i)(VI) states that the representative will provide "written representations to the Special Entity regarding fair pricing and the appropriateness of the transaction." Proposed § 23.450(b)(6) refined the statutory language to state that the representative "evaluates, consistent with any guidelines provided by the Special Entity, fair pricing and the appropriateness of the swap."[862] Having considered the comments, the Commission is adopting

[860] For example, where a representative's fee is expressed as basis points on the notional amount of the transaction, the representative should also disclose a calculation of the fee in dollars.

[861] The Commission encourages Special Entities to consider the factors discussed in this adopting release in developing appropriate policies and procedures for selecting a qualified representative and monitoring their ongoing performance.

[862] Proposing release, 75 FR at 80652-53 and 80660. A commenter requested that the Commission confirm that implementation of a hedge policy and periodic review of compliance with the policy would be sufficient to meet the fair pricing and appropriateness criterion. APGA Feb. 22 Letter, at 6. The Commission declines to endorse any particular method of compliance with the statutory criteria in light of the principles based nature of the rule but believes such considerations would be relevant to an assessment of compliance with the criterion.

§ 23.450(b)(6) as proposed (renumbered as § 23.450(b)(1)(vi)).

The Commission also clarifies that this provision does not require that the representative provide transaction-by-transaction documentation to the Special Entity with respect to fair pricing and appropriateness of the swap. The Commission expects that in circumstances where the representative is given discretionary trading authority, for example, the representative could undertake in an investment management agreement or other agreement to ensure that the representative will evaluate pricing and appropriateness of each swap consistent with any guidelines provided by the Special Entity prior to entering into the swap. The Commission notes, however, that the independent representative would be expected to prepare and maintain adequate documentation of its evaluation of pricing and appropriateness to enable both the representative and Special Entity to audit for compliance with the duty.

viii. Restrictions on Political Contributions by the Independent Representative of a Governmental Special Entity

The Commission is adopting § 23.450(b)(8) (renumbered as § 23.450(b)(1)(vii)) with modifications to the term "municipal entity."[863] Consistent with the modifications to § 23.451, the phrase "municipal entity as defined in § 23.451" has been replaced with the phrase "Special Entity as defined in § 23.401(c)(2) or (4)." This modification clarifies that the rule only applies to representatives of State and municipal Special Entities and governmental plans. The Commission also clarifies that the exclusion for employees of such Special Entities is limited to paragraph § 23.450(b)(1)(vii).

[863] Although the Commission did not receive any comments regarding the requirements of proposed § 23.450(b)(8), two commenters requested the Commission clarify the differences between the term "municipal entity" in proposed § 23.450(b)(8) and § 23.451 and the definition of Special Entity. See, APGA Feb. 22 Letter, at 2; AMG-SIFMA Feb. 22 Letter, at 13. The Commission has addressed the substance of those comments in the definitions section (see Section IV.A.3.b. of this adopting release) and the section on § 23.451 (see Section IV.D.3. of this adopting release).

The Commission also notes that while the provision requires an assessment of whether the representative is subject to restrictions on certain political contributions imposed by the Commission, SEC, or an SRO, neither the Commission nor a registered futures association has, as of the adoption of these rules, promulgated such requirements for CTAs that advise State and municipal Special Entities or governmental plans.[864] Therefore, the Commission has set a separate implementation schedule for § 23.450(b)(1)(vii).[865]

e. Reasonable Reliance on Representations

Final § 23.450 allows swap dealers and major swap participants to comply with the rule by relying on representations of counterparties with respect to the qualifications of their independent representatives. Commenters were particularly concerned with the language in proposed § 23.450(d) (renumbered as § 23.450(e)) that the representations be reliable "taking into consideration the facts and circumstances of a particular Special Entity-representative relationship, assessed in the context of a particular transaction" and that the representations be "sufficiently detailed."[866] New final § 23.450(d) (safe harbor) and final § 23.450(e) (reasonable reliance on representations of the Special Entities) together address many of the commenters' concerns by clarifying the content of representations that will be deemed to provide a swap dealer or major swap participant a reasonable basis to believe a Special Entity's representative

[864] Investment advisers registered with the SEC are currently subject to SEC Advisers Act Rule 206(4)-5, Political Contributions by Certain Investment Advisers, effective date Sept. 13, 2010, 17 CFR 275.206(4)-5; see also SEC's proposed rules, 76 FR 41018. Pending final adoption of the SEC's registration rule for municipal advisors, the MSRB has withdrawn the Proposed Interpretive Notice Concerning the Application of Rule G-17, on Conduct of Municipal Securities and Municipal Advisory Activities, to Municipal Advisors, SR-MSRB-2011-15 (August 24, 2011). In a press release, the MSRB stated, "Upon the SEC's adoption of a permanent definition of the term 'municipal advisor' under the Exchange Act, the MSRB plans to resubmit these rule proposals," MSRB Notice 2011-51 (Sept. 9, 2011).

[865] See Section V at fn. 926 of this adopting release for a discussion of the implementation schedule for § 23.450(b)(1)(vii).

[866] See, e.g., SIFMA/ISDA Feb. 17 Letter, at 36; proposing release, 75 FR at 80660.

meets the qualification criteria.[867] The Commission also confirms that such representations, where appropriate, can be contained in counterparty relationship documentation to avoid transaction-by-transaction compliance.[868]

Some commenters suggested that the Commission permit a simple representation that a Special Entity's representative satisfies the criteria in the statute and rule. The Commission does not believe that such an approach is consistent with the statutory framework or the intent of Congress to provide meaningful protections for Special Entities. Nevertheless, the Commission believes it is appropriate to limit the ability of swap dealers and major swap participants to subvert the purpose of the independent representative provisions in Section 4s(h)(5). The Commission further believes that the final rule addresses commenters concerns while encouraging processes to ensure that the quality of representation is consistent with the statutory criteria. The Commission's formulation of the representations will encourage Special Entities

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[867] Final § 23.450(d) and (e) provide:
(d) Safe Harbor. (1) A swap dealer or major swap participant shall be deemed to have a reasonable basis to believe that the Special Entity, other than a Special Entity defined in § 23.401(c)(3), has a representative that satisfies the applicable requirements of paragraph (b)(1) of this section, provided that: (i) The Special Entity represents in writing to the swap dealer or major swap participant that it has complied in good faith with written policies and procedures reasonably designed to ensure that it has selected a representative that satisfies the applicable requirements of paragraph (b) of this section, and that such policies and procedures provide for ongoing monitoring of the performance of such representative consistent with the requirements of paragraph (b) of this section; and (ii) The representative represents in writing to the Special Entity and swap dealer or major swap participant that the representative: (A) Has policies and procedures reasonably designed to ensure that it satisfies the applicable requirements of paragraph (b) of this section; (B) Meets the independence test in paragraph (c) of this section; and (C) Is legally obligated to comply with the applicable requirements of paragraph (b) of this section by agreement, condition of employment, law, rule, regulation, or other enforceable duty. (2) A swap dealer or major swap participant shall be deemed to have a reasonable basis to believe that a Special Entity defined in § 23.401(c)(3) has a representative that satisfies the applicable requirements in paragraph (b)(2) of this section provided that the Special Entity provides in writing to the swap dealer or major swap participant the representative's name and contact information, and represents in writing that the representative is a fiduciary as defined in Section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002).
(e) Reasonable reliance on representations of the Special Entity. A swap dealer or major swap participant may rely on written representations of a Special Entity and, as applicable under this section, the Special Entity's representative to satisfy any requirement of this section as provided in § 23.402(d).

[868] As the Commission stated in the proposing release, such representations can be included in counterparty relationship documentation 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 if the representations continue to be accurate and relevant with respect to the subsequent swaps. Proposing release, 75 FR at 80641.

and independent representatives to undertake appropriate due diligence to ensure that they incorporate the statutory criteria in the selection and ongoing performance of the independent representative.[869] For example, a representative with specific expertise in interest rate swaps might not be qualified to advise on an oil swap. Under the rule, the Special Entity and independent representative would have to undertake to ensure that their policies and procedures were sufficiently robust to take account of changing circumstances. In addition, Special Entities and their representatives should ensure that their policies and procedures require that the representations provided to the swap dealer or major swap participant are authorized at the appropriate decision making level of the Special Entity or representative.[870]

A swap dealer or major swap participant would be able to rely on representations unless it had information that would cause a reasonable person to question the accuracy of the representation.[871] The Commission declines to adopt other commenters' suggestion that swap dealers and major swap participants be permitted to rely on representations unless it had actual knowledge that the representations were untrue. The Commission has determined that an actual knowledge standard may inappropriately encourage the swap dealer or major swap participant to

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[869] See, e.g., SEC and DOL guidance – Selecting and Monitoring Pension Consultants: Tips for Plan Fiduciaries, available at http://www.dol.gov/ebsa/newsroom/fs053105.html; also available at http://www.sec.gov/investor/pubs/sponsortips.htm.

[870] Such representations would also apply to representatives that are employees of the Special Entity. For example, the Special Entity could represent that it has (1) complied in good faith with policies and procedures reasonably designed to ensure that its representative employee meets the criteria, and (2) has reasonably designed policies and procedures that the employee must follow to ensure that it satisfies the criteria. The employee could represent that it has complied in good faith with the Special Entity's policies and procedures and that it is legally obligated under its employment agreement or by law to comply with the applicable criteria of § 23.450(b).

[871] The Commission's determination is consistent with several commenters' suggestions. See, e.g., SIFMA/ISDA Feb. 17 Letter, at 36 ("[swap dealers] should be permitted to rely on a written representation . . . that the counterparty and/or its representative satisfies the standards . . . absent actual 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."); see also supra fn. 724 and 820.

ignore red flags.[872]

Commenters requested that the Commission clarify that the exchange of representations will not give parties any additional rescission, early termination, or monetary compensation rights.[873] The Commission declines to opine as to potential liability in disputes between private parties, which will depend on the facts and circumstances of the particular case and applicable law.[874]

f. Chief Compliance Officer Review

The Commission has determined to adopt proposed § 23.450(e) (renumbered as § 23.450(f)) with one modification. The phrase "determines that the representative . . . does not meet the criteria" has been changed to read "determines that [the swap dealer or major swap participant] does not have a reasonable basis to believe that the representative . . . meets the criteria." This clarifies the Commission's view that § 23.450 does not give swap dealers and major swap participants the authority to determine whether a representative meets the criteria under § 23.450(b). Rather, consistent with the duty, a swap dealer or major swap participant is required to have a reasonable basis to believe the representative satisfies the criteria. The Commission has determined that the clarifications and modifications to § 23.450 provide meaningful protections against commenters' concerns that a swap dealer or major swap participant may overreach or otherwise gain a negotiating advantage when requesting information from the Special Entity.

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[872] See Section III.A.3.d. of this adopting release for a discussion of § 23.402(d)–Reasonable reliance on representations.

[873] See, e.g., ABC/CIEBA Feb. 22 Letter, at 12-13 (asserting that a swap dealer faced with a highly volatile market and disadvantageous swap position could claim that a Special Entity provided inaccurate representations to avoid its obligations); AMG-SIFMA Feb. 22 Letter, at 10.

[874] For the same reasons, the Commission declines to opine as to whether a swap dealer or major swap participant would have liability to the Special Entity or its representative as a result of its good faith determination that the representative was not qualified. See, e.g., SIFMA/ISDA Feb. 17 Letter, at 38-39. The Commission notes, however, that the duty under Section 4s(h)(5)(A) and final § 23.450 only requires a swap dealer to have a reasonable basis to believe that a representative is qualified. Thus, any determination under proposed § 23.450(e), as clarified in the final rule (renumbered as § 23.450(f)), would not be a determination by the swap dealer or major swap participant that the representative is unqualified.

The Commission declines to adopt a commenter's suggestion that the written determination be made by the trading supervisor instead of the chief compliance officer. As stated in the rule, the Commission expects the chief compliance officer to review such determination to ensure that the swap dealer or major swap participant has a substantial, unbiased basis for the determination.[875] The Commission believes that a chief compliance officer is in a better position to review such a determination for compliance with the rules. A trading supervisor is more likely to be directly involved with the Special Entity and to have direct material incentives or bonus structures that could be affected by such a determination.

One commenter also requested that the rule require the written record also be submitted to the Commission for review. The Commission notes that such records of compliance must be kept and made available to the Commission for inspection.[876] In addition, chief compliance officers are required under Section 4s(k) of the CEA and proposed § 3.3 to report to the Commission annually about the firm's compliance record.[877] Thus, the Commission will be apprised of material compliance failures on an annual basis.

g. Disclosure of Capacity

The Commission is adopting § 23.450(f) (renumbered as § 23.450(g)) as proposed. A swap dealer or major swap participant that acts in a capacity other than as a swap counterparty to a Special Entity must disclose the material differences between such capacities. For example, a swap dealer that is also a registered FCM would have to disclose that when it acts as an FCM it is the Special Entity's agent with respect to executing orders; however, when it acts as a swap

[875] The Commission believes that reviewing the determination is part of the CCO's duty to "take reasonable steps to ensure compliance." See proposed § 3.3(d)(3), CCO proposed rules, 75 FR at 70887.
[876] Section 23.402(g) requires swap dealers and major swap participants to create a record of their compliance and retain and make available for inspection such records in accordance with § 1.31 (17 CFR 1.31).
[877] See Section 4s(k) of the CEA and proposed § 3.3, CCO proposed rules, 75 FR at 70887.

dealer it is the Special Entity's counterparty and its interests are adverse to the Special Entity's. Such disclosure would be required, at a minimum, at a reasonably sufficient time prior to entering into a swap.[878] The Commission declines commenters' suggestion that the required disclosure should be limited to different capacities in connection with the swap. Such a limitation would not address counterparty confusion that could arise when a swap dealer changes status from transaction to transaction. The Commission clarifies that such disclosures could be made on a relationship basis in counterparty relationship documentation, where appropriate. Permitting such disclosure on a relationship basis implements the statutory duty while appropriately mitigating associated costs.

D. Section 23.451–Political Contributions by Certain Swap Dealers

1. Proposed § 23.451

Pursuant to the Commission's discretionary rulemaking authority under Section 4s(h) of the CEA, proposed § 23.451 prohibited swap dealers and major swap participants from entering into swaps with "municipal entities" if they make certain political contributions to officials of such entities.[879] The Commission stated that the proposed rule was meant to deter undue influence and other fraudulent practices that harm the public and to promote consistency in the business conduct standards that apply to financial market professionals dealing with municipal entities. Proposed § 23.451 complemented existing pay-to-play prohibitions imposed by the SEC and the MSRB.

In a manner similar to the prohibitions contained in SEC Advisers Act Rule 206(4)-5[880] and

[878] See, e.g., Section III.D. of this adopting release for a discussion of § 23.431 (§ 23.431(a) requires disclosures "at a reasonably sufficient time prior to entering into a swap").
[879] Proposing release, 75 FR at 80654.
[880] 17 CFR 275.206(4)-5 ("SEC Advisers Act Rule 206(4)-5").

MSRB Rules G-37 and G-38,[881] proposed § 23.451, generally, made 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 prohibited 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 so-called pay-to-play restriction under applicable law.

The Commission proposed to define "regulated person," for purposes of § 23.451, to mean, generally, a person that is subject to rules of the SEC, the MSRB, an SRO or the Commission prohibiting it from engaging in specified activities if certain political contributions have been made, or its officers or employees.[882] Similar to SEC Advisers Act Rule 206(4)-5, the proposing release defined "covered associate" of a swap dealer or major swap participant 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."[883]

The proposed rule barred 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

[881] See MSRB Rule G-37, Political Contributions and Prohibitions on Municipal Securities Business; MSRB Rule G-38, Solicitation of Municipal Securities Business.
[882] Proposing release, 75 FR at 80654 fn. 133.
[883] Id., at 80654.

seeking to enter into or has entered into a swap.[884] The proposed rule also included 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.[885]

The Commission's proposal included three exceptions. First, the proposed rule permitted 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, to 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. Second, the proposed rule did 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. Third, the prohibitions did 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.

In addition to the above-mentioned exceptions, proposed § 23.451 included an automatic exemption for those cases where (1) a contribution made by a covered associate did not exceed $150 or $350, as applicable, (2) was discovered by the swap dealer or major swap participant within four months of the date of contribution, and (3) was returned to the contributor within 60 calendar days of the date of discovery.[886] In addition, the Commission proposed that a swap dealer or major swap participant could apply to the Commission for an exemption from the two-year ban and, when considering the exemption application, the Commission would consider

[884] Id.
[885] Id.
[886] The scope of this proposed exception was limited to the types of contributions that are less likely to raise pay-to-play concerns, and the exception is intended to provide swap dealers with the ability to undo certain mistakes. Because it would operate automatically, the proposed exception was subject to conditions that are objective and limited to capture only those contributions that are unlikely to raise pay-to-play concerns. See also SEC Final Rules, Political Contributions by Investment Advisors, 75 FR 41035-36, Jul. 14, 2010.

certain factors enumerated in the proposing release, including, for example, whether the exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes of the CEA.[887]

The Commission sought general and specific comment on a number of questions regarding proposed § 23.451, including whether the term "municipal entity" was appropriately defined or whether certain alternatives should be considered. The Commission also sought comment on whether the proposed rule should apply only to swap dealers.[888]

2. Comments

The Commission received several comments representing a diversity of views on proposed § 23.451. Where one commenter believed proposed § 23.451 represented an indispensable element of the business conduct standards and should be strengthened to prohibit a swap dealer from making a political contribution after the completion of a transaction, another believed the proposed rule should be deleted as unduly burdensome for those swap dealers that are part of financial institutions that are not, or will not be, subject to the rules of the MSRB.[889] Alternatively, it was suggested by the latter commenter that any final rule parallel in certain respects the MSRB regulations on political contributions made in connection with municipal securities business and, in so doing, limit the final rule's scope to swap dealers and major swap participants already covered by the relevant MSRB regulations.[890] In another alternative, this commenter requested that the Commission consider replacing as the triggering occasion for the application of the rule an "offer to enter into or enter into a swap or a trading strategy involving a

[887] Id., at 80655.
[888] Id.
[889] Cf. CFA/AFR Feb. 22 Letter, at 18, with SIFMA/ISDA Feb. 17 Letter, at 39-40.
[890] SIFMA/ISDA Feb. 17 Letter, at 40.

swap" with the phrase "engage in municipal swaps business."[891] The commenter suggested that "municipal swap business" be defined to mean "the execution of a swap with a municipal entity."[892]

Regarding proposed § 23.451(a)(3)'s definition of municipal entity,[893] one commenter requested the Commission clarify differences with the definition of a State and municipal Special Entity under Section 4s(h)(1)(C)(2)(ii)[894] and proposed § 23.401, which limits the definition of Special Entity to "a State, State agency, city, county, municipality, or other political subdivision of a State."[895] Another commenter recommended excluding certain state-established plans that are run by third-party investment advisers, such as 529 college savings plans, from the definition of "municipal entity" or, at a minimum, creating a safe harbor from the pay-to-play provision where a Special Entity is represented by a qualified financial advisor and that advisor affirmatively selects the swap dealer.[896]

Regarding the proposed rule's definition of "solicit," one commenter stated that the term could implicate communication by employees of a financial institution that do not have a role in the swaps business and who are already regulated by the MSRB.[897] This commenter advocated that the Commission narrow the definition of "solicit" to include only "direct communication by any person with a municipal entity for the purpose of obtaining or retaining municipal swaps business." In so doing, the commenter stated that the proposed rule does not include an analogous provision of MSRB Rule G-37 (and MSRB Proposed Rule G-42, Political

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[891] Id.
[892] Id.
[893] See supra fn. 60 for a definition of the term "municipal entity."
[894] See Section IV.A. of this adopting release for a discussion of municipal entities and Special Entities.
[895] APGA Feb. 22 Letter, at 2.
[896] AMG-SIFMA Feb. 22 Letter, at 13.
[897] SIFMA/ISDA Feb. 17 Letter, at 40.

Contributions and Prohibitions on Municipal Advisory Activities) limiting the scope of the rule to municipal financial professionals "primarily engaged in municipal financial representative activities . . . ."[898] The same commenter urged the Commission to include a provision, parallel to the relevant MSRB rules, which specifies an operative date for the rule, such that it only applies to contributions made on or after its effective date.[899]

Another commenter stated that it is unclear how regulated entities will monitor for compliance with the proposed rule and suggested a re-writing of the rule in a more targeted fashion prohibiting "political contributions with the intent to solicit swaps business."[900] This commenter also stated that the term "offer" should be defined in a manner that is consistent with its traditional legal definition.[901]

3. Final § 23.451

The Commission has determined to adopt proposed § 23.451 with changes to reflect certain of the comments and to harmonize its rule with the SEC's proposed pay-to-play prohibition.[902] The SEC's proposed prohibition on certain political contributions by security-based swap dealers, proposed Rule 15Fh-6, would bar an SBS Dealer from entering into a security-based swap agreement with a "municipal entity" after they make contributions, with the aim of eliminating pay-to-play.[903] Moreover, the Commission's approach to final § 23.451 is also consistent with MSRB Rules G-37 and G-38. Through such harmonization, the Commission

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[898] Id.
[899] Id.
[900] CEF Feb. 22 Letter, at 24.
[901] Id.
[902] In making this determination, the Commission concluded that final § 23.451 is fully authorized by the discretionary rulemaking authority vested in the Commission by Section 731 of the Dodd-Frank Act, which amended the CEA by adding Section 4s(h). 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 [the CEA]."); see also Sections 4s(h)(1)(D), 4s(h)(5)(B) and 4s(h)(6).
[903] SEC's proposed rules, 76 FR at 42432-33.

achieves its goal of preventing quid pro quo arrangements while avoiding unnecessary burdens associated with disparities between the SEC's proposed rule and the Commission's final rule and guidance. In this way, the incremental cost of complying with the Commission's prohibition is expected to be minimal as many of the entities that will be subject to its restrictions should already have in place policies and procedures on political contributions by way of their compliance with existing requirements under SEC Advisers Act Rule 206(4)-5 and MSRB Rules G-37 and G-38.

There were two main changes made to proposed § 23.451 in final § 23.451. First, the Commission decided to exclude major swap participants from the pay-to-play prohibition because major swap participants, as defined, do not "solicit" swap transaction business within the meaning of the final rule and, as such, the Commission does not expect that major swap participants will assume a dealer-type role in the swap market.

Second, in place of the term "municipal entity" in § 23.451(a), the Commission used the term "governmental Special Entity" as defined in final § 23.451(a)(3).[904] This change clarifies that the pay-to-play prohibition applies not just to municipalities, but to any contributions made for the purpose of obtaining state and/or local government business. It also addresses comments recommending that the Commission clarify that the prohibition only applies to certain Special Entities as defined in Section 4s(h) and final § 23.401.

The Commission declined to make changes to proposed § 23.451 based on comments recommending the prohibition on pay-to-play be deleted as unduly burdensome for those swap

[904] Section 23.451(a)(3) defines "governmental Special Entity" as any Special Entity defined in § 23.401(c)(2) (a State, State agency, city, county, municipality, other political subdivision of a State, or any instrumentality, department, or a corporation of or established by a State or political subdivision of a State) or § 23.401(c)(4) (any governmental plan, as defined in Section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002)).

dealers that are part of financial institutions that are not, or will not be, subject to the rules of the MSRB. Rather, the Commission believes that a pay-to-play prohibition is integral to the business conduct standards framework for the protection of governmental Special Entities. The final rule is intended to protect the public by ensuring that swap dealers solicit and compete for governmental Special Entity business on the merits of their proposals rather than on the basis of their ability and willingness to make political contributions. Similarly, the Commission declines, as one commenter suggested, to limit the prohibition to the "execution" of swap business because the final rule is designed to protect the public in all phases of the transaction, including the solicitation or offering stage. At the same time, the Commission is taking steps to mitigate costs by harmonizing the final rule with both the SEC's and MSRB's prohibitions on certain political contributions.

The Commission does not believe that a safe harbor from the final rule is appropriate merely because a governmental Special Entity is being represented by a qualified financial advisor who selects the swap dealer. By its nature, pay-to-play is covert because participants do not broadcast that contributions or payments are being made or accepted for the purpose of influencing the selection of a particular financial services provider. Given the covert and nefarious purpose behind such contributions or payments, the Commission believes any potential loophole, or Commission parsing of the word "offer," would only breed mischief by would-be wrongdoers and unnecessarily expose the public to fraudulent dealings.

As the rule text makes clear, the final rule is designed to prevent "fraud." Given this fact, the Commission believes that it is unnecessary, as some commenters requested, to fashion the prohibition to reach only those "political contributions made with the intent to solicit swaps business." Such an intent-based test in this context would again ignore the covert nature of such

contributions or payments. Rather, the Commission believes that § 23.451(b)(1)'s limiting principle (i.e., that it prohibits fraud), and the various exceptions to the prohibitions contained in § 23.451(b)(2), should ameliorate any concerns that the prohibition may be unduly burdensome to monitor for compliance. Presumably, swap dealers already have in place policies and procedures designed to prevent their employees and agents from perpetrating fraud of this sort.

As with the other business conduct standards being promulgated in this adopting release, § 23.451 cannot be read in insolation. Of particular relevance here is the Commission's anti-evasion rule § 23.402(a) which, together with § 23.451(c)'s provision that no swap dealer shall circumvent the prohibitions of the rule, will provide an effective safeguard against those who may be inclined to devise an end-run around final § 23.451. Given these protections, the Commission does not find it necessary, as one commenter recommended, to change the rule text to make sure that improper contributions do not occur both before and after the solicitation and consummation of the transaction. Further, § 23.451(d) provides a mechanism by which a swap dealer can apply for an exemption from the prohibitions of the final rule. Together, these rules ensure that § 23.451 is balanced, flexible and capable of prohibiting multifarious forms of fraud while accommodating legitimate requests for relief based on various facts and circumstances. Similarly, § 23.451(e) specifies where prohibitions are inapplicable, including where the contribution does not exceed the dollar thresholds or timing considerations provided in the rule.

V. Implementation

A. Effective Dates and Compliance Dates

In the proposing release, the Commission requested comment on whether it should delay the effective date of any of the proposed requirements to allow additional time to comply and, if so, commenters were asked to identify the particular requirement and compliance burden that should

merit a delay. Under Section 754 of the Dodd-Frank Act, the rules in subpart H of part 23 would be effective not less than 60 days after publication of the final rules implementing Section 731, which adds Section 4s(h) to the CEA.

B. Comments

The Commission received comments concerning implementation of the final external business conduct standards rules. The majority of the comments urged the Commission to implement the external business conduct standards after the implementation of the entity definitions and registration rules applicable to swap dealers and major swap participants and to allow sufficient time to implement appropriate policies and procedures and execute counterparty relationship documentation.[905]

Other commenters suggested that the Commission's rules, including the business conduct standards rules, be implemented in a certain number of phases. The suggestions varied from as few as three to as many as sixteen phases. From among the commenters who believed that the rules should be implemented in phases, one commenter stated that the Commission should divide the rulemakings into three phases, with business conduct standards in the middle phase.[906] Another commenter believed that the business conduct rules should be effective in the third of

[905] See MFA Mar. 24 Letter, at Annex A p. 3; EEI June 3 Letter, at 7; NFA Aug. 31 Letter, at passim, NextEra Mar. 11 Letter, at 6; Comm. Cap. Mkts. June 24 Letter, at 2; Financial Assns. May 26 Letter, at 3; Financial Assns. June 10 Letter, at 8-9 (The business conduct standards rulemaking should occur after the definitions rulemakings because, in most places, the Dodd-Frank Act refers to "swap dealers" instead of "registered swap dealers," and the statutory definition of swap dealer is vague. Many persons could unwittingly violate the business conduct standards rules because they would not have known that they were subject to the rules. Certain terms such as "Special Entity," "best interests" and "acts as an advisor" must be clarified by rule prior to the effectiveness of the business conduct standards rules.); see also ISDA June 3 Letter, at 2-4; WMBAA June 3 Letter, at 5; AGA June 3 Letter, at 3.

[906] CME June 3 Letter, at 3-4 and 7 (Rulemaking should occur in three phases - "early," "middle" and "late." The early phase rules should deal solely with systemic risk. Business conduct standards, by contrast, should be in the middle phase.).

three phases.[907]

Among the commenters who believed that the rules should be implemented in four phases, one commenter stated that the external business conduct rules should be implemented during the second of four phases, following the implementation of the definitions rules.[908] Another commenter believed the Commission should issue the business conduct standard rules in the second of four phases, but they recommended that the Commission should grant a "one year blanket exemption" for entities that engage in bilateral exempt commodity transactions.[909] Another commenter suggested that the Commission should implement the business conduct standards during the last of four phases.[910] One commenter suggested that the Commission's swap rules should be implemented in the fourth of eight phases,[911] while another commenter opined that the rules should be divided into 16 phases with business conduct standards being

[907] BlackRock June 3 Medero, Prager and VedBrat Letter, at 2-3 (The Commission should publish a proposed sequencing plan that details both the sequence and implementation for all rules. Implementation should be divided into three phases and business conduct rules would be effective in the final phase.); see also BlackRock June 3 Medero and Prager Letter, at 6.

[908] MFA Mar. 24 Letter, at Annex A p.3 (Business conduct standards rules should be implemented during the second of four phases, following the implementation of definitions rules. The second phase should include implementation of clearing rules, swap-data reporting rules and internal/external business conduct standards for swap dealers and major swap participants. The third phase should prioritize SEF trading and segregation of uncleared swaps. The final phase should include real-time/public reporting and all other rulemaking, including antifraud and market manipulation rules.).

[909] NextEra Mar. 11 Letter, at 6 and 8 (The Commission should issue definitional rules first, then proceed to the core substantive rules, and then turn to non-core and ancillary rules. The second phase of rule implementation, which would follow the first phase of definitional rules, would implement business conduct standards, registration, governance, and capital and margin rules. The third phase would implement clearing requirements, the fourth phase would cover reporting and record-keeping standards, and the fifth phase would implement ancillary rules and necessary discretionary rules.).

[910] EEI June 3 Letter, at 7 (The Commission: (i) should build its final rules in a common-sense manner (to start with basic definitions of "swap," "swap dealer," and "major swap participant"); (ii) next build strong institutions such as SEFs, DCOs, and SDRs; (iii) then implement the mandatory clearing, exchange-trading, reporting, recordkeeping and other rules controlling those new markets; and (iv) then, finally, implement the obligations [e.g., business conduct standards] of swap dealers and major swap participants in a phased manner that is synchronized to the development of the new markets and the institutions that support them.).

[911] Comm. Cap. Mkts. June 24 Letter, at 2 (The first phase would include definitions and standards, and the second phase would include rules to reduce systemic risk, such as central clearing. Business conduct standards would occur in the fourth phase.).

implemented in phase number seven.[912]

One commenter specifically mentioned the phases that were suggested by Commissioner O'Malia.[913] The commenter stated that the Commission should adopt a schedule for implementation with each such phase. The commenter stated that if all the rules cited in Commissioner O'Malia's Phase 2 were adopted simultaneously, then it would be a burden on the commenter and, therefore, the rules should be implemented in a staggered schedule.[914]

Some commenters did not suggest a specific number of phases, but had suggestions regarding the implementation of the rules. One commenter stressed the importance of the Commission providing a clear date for implementation and believed that market participants would work towards that date.[915] The commenter also suggested that if documentation of customer relationships is a concern because of the large numbers of customers, some phasing in should be considered by the Commission.[916]

Another commenter believed that the public should be given an opportunity to review the rule changes that resulted from public comments and have an opportunity to comment on the changes prior to the final rules being promulgated.[917]

One commenter suggested that the Commission should sequence and implement the final rules by asset class.[918] Another commenter opined that the Commission should require clearing,

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[912] Financial Serv. Roundtable April 6 Letter, at 4-5.
[913] MGEX June 3 Letter, at 1-2; see also Extension of Comment Periods, 76 FR at 25276 Appendix 2.
[914] MGEX June 3 Letter, at 1-2.
[915] Better Markets June 3 Letter, at 20.
[916] Id.
[917] Noble July 7 Letter, at 2. The Commission declines to reopen the comment period on this rulemaking. If the Commission were to delay the final rulemaking to allow additional comments to address changes that were a result of comments that are already part of the public record, then it would only be fair to allow further comments to changes made as a result of those subsequent comments. The result would be the indefinite delay of the final rules for so long as someone is willing to comment on changes that were made.
[918] ETA May 4 Letter, at 2-5 (The rules should be implemented first for market infrastructure entities, then registration of market professionals, and finally registration of financial entities with new roles in each asset class.).

reporting and electronic execution for the "better-prepared" asset classes first (e.g., certain commodity and interest rate products that are already quite liquid and standardized) and should provide ample time for the maturation of those asset classes and products that are not yet at that stage.[919]

The Commission received numerous comments on other portions of the business conduct standards rules that deal with Special Entities.[920] With regard to the implementation and phasing of the Commission's rules, one commenter stated that it is "critical" that, on or before finalization of the proposed rules, the Commission and DOL make a joint formal announcement that no action required by the business conduct standards will make a swap dealer or major swap participant an ERISA fiduciary.[921]

Two commenters believed that the rules should be phased in with the mandatory rulemaking being implemented first, followed by the implementation of rules issued using the Commission's

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[919] Financial Assns. May 4 Letter, at 2-3 (Phased implementation by type of market participant will also allow the Commission and market participants to use lessons learned from larger market participants when developing rules applicable to end users. In addition, the Commission should, within each asset class and type of market participant, prioritize implementation of requirements that reduce systemic risk ahead of other requirements. Implementation of requirements designed to achieve other goals, such as trade execution, should be phased in only once clearing has been successfully implemented. This commenter also submitted charts that would sequence rules over nine separate stages. The Associations propose that the CFTC "initiate" business conduct standards in the sixth stage and "finalize" business conduct standards in the ninth and final stage.).

[920] Commenters submitted alternatives to the proposed rule regarding independent representatives for Special Entities (proposed § 23.450). See, e.g., CalPERS Feb. 18 Letter, at 5-6; CEF Feb. 22 Letter, at 23; Cityview Feb. 22 Submission; Riverside Feb. 22 Letter, at 1-2; SFG Feb. 22 Letter, at 1; CFA/AFR Aug. 29 Letter, at 23. CalPERS suggested a testing regime for independent representatives but noted that it would take time to create the testing framework. CalPERS recommended that, should their proposal advance, it may be necessary to delay the effective date of the independent representative provision of the regulations to permit implementation of their alternative approach. The Commission has modified proposed § 23.450 to respond to commenters concerns, but has determined not to adopt a testing regime at this time. CalPERS Feb. 18 Letter, at 4-6. See Section IV.C.3. of this adopting release for a discussion of final § 23.450.

[921] ABC/CIEBA Feb. 22 Letter, at 2-3 (The proposed rules should not be finalized when there is any uncertainty regarding whether the DOL regulations will be compatible with the CFTC's rules. If the DOL is not prepared to make the announcement when the CFTC is ready to finalize its proposed rules, the only workable solution is to delay the finalization of the business conduct standards with respect to ERISA plans until the DOL is prepared to act. Any other course of action would elevate timing issues over the retirement security of millions of Americans.). The Commission has harmonized the rulemaking with DOL requirements. See Section II of this adopting release for a discussion of "Regulatory Intersections."

discretionary authority.[922]

One commenter stated that the Commission should continue to apply the exclusion for swaps available under pre-Dodd-Frank Act Section 2(h) of the CEA to allow firms such as its members to facilitate an orderly transition to the new rules. The commenter suggested that the Commission's rules be applicable first to bank holding companies, then later to other swaps participants.[923]

One commenter stated that, although Section 721 of the Dodd-Frank Act limits the Commission's exemptive authority with regard to certain provisions of the CEA, the Commission still retains authority to exempt persons from its own implementing rules.[924] This commenter asked that the Commission use its authority to exempt persons from its implementing regulations to address instances where such an exemption would be in the public interest.

Another commenter suggested that the Commission should adopt implementing regulations deferring the effective date of the provisions of Title VII to be in line with the ongoing international effort to implement reforms of the OTC derivatives market by December 31, 2012, following the September 2009 meeting of the G20 in Pittsburgh.[925]

C. Commission Determination

After considering the comments, the Commission has determined that the effective date of

[922] BlackRock Feb. 22 Letter, at 2 (The Commission should adopt only mandatory rules, and after the Commission has gained more familiarity with the swaps marketplace, it may consider changing those standards.); Encana Feb. 22 Letter, at 2 (Some of the business conduct standards rules were not mandated by Congress and, in light of the compressed timeline for the implementation of the Dodd-Frank Act and current budgetary constraints, the Commission should reconsider its decision to impose non-mandatory requirements on swap dealers and major swap participants at this time. Encana suggests that, for swap dealers and major swap participants whose counterparties are normally end-users, the Commission should limit the rules to the requirements mandated by the Dodd-Frank Act. If, after a few years of experience, the Commission believes that additional business conduct standards are necessary, then the Commission could explore imposing additional requirements on swap dealers and major swap participants at that time.). The Commission has determined to adopt both mandatory and discretionary rules. See Section III.A.1. of this adopting release for a discussion of § 23.400–Scope.
[923] CEF June 3 Letter, at 2.
[924] NY City Bar June 13 Letter, at 3.
[925] Bank of Tokyo May 6 Letter, at 4.

the rules in subpart H of part 23 will be 60 days after publication of the final rules in the Federal Register. Swap dealers and major swap participants must comply with the rules in subpart H of part 23 on the later of 180 days after the effective date of these rules or the date on which swap dealers or major swap participants are required to apply for registration pursuant to Commission rule 3.10.[926]

The compliance schedule established by the Commission for the subpart H rules will allow swap dealers and major swap participants to, among other things, implement appropriate policies and procedures, train relevant personnel, execute any necessary amendments to counterparty relationship documentation, receive any representations from counterparties and enable Special Entities to ensure that they have qualified independent representatives as provided in § 23.450.[927] While the schedule does not distinguish among swap dealers, asset classes or counterparties as suggested by various commenters, the schedule does provide a time certain for compliance and a substantial lead time of a minimum of eight months to accommodate the tasks that must be completed by affected market participants. The Commission was not persuaded that the distinctions among swap dealers, asset classes, counterparties or mandatory versus discretionary rules provide a compelling basis for the Commission to phase-in the implementation of the bulk

[926] Under § 23.450(b)(1)(vii), any swap dealer or major swap participant that offers to enter or enters into a swap with a Special Entity, other than a Special Entity defined in § 23.401(c)(3), shall have a reasonable basis to believe that the Special Entity has a representative that, in the case of a Special Entity as defined in § 23.401(c)(2) or (4), is subject to restrictions on certain political contributions imposed by the Commission, the SEC, or an SRO subject to the jurisdiction of the Commission or the SEC; provided however, that § 23.450(b)(1)(vii) shall not apply if the representative is an employee of the Special Entity. Because neither the Commission nor an SRO registered with the Commission has established restrictions on certain political contributions as provided in § 23.450(b)(1)(vii), swap dealers and major swap participants will not have to have a reasonable basis to believe that a qualified independent representative of a Special Entity is subject to such restrictions on political contributions until the later of 180 days after the effective date of the final subpart H rules or the effective date of any rules promulgated by the Commission or an SRO registered with the Commission imposing such restrictions on political contributions that would apply to such qualified independent representative.

[927] The compliance dates in this adopting release are subject to any superseding order of the Commission providing exemptive relief from certain requirements under the CEA pending completion of certain other rulemakings, including the entity and product definitions rulemakings. See, e.g. Effective Date for Swap Regulation, 76 FR 42508, Jul. 19, 2011; Amendment to July 14, 2011 Order for Swap Regulation, 76 FR 80233, Dec. 23, 2011.

of the external business conduct standards rules. Rather, the Commission believes that swap dealers and major swap participants will be able to develop and implement the required compliance mechanisms efficiently by considering their affected business processes across the board. Within the time frame provided, swap dealers and major swap participants will be able to phase-in their compliance according to their own priorities, provided that the requirements are implemented by the applicable compliance date.

VI. Related Matters

A. Regulatory Flexibility Act

The Regulatory Flexibility Act ("RFA") requires Federal agencies to consider the impact of its rules on "small entities."[928] A regulatory flexibility analysis or certification typically is required for "any rule for which the agency publishes a general notice of proposed rulemaking pursuant to" the notice-and-comment provisions of the Administrative Procedure Act, 5 U.S.C. 553(b).[929] As the Commission stated in the proposing release, it previously has established that certain entities subject to its jurisdiction are not small entities for purposes of complying with the RFA.[930] However, as the Commission also noted in the proposing release, swap dealers and major swap participants are new categories of registrant for which the Commission had not previously addressed the question of whether such persons are small entities.[931]

In this regard, the Commission explained in the proposing release that it previously had determined that FCMs should not be considered small entities for purposes of the RFA, based, in part, upon FCMs' obligation to meet the minimum financial requirements established by the Commission to enhance the protection of customers' segregated funds and protect the financial

[928] 5 U.S.C. 601 et seq.
[929] 5 U.S.C. 601(2), 603, 604 and 605.
[930] Proposing release, 75 FR at 80655-56.
[931] See id.

condition of FCMs generally.[932] Like FCMs, swap dealers will be subject to minimum capital and margin requirements and are expected to comprise the largest global financial firms, and the Commission is required to exempt from designation as a swap dealer entities that engage in a de minimis quantity of swap dealing in connection with transactions with or on behalf of customers.[933] Accordingly, for purposes of the RFA for the proposing release and future rulemakings, the Commission proposed that swap dealers should not be considered small entities for essentially the same reasons that it had previously determined FCMs not to be small entities.[934]

The Commission further explained that it also had previously determined that large traders are not small entities for RFA purposes, with the Commission considering the size of a trader's position to be the only appropriate test for the purpose of large trader reporting. The Commission then noted that a person will be obligated to register as a major swap participant based upon its maintenance of 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, for purposes of the RFA for the proposing release and future rulemakings, the Commission also proposed that major swap participants should not be considered to be small entities for essentially the same reasons that it previously had determined large traders not to be small entities.[935]

In response to the proposing release, one commenter, representing a number of market participants, submitted a comment related to the RFA, stating that "[e]ach of the complex and

[932] Policy Statement and Establishment of Definitions of "Small Entities" for Purposes of the Regulatory Flexibility Act, 47 FR 18618, Apr. 30, 1982.
[933] See Section 1a(49)(D) of the CEA.
[934] Proposed Rules for Registration of Swap Dealers and Major Swap Participants, 75 FR at 71385.
[935] Id., at 71385-86.

interrelated regulations currently being proposed by the Commission has both an individual, and a cumulative, effect on [certain] small entities," and that the Small Business Administration had determined some of its members to be small entities.[936] These members, as the Commission understands, have been determined to be small entities by the SBA because they are "primarily engaged in the generation, transmission, and/or distribution of electric energy for sale and [their] total electric output for the preceding fiscal year did not exceed 4 million megawatt hours."[937] Thus, the commenter concluded that the Commission should conduct a regulatory flexibility analysis for each of its rulemakings under the Dodd-Frank Act, including this rulemaking applicable to Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties.[938]

This commenter did not provide any information on how the proposing release may have a significant economic effect on a substantial number of small entities. Nonetheless, the Commission has reevaluated this rulemaking in light of the statements made to it by this commenter. After further consideration of those statements, the Commission has again determined that this final rulemaking, which is applicable to swap dealers and major swap participants, will not have a significant economic effect on a substantial number of small entities.

In terms of affecting a substantial number of small entities, the Commission is statutorily required to exempt from registration as a swap dealer those entities that engage in a de minimis quantity of swap dealing. Thus, it is expected that most small entities will not be required to register with the Commission as a swap dealer.[939] Additionally, the Commission does not expect that the small entities identified by the commenter will be subject to registration with the

[936] ETA June 3 Letter, at 20-21.
[937] Small Business Administration, Table of Small Business Size Standards, (Nov. 5, 2010).
[938] ETA June 3 Letter, at 20-21.
[939] Section 1a(49)(D) of the CEA (7 U.S.C. 1a(49)(D)).

Commission as a major swap participant, as most entities with total electric output not exceeding 4 million megawatt hours are not expected to maintain "a substantial position in swaps" or swap positions that will "create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets."[940] Accordingly, for the reasons stated in the proposing release, the Commission continues to believe that the Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties rulemaking will not have a significant economic impact on a substantial number of small entities. Therefore, the Chairman, on behalf of the Commission, hereby certifies, pursuant to 5 U.S.C. 605(b), that these regulations being published today by this Federal Register release will not have a significant economic impact on a substantial number of small entities.

B. Paperwork Reduction Act

The Paperwork Reduction Act ("PRA")[941] imposes certain requirements on Federal agencies in connection with their conducting or sponsoring any collection of information as defined by the PRA. Certain provisions of these regulations will result in new collection of information requirements within the meaning of the PRA. 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.

In the proposing release, the Commission informed the public that, while the proposed rules did contain collections of information, these collections would overlap with collections proposed

[940] Section 1a(33)(A)(ii) of the CEA (7 U.S.C. 1a(33)(A)(ii)). See also Section 1a(33)(B) (7 U.S.C. 1a(33)(B)) (requiring the application of a threshold for "substantial position," below which an entity will not be required to register as an MSP).
[941] 44 U.S.C. 3501 et seq.

by the Commission in the Business Conduct Standards – Internal rulemakings[942] and with collections under the proposed rules adapting the recordkeeping, reporting and daily trading records requirements under § 1.31 to account for swap transactions.[943] Thus, the Commission did not submit the proposing release to OMB for approval or for assignment of an OMB control number.

The Commission invited comment on the accuracy of its estimate that no additional recordkeeping or information collection requirements or changes to existing collection requirements, other than those in the overlapping rulemakings, would result from the proposed rules. The Commission received no comments directly addressing this request, but it did receive one comment indirectly responsive to its invitation.[944] In it, the commenter asserted that, for electric utilities that are governmental entities, the proposed rules require swap dealers and major swap participants to provide valuation and scenario analysis, as well as advice and disclaimers that are not currently requested or required by these electrical utilities.[945] According to this commenter, these requirements will create new "paperwork" for the swap dealer or major swap participant, thereby creating new costs for the end-user.

The Commission has accounted for the information collection costs attributable to the swap dealer and major swap participant as required by the PRA in the information collections prepared for the rulemakings noted above, and understands that the only costs that may be created for end-

[942] See proposing release, 75 FR at 80656. The Business Conduct Standards – Internal rulemakings referenced in the proposing release and their proposing release citations are: Governing the Duties of Swap Dealers, 75 FR 71397; CCO proposed rules, 75 FR 70881; and Conflict-of-Interest Standards by Swap Dealers, 75 FR 71391. The Commission submitted these proposing releases to the Office of Management and Budget (OMB) for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The Commission requested that OMB approve, and assign a new control number for, the collections of information covered by the proposing releases.
[943] See Adaptation of Regulations to Incorporate Swaps, 76 FR 33066, Jun. 7, 2011. The Commission requested that OMB approve amendments to existing collections of information in connection with this proposal.
[944] ETA May 4 Letter.
[945] Id., at 8.

users is any costs for which the Commission has accounted that may be passed on to the end-user in the form of transaction fees, if at all, which would not require an increase in the Commission's burden estimates in the information collections. Moreover, as the Commission noted in the proposing release, not only were the proposed disclosure rules aligned with current industry best practices, but several large swap dealers had told the Commission staff during consultations that they were already providing counterparties with scenario analysis, at no extra charge.[946] Therefore, considering what swap dealers have represented the current landscape to be, any "paperwork" associated with scenario analysis should already be passed along to today's end-user. Moreover, to address counterparty concerns about costs and delay, the final rules will require scenario analysis only when requested by the counterparty for any swap not available for trading on a DCM or SEF and only from swap dealers, not major swap participants. In other circumstances, a swap dealer will have to notify its counterparty of the right to receive a scenario analysis. Thus, any pass-through costs for scenario analysis will be borne by those end-users that elect to receive it.

Regardless, for purposes of this PRA analysis, these collections are part of the overall (1) supervision, compliance and recordkeeping requirements imposed by the Commission in the Business Conduct Standards – Internal rulemakings[947] and (2) recordkeeping, reporting and daily trading records requirements under §§ 1.31 and 1.35 of the Commission Regulations (17 CFR

[946] See proposing release, 75 FR at 80645.

[947] The Business Conduct Standards – Internal rulemakings referenced in the proposing release and their proposing release citations are: Governing the Duties of Swap Dealers, 75 FR 71397; CCO proposed rules, 75 FR 70881; and Conflict-of-Interest Standards by Swap Dealers, 75 FR 71391. The Commission submitted these proposing releases to the Office of Management and Budget (OMB) for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The Commission requested that OMB approve, and assign a new control number for, the collections of information covered by the proposing releases.

1.31 and 1.35).[948] By their terms, these rules are part of the supervision, compliance and recordkeeping requirements that are provided for under the Business Conduct Standards–Internal rulemaking and the rulemaking adapting §§ 1.31 and 1.35 to swap transactions, and those rulemakings are compliant with PRA.

C. Cost-Benefit Considerations

Section 15(a) of the CEA requires the Commission to consider the costs and benefits of its action before promulgating a regulation under the CEA.[949] In particular, the costs and benefits of the proposed Commission action shall be evaluated in light of the following five considerations: (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 has considered the costs and benefits of its business conduct standards rulemaking as part of the deliberative rulemaking process and discussed them below and throughout the preamble.

The final rules in this adopting release implement Section 4s(h) of the CEA, which provides the Commission, subject to certain statutory requirements, with both mandatory and discretionary rulemaking authority to impose business conduct standards requirements on swap dealers and major swap participants in their dealings with counterparties, including Special Entities. Many of the final rules in this adopting release are mandated by Section 731 of the Dodd-Frank Act, leaving the Commission with little or no discretion to consider any alternatives where the statute prescribes particular requirements. Therefore, in many cases, the Commission's final regulations adhere closely to the enabling language of the statute. For example, the statute

[948] See Adaptation of Regulations to Incorporate Swaps, 76 FR 33066, Jun. 7, 2011. The Commission requested that OMB approve amendments to existing collections of information in connection with this proposal.
[949] 7 U.S.C. 19(a).

directs the Commission to adopt rules requiring swap dealers and major swap participants to verify that counterparties meet eligibility criteria, disclose material information about contemplated swaps to counterparties, including the material risks and characteristics of the swap, and incentives and conflicts of interest that the swap dealer or major swap participant may have in connection with the swap. The Commission also must adopt rules that require swap dealers and major swap participants to provide counterparties with a daily mark for swaps and 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 formulating the final mandatory rules, the Commission adopted approaches that mitigate the potential costs while maintaining fidelity to the congressional intent behind Section 731 the Dodd-Frank Act.

In adopting rules using its discretionary authority, the Commission has acted consistently with the intent of Congress as expressed in Section 4s(h)(3)(D) to establish business conduct standards that the Commission determines are appropriate in the public interest, for the protection of investors or otherwise in furtherance of the purposes of the CEA.[950] The discretionary rules include confidential treatment of counterparty information, institutional suitability, "know your counterparty," scenario analysis and pay-to-play restrictions. The discretionary rules reflect the Commission's expertise in establishing and overseeing an effective regulatory scheme for derivatives market professionals and appropriate harmonization with existing business conduct standards across market sectors. The final rules strike an appropriate

[950] In exercising its broad discretionary authority under Section 4s(h), the Commission was guided by the purposes of the CEA contained in Section 3. Section 3 explicitly includes among the purposes of the CEA "to protect all market participants from fraudulent or other abusive sales practices . . ." and "to promote . . . fair competition . . . among . . . market participants." The final business conduct standards accomplish that by holding swap dealers and major swap participants to fair dealing standards and by providing counterparties with tools necessary to negotiate effectively with swap dealers and major swap participants and make informed trading decisions. See also Sections 4s(h)(1)(D), 4s(h)(5)(B) and 4s(h)(6) of the CEA.

balance between protecting the public interest and providing a workable compliance framework for market participants.

Section 731 of the Dodd-Frank Act, which added new Section 4s(h) to the CEA, gave the Commission broad new authority to set business conduct standards rules for swap dealers and major swap participants in response to abuses in the unregulated derivatives markets. Among the abuses were those that targeted Special Entities, such as municipalities and school districts, which led to the heightened protections for Special Entities in Sections 4s(h)(4) and (5). These abuses have been the subject of congressional hearings, regulatory enforcement actions and private litigation. Section 4s(h) is aimed at reversing a caveat emptor trading environment and providing transparency in dealings between swap dealers or major swap participants and their counterparties. Transparency is enhanced through: Mandatory pre-trade disclosures of material information and a daily mark; communications based on principles of fair dealing and good faith; and Special Entity provisions to ensure that swap transactions are in the "best interests" of the Special Entity. Congress also included a robust anti-fraud provision that applies to swap dealers and major swap participants in their dealings with counterparties.

As contemplated by Congress through its grant of broad discretionary authority, the Commission supplemented the mandatory provisions in Section 4s(h) to limit the ability of dealers to employ abusive practices that could disadvantage market participants that are less sophisticated or have less market power. The final rules endeavor to protect market participants and the public without unduly restricting access to the important risk management tools and investment opportunities provided by swap markets. The final rules are informed by extensive consultations with relevant federal and foreign regulators and stakeholders. Where possible, the rules are harmonized with requirements in related market sectors, industry best practice

recommendations and SRO rules.

The Commission received comments regarding the potential costs and benefits of the proposed rules, which are discussed in detail above in each section of the preamble relating to the rules. The Commission considered these comments in adopting the final rules. The benefits of the final rules identified by commenters and the Commission include: (1) Enhanced transparency and reduced information asymmetries among market participants resulting from required disclosures and communications standards; (2) principles based duties that are sufficiently flexible to address emerging compliance issues; (3) Special Entity provisions to protect taxpayers, pensioners and charitable institutions from abusive practices; (4) a compliance framework and mechanisms, including safe harbors, that facilitate information flow and market access, mitigate costs and enhance legal certainty, while raising business conduct standards consistent with legislative intent; and (5) regulatory harmonization of existing business conduct standards and best practices in related market sectors and among dealers, including consideration of SRO guidance for comparable principles based rules.

The costs identified by commenters include assertions that: (1) Required disclosures are costly both in resources and possible delays, and could create potential liability unless disclosure can be standardized with appropriate safe harbors; (2) requiring swap dealers and major swap participants to make suitability evaluations of counterparties for specific trades will increase transaction costs and may create execution delays (both when a counterparty with an established relationship with a given swap dealer elects to begin trading a product outside of that relationship and a counterparty with no such relationship looks to begin trading with a given dealer); (3) principles based rules may expose swap dealers and major swap participants to potential compliance risk in both enforcement and private rights of actions; as a result, swap dealers and

major swap participants will pass the costs of added risk to their counterparties or there will be fewer possible swap dealer trading relationships, which could reduce liquidity; (4) execution delay and the chilling of trading activity may result as the rules will interfere with the flow of information between swap dealers or major swap participants and counterparties and impose barriers to efficient execution of transactions and possibly create moral hazard; and (5) the cost and risks to Special Entities may increase if dealers avoid such counterparties, and sophisticated Special Entities may not need the protections provided by the rules.

The Commission considered the comments it received and, as discussed in detail in the various sections of the preamble above, and as highlighted below, has taken steps to mitigate the costs and lower the burdens to the extent possible while also achieving the regulatory objectives of the Dodd-Frank Act. For example, the final rules in this adopting release allow compliance on a relationship basis rather than a transaction basis, when appropriate, to meet disclosure and due diligence duties. In addition, whenever possible, the Commission provides guidance in complying with the principles based statutory disclosure duties, which should reduce the burdens of complying with such obligations. The Commission also confirmed that certain business conduct standards rules will not apply to swaps executed on a SEF or DCM where the swap dealer or major swap participant does not know the identity of the counterparty prior to execution, including verification of eligibility, disclosures and Special Entity requirements. Finally, the Commission created safe harbors where appropriate, including an affirmative defense for swap dealers and major swap participants to a non-scienter fraud claim, and, for non-scienter violations of the other rules, the Commission will consider good faith compliance with policies and procedures in exercising its prosecutorial discretion if such policies and procedures are reasonably designed to comply with the requirements of any particular rule.

The Commission has considered the costs and benefits of the final rules in this adopting release pursuant to Section 15(a) of the CEA, including the comments it received relating to potential costs and benefits of each rule, where applicable. A discussion of the final rules in light of the Section 15(a) considerations is included below. In some cases, the Section 15(a) discussions apply to clusters of rules where the rules have a common purpose and shared costs and benefits. For example, the rules requiring disclosure of material information (risks, characteristics, incentives and conflicts of interest) have the common purpose of providing information to counterparties in a manner sufficient to enable counterparties to assess transactions before assuming the associated risks. The costs and benefits of providing such disclosures are similarly shared and, therefore, are addressed together to fully appreciate their cumulative effects. The Commission has indicated with respect to each rule how it has analyzed the five considerations in Section 15(a) of the CEA.

With respect to quantification of the costs and benefits of the final business conduct standards rules, the Commission notes that, because the Dodd-Frank Act establishes a new regulatory regime for the swaps market, there is little or no reliable quantitative data upon which the Commission can evaluate, in verifiable numeric terms, the economic effects of the final business conduct standards rules. No commenters presented the Commission with verifiable data pertinent to any of the proposed rules, stated whether such verifiable data exists, or explained how such cost data or any empirical analysis of that data would inform the choice of implementation pursuant to a specific provision of the Dodd-Frank Act or whether such data and resultant empirical analysis is ascertainable with a degree of certainty that could inform

Commission deliberations.[951] Commenters did not provide any verifiable cost estimates.[952]

1. Section 23.402(a)–Policies and Procedures to Ensure Compliance and Prevent Evasion and Section 23.402(g)–Record Retention

a. Benefits

Section 23.402(a) requires that swap dealers and major swap participants (1) have written policies and procedures to ensure compliance with subpart H of part 23 and to prevent evasion of any provision of the CEA or Commission Regulations, and (2) implement and monitor compliance with such policies and procedures as part of their supervision and risk management requirements as specified in subpart J of part 23. Section 23.402(g) requires that swap dealers and major swap participants create a record of their compliance with subpart H and retain records in accordance with subpart F and § 1.31. As a result, the requirements of § 23.402(a) and

[951] For example, with respect to potential costs associated with restrictions on information flows from dealers to their counterparties and increased reliance by counterparties on dealers, there is no clear means of quantification because of the difficulty in designing metrics for these potential costs. In addition, because there is no historical period in which similar rules were in effect, there remains the formidable (and costly) challenge of comparing the current environment to the post-rule environment. This challenge is compounded by the likelihood that the effect of the rule will differ across dealers and across counterparties. Quantification of the potential delays in swap execution and higher associated fees faces similar challenges, including lack of available data over which to measure the effect (if any) of such delays. The combination of these factors makes it impractical to determine reliable estimates of these types of costs. Moreover, no commenters provided verifiable estimates. As a consequence, the discussion of these potential costs is undertaken in qualitative terms.

The Commission recognizes that the business conduct standards rules impose certain compliance costs, most of which are the result of statutory mandates. Generally, the costs are anticipated to be incremental, because they are associated with existing, highly complementary compliance burdens imposed by the SEC or prudential regulators. These existing regulations, however, are not uniformly applied across the entire dealer community. As a consequence, certain dealers are expected to face higher compliance costs than others. The lack of dealer-specific information (e.g., on current staffing levels and those levels envisioned as being necessary for compliance with the rule) prevents reliable estimation of these costs, and no such information was provided to the Commission during the comment period.

[952] One late-filing commenter recently provided the Commission with a report to support its position that cost-benefit considerations compel excluding entities "engaged in production, physical distribution or marketing of natural gas, power, or oil that also engage in active trading of energy derivatives"—termed "nonfinancial energy companies" in the report—from regulation as swap dealers, including this final rulemaking. See NERA Dec. 20 letter, at 1. Based on responses to an anonymous survey of an unspecified number of firms identified only in the aggregate as nonfinancial energy companies that "could be captured" under the swap dealer definition, the report estimates that nonfinancial energy companies would incur certain initial and recurring regulatory compliance costs relevant to this rulemaking. As indicated in fn. 951, the Commission recognizes the potential for compliance costs associated with this rule to fall disproportionately across all swap dealers. The final rule attempts to minimize these burdens overall while remaining consistent with statutory intent.

(g) are part of the overall supervision, compliance and recordkeeping regime established in Section 4s of the CEA and as implemented in the relevant internal business conduct standards rulemakings. As such, the costs and benefits of § 23.402(a) and (g) discussed herein are part of the overall costs and benefits of the related internal business conduct standards requirements as discussed in connection with those rulemakings[953] and are a function of the requirements in the other rules that comprise subpart H. In this way, § 23.402(a) and (g) facilitates compliance with all of the subpart H business conduct standards rules.

Although difficult to quantify, robust policies and procedures and documentation requirements will benefit all market participants.[954] Swap dealers and major swap participants will benefit because, in the absence of fraud, the Commission will consider good faith compliance with policies and procedures reasonably designed to comply with the business conduct standards rules as a mitigating factor when exercising its prosecutorial discretion for violation of the rules.[955] In addition, swap dealers and major swap participants will be able to rely on their policies and procedures to demonstrate compliance with subpart H in connection with their registration applications.[956] The requirement to document compliance with the business conduct standards

[953] Because the firm-wide supervision, compliance, and recordkeeping functions are all accounted for in the Business Conduct Standards–Internal Rulemakings (see Governing the Duties of Swap Dealers, 75 FR 71397; CCO proposed rules, 75 FR 70881; and Conflict-of-Interest Standards by Swap Dealers, 75 FR 71391) and § 1.31 (see Adaptation of Regulations to Incorporate Swaps, 76 FR 33066, Jun. 7, 2011), and these policies and procedures and record retention provisions are subsets of the overall supervision, compliance and recordkeeping functions of the swap dealer or major swap participant, the Commission also has considered the costs and benefits of these rules in connection with those other rulemakings.

[954] This benefit is enhanced by the Commission requirement that recordkeeping policies and procedures ensure that records are sufficiently detailed to allow compliance officers and regulators to determine compliance.

[955] In particular, in connection with allegations of fraud under § 23.410(a)(2) and (3) (for violations of the fraud provisions under subpart H), final § 23.410(b) provides that a swap dealer or major swap participant may establish an affirmative defense against allegations of violations of final § 23.410(a)(2) and (3) by demonstrating that it did not act intentionally or recklessly and complied in good faith with written policies and procedures reasonably designed to meet the particular requirement that is the basis for the alleged violation.

[956] As part of the materials submitted in an application for registration as a swap dealer or major swap participant, an applicant may submit its written policies and procedures to "demonstrate, concurrently with or subsequent to the filing of their Form 7–R with the National Futures Association, compliance with regulations adopted by the

rules will reduce misunderstandings and complaints between swap dealers or major swap participants and counterparties. Robust compliance procedures will also benefit counterparties by encouraging a culture of compliance that will help to ensure that swap dealers and major swap participants deliver the protections intended by Section 4s(h). Section 23.402(a) also requires swap dealers and major swap participants to have policies and procedures to prevent evasion of the CEA and Commission Regulations. Such policies and procedures will assist regulators in ensuring that the intent of Congress, particularly through the Dodd-Frank Act amendments, is abided and that the Commission's jurisdictional markets are not used to circumvent regulatory requirements, including by engaging in fraud or other abuses.[957] Implementing anti-evasion policies and procedures as part of the supervision, risk management and compliance regimes of swap dealers and major swap participants should benefit swap markets by enhancing transparency and encouraging participation.

b. Costs

While there will be costs associated with establishing, implementing, testing, reviewing and auditing compliance with policies and procedures, the Commission expects these costs to be incremental. Many swap dealers and major swap participants are already subject to comprehensive supervision, compliance and recordkeeping requirements imposed in related regulated market sectors, including futures, banking and securities. Therefore, the additional costs will be limited to adapting existing policies and procedures to accommodate these new requirements. Regardless, the costs will be an incremental part of a swap dealer's or major swap participant's overall risk management program as required under subpart J and may be tailored to

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Commission pursuant to section[] . . . 4s(h) . . . of the [CEA] . . . ." The Commission adopted final registration rules on the same day as these business conduct standards rules. See also proposed § 3.10(a)(1)(v)(A), Proposed Rules for Registration of Swap Dealers and Major Swap Participants, 75 FR 71379.

[957] See Section 747 of the Dodd-Frank Act.

the swap related business conducted by a particular swap dealer or major swap participant.

Similarly, there will be costs associated with record retention, including the costs of creating a record of compliance and storing it. To mitigate these costs, the Commission has confirmed that counterparty relationship documentation containing standard form disclosures, other material information and counterparty representations may be part of the written record of compliance with the external business conduct rules that require certain disclosures and due diligence. Further, swap dealers and major swap participants may choose to use internet based applications to provide disclosures and daily marks.[958]

c. Section 15(a) of the CEA

In light of the foregoing, the Commission has evaluated the costs and benefits of final § 23.402(a) and (g) pursuant to the five considerations identified in Section 15(a) of the CEA as follows:

i. Protection of Market Participants and the Public

The Commission believes that the § 23.402(a) policies and procedures and record retention requirements, which are part of the overall supervision, risk management and compliance systems of swap dealers and major swap participants included in subparts F and J of part 23, reinforce subpart H's protections for swap market participants and the public by promoting compliance with subpart H and discouraging evasion of regulatory requirements. The costs of compliance are incremental and do not diminish the intended benefits of the business conduct standards rules for market participants.

ii. Efficiency, Competitiveness and Financial Integrity

The Commission believes that effective internal risk management and oversight protects the

[958] Swap dealers and major swap participants will have to retain a record of all required information irrespective of the method used to convey such information.

financial integrity of the critical market participants - individual swap dealers and major swap participants. Their financial integrity, in turn, promotes the financial integrity of derivatives markets as a whole by fostering confidence in financial system stability. Additionally, the Commission believes that § 23.402(a) will enhance the efficiency and competitiveness of markets to the extent that swap dealers and major swap participants have sound risk management programs.

Accurate recordkeeping is foundational to sound risk management and the financial integrity of swap dealers and major swap participants. The recordkeeping rules, including § 23.402(g), will enhance confidence in the financial integrity of the market and encourage participation by avoiding misunderstandings and reducing the potential for disputes between counterparties and evasion of regulatory requirements. Documentation will facilitate compliance reviews and Commission enforcement actions for failure to comply with disclosure, due diligence and fair dealing requirements.

iii. Price Discovery

The Commission does not believe that § 23.402(a) and (g) will have a material impact on price discovery.

iv. Sound Risk Management Practices

The policies and procedures and record retention provisions in § 23.402(a) and (g) which apply principally to counterparty relationships of swap dealers and major swap participants are subsets of the overall supervision, compliance, recordkeeping and risk management functions of the swap dealer or major swap participant (as accounted for in the Business Conduct Standards–

Internal rulemakings).[959] The Commission believes that proper recordkeeping is essential to risk management because it facilitates an entity's awareness of its swap business. Such awareness supports sound internal risk management policies and procedures by ensuring that decision-makers within swap dealers and major swap participants are fully informed about the entity's activities, including its dealings with counterparties, and can take steps to mitigate and address significant risks faced by the entity. When individual market participants engage in sound risk management practices, the entire market benefits. On the other hand, compliance with these policies and procedures and recordkeeping requirements is likely to require investment in recordkeeping, as well as front office and back office systems. The costs associated with this investment might otherwise be used to enhance other aspects of a firm's risk management program.

v. Other Public Interest Considerations

The Commission has not identified any other public interest considerations in connection with § 23.402(a) or (g).

2. Section 23.402(b)–Know Your Counterparty; Section 23.402(c)–True Name and Owner; and Section 23.434–Recommendations to Counterparties–Institutional Suitability

a. Benefits

The Commission is promulgating certain due diligence rules for swap dealers pursuant to its discretionary authority under Section 4s(h) that further the purposes of the Dodd-Frank Act business conduct standards provisions. These final rules are §§ 23.402(b)–Know your counterparty, 23.402(c)–True name and owner, and 23.434–Institutional suitability (collectively,

[959] See Governing the Duties of Swap Dealers, 75 FR 71397; CCO proposed rules, 75 FR 70881; Conflict-of-Interest Standards by Swap Dealers, 75 FR 71391; and § 1.31 (see Adaptation of Regulations to Incorporate Swaps, 76 FR 33066).

the “due diligence rules”).

Sections 23.402(b) and 23.402(c) require a swap dealer to use reasonable due diligence to obtain and retain a record of the essential facts concerning each counterparty whose identity is known to the swap dealer prior to the execution of the transaction and the authority of any person acting for such counterparty. Final § 23.434 requires swap dealers making recommendations to undertake reasonable diligence to understand the potential risks and rewards of the swap or trading strategy and to have a reasonable basis to believe that the swap is suitable for the counterparty.

All of the due diligence rules confer similar benefits in that they protect the public and market participants by requiring swap dealers to have essential information about their counterparties prior to entering into transactions and, to the extent they are making a recommendation, understand the trading objectives and characteristics of the counterparty. While not readily amenable to quantification, the benefits of the rules are significant. The rules are designed to prevent the potentially considerable costs for the counterparty (and incidentally the swap dealer when a counterparty is unable or unwilling to cover losses) of entering into unsuitable transactions. Such costs include losses associated with the position, generally, and the costs (at times considerable) of both exiting the position and establishing a new position, recognizing that the discovery of an “unsuitable” trade is more likely to occur during a period of market stress, which may magnify these costs. In this way, the due diligence rules are an integral component of the business conduct standards that are, in large part, designed to ensure that the counterparties and dealers understand the swap or trading strategy and place the dealer and counterparty on equal footing with respect to the risks and rewards of a particular swap or trading strategy.

The Commission believes that the due diligence rules will secondarily benefit dealers and regulators by requiring that a dealer be able to document essential information about its counterparties and any swaps or trading strategies that it recommends. While not a quantifiable benefit, documentation will facilitate effective review of a recommendation's suitability and render such recommendations less susceptible to "second-guessing," as well as review of the authority of its counterparty to enter into transactions. The due diligence rules relate to the risk management systems of the swap dealer making explicit the requirement that the swap dealer obtain facts required to implement the swap dealer's credit and operational risk management policies in connection with transactions entered into with the counterparty. The due diligence rules also harmonize the requirements for market professionals in related market sectors, including futures, securities and banking. An ancillary public interest benefit of such rules in those related markets has been their deterrence of counterparty misconduct, including, for example, unauthorized trading and money laundering.

b. Costs

The primary costs of final §§ 23.402(b), (c) and 23.434 are associated with obtaining information necessary to identify the counterparty, conducting any required due diligence before making a recommendation and maintaining records of essential customer information and suitability determinations. The Commission believes these costs are mitigated by at least five factors. First, as stated above, many of the dealers subject to these rules have long been subject to similar obligations under either NFA rules or the mandates of regulatory authorities in other markets, including banking and securities.[960] As such, the incremental costs of complying with the Commission's final rules are likely to be insignificant. Indeed, the Commission confirmed

[960] See, e.g., Section III.A.3.b. at fn. 179 discussing SRO know your customer rules; see also Section III.G.3. at fn. 536 discussing suitability requirements under the banking and federal securities laws.

that it would consider SRO interpretations of analogous provisions, as appropriate, when assessing compliance with the due diligence rules by swap dealers.[961] Second, in response to the comments it received, the Commission elected to promulgate several cost-mitigating alternatives to the proposed due diligence rules. For example, the Commission made clear that a dealer could fulfill its counterparty-specific suitability obligations through certain representations from the counterparty. Third, the Commission provided additional guidance, including a detailed explanation of what is likely and, as importantly, unlikely to constitute a "recommendation" within the meaning of final § 23.434. The guidance is included in the preamble to the final rules as well as in Appendix A to subpart H of part 23 of the Commission's Regulations. Fourth, the Commission made clear that a determination of whether a dealer acted in compliance with the rules is an objective inquiry based on a consideration of all the relevant facts and circumstances surrounding a particular recommendation. Fifth, the Commission set forth various safe harbors from which a dealer could demonstrate compliance. In these and other ways, the Commission believes that it has taken meaningful steps to minimize the risks and costs of compliance and any ancillary costs associated with, for example, vexatious litigation by a counterparty experiencing buyer's remorse.

Commenters expressed concerns about potential costs of the due diligence rules. They claimed that the proposed due diligence requirements would interfere with efficient execution of transactions if required on a transaction-by-transaction basis. The proposed rules also may have disadvantaged counterparties by requiring them to provide confidential information to swap dealers that could be used against them in negotiations or misappropriated by swap dealers. The

[961] See Section III.A.3.b. of this release at fn. 188 discussing final § 23.402(b) (know your counterparty), Section III.F.3. of this release at fn. 500 discussing final § 23.433 (communications-fair dealing), and Section III.G.3. of this release at fn. 542 discussing final § 23.434 (recommendations to counterparties–institutional suitability).

Commission has made a number of changes in the final rules to mitigate those costs. For example, the Commission clarified that the due diligence requirements can be satisfied on a relationship basis, where appropriate, in accordance with final § 23.402(d), through representations from the counterparty that can be contained in counterparty relationship documentation. The Commission also amended the requirements in the "know your counterparty" rule to align with the arm's length nature of the relationship between swap dealers and counterparties. In addition, the Commission adopted a confidential treatment rule, § 23.410(c), that protects confidential counterparty information from disclosure and use that would be materially adverse to the interests of the counterparty.

c. Section 15(a) of the CEA

In light of the foregoing, the Commission has evaluated the costs and benefits of the final due diligence rules pursuant to the five considerations identified in Section 15(a) of the CEA as follows:

i. Protection of Market Participants and the Public

The final due diligence rules, although discretionary, are important components of the business conduct standards regime that Congress mandated to add to the integrity of the swaps market. By codifying and, in some cases, enhancing current market practices, the final rules provide protections for counterparties. More specifically, the rules protect market participants and the public from the risks attendant to swap dealers subrogating customers' interests to increase the dealer's own profit maximizing interests by selling unsuitable swaps or trading strategies. The requirement that dealers make suitable recommendations, together with the requirement that swap dealers know their counterparty, should help to ameliorate the risks associated with unfair dealing. Taken together, these practices should also help regulators

perform their functions in an effective manner. The informational and diligence costs associated with this rulemaking are incremental and do not diminish these benefits.

ii. Efficiency, Competitiveness and Financial Integrity

A frequent criticism of the swaps market leading up to the 2008 financial crisis was that dealers engaged in self-dealing to the detriment of customers and counterparties, such as by offering swaps and trading strategies that the dealers knew were unsuitable for the specific counterparty.[962] Recommending products that have no beneficial purpose other than to enrich the dealer erodes confidence in markets, which, in turn, casts doubt on the efficiency, competitiveness and financial integrity of the markets subject to the jurisdiction of the Commission.

The Commission designed these rules to achieve the intended statutory benefits set forth in the Dodd-Frank Act and concludes that any incremental costs above the statutory-baseline will not be of such magnitude so as to impede swap market efficiency, competitiveness or financial integrity of the markets.

iii. Price Discovery

To the extent the final due diligence rules, which are part of a larger business conduct standards regulatory framework, prevent the aforementioned erosion of confidence in the markets, they also facilitate price discovery albeit indirectly.

iv. Sound Risk Management Practices

Verification and recording of counterparty identities, and carefully considered and well-documented recommendations, improve the risk management practices of a swap dealer and

[962] See, e.g., CFA/AFR Feb. 22 Letter, at 1-4; Better Markets Feb. 22 Letter, 1-2; Sen. Levin Aug. 29 Letter, at 2-5 and 8-10; Senate Report, at 382, 397-98 and 619-24.

have concomitant benefits in that actual compliance with the final rules will help to insulate the dealer from later accusations by a disgruntled counterparty seeking to exit an unprofitable swap position by alleging, for example, that the dealer engaged in malfeasance or recklessness in recommending a swap or trading strategy. The above-acknowledged informational and diligence costs do not directly diminish these benefits.

v. Other Public Interest Considerations

The due diligence rules have the ancillary benefit of dissuading market participants from using Commission regulated derivatives markets to engage in illegal conduct in violation of other criminal laws, including money laundering and tax evasion. Swap dealers will be required to obtain certain essential information from counterparties to know their identity, their authority to trade and who controls their trading. This type of information has been helpful in related market sectors, like futures, securities and banking, in detecting and deterring such misconduct.

3. Section 23.402(d)–Reasonable Reliance on Representations

a. Benefits

Section 23.402(d) does not impose any affirmative duties on swap dealers or major swap dealers, but rather provides them with an alternative means of compliance with certain other rules under subpart H of part 23 that require due diligence.[963] In this way, the rule benefits market participants by facilitating compliance with certain of the business conduct standards rules without undermining the protections intended by the rules.

The rule allows swap dealers and major swap participants to rely on written representations

[963] See Sections III.A.3.b., III.C., III.G., IV.B. and IV.C. in this adopting release for a discussion of the following final due diligence rules, respectively: § 23.402(b)–Know your counterparty; § 23.430–Verification of counterparty eligibility; § 23.434–Institutional suitability; § 23.440–Requirements for swap dealers acting as advisors to Special Entities; and § 23.450–Requirements for swap dealers and major swap participants acting as counterparties to Special Entities.

from counterparties and their representatives to satisfy certain due diligence obligations unless the swap dealer or major swap participant has information that would cause a reasonable person to question the accuracy of the representation. Furthermore, representations can be made on a relationship basis in counterparty relationship documentation and need not be made on a transaction-by-transaction basis, provided that the counterparty undertakes to timely update such representations in connection with new swaps.

Swap dealers and major swap participants requested clarity about the type of information that would satisfy their due diligence obligations, and counterparties were concerned that they would be required to provide confidential financial and position information that would give swap dealers and major swap participants an unfair advantage in their swap related negotiations. Section 23.402(d), coupled with the safe harbors and guidance provided to address compliance with the due diligence rules in subpart H, will benefit all parties by streamlining the means of compliance to enable efficient execution of transactions without materially diminishing the protections intended by the Dodd-Frank Act business conduct standards.

b. Costs

Section 23.402(d) does not, by itself, impose any direct costs on market participants. The costs of this rule, if any, are indirect since the rule is only applicable where swap dealers, major swap participants and counterparties choose to rely on counterparty representations to satisfy due diligence requirements imposed by other business conduct standards rules. As such, any costs of the rule are accounted for in the analysis of the related rules. One other cost that could arise is if the swap dealer or major swap participant had information that would cause a reasonable person to question the accuracy of a representation. In that situation, the swap dealer or major swap participant could not rely on the representation without undertaking appropriate due diligence

and incurring any costs associated with further inquiry. However, swap dealers and major swap participants benefit from such inquiry if it keeps them from entering into a swap under false pretenses. Moreover, if the Commission determined not to adopt the rule, the cost to swap dealers and major swap participants would be significant. Under that alternative, as one commenter asserted in connection with § 23.450–Acting as a counterparty to a Special Entity, swap dealers and major swap participants might stop entering into swaps altogether or, at the very least, pass increased costs onto their counterparties.[964]

c. Section 15(a) of the CEA

In light of the foregoing, the Commission has evaluated the costs and benefits of final § 23.402(d) pursuant to the five considerations identified in Section 15(a) of the CEA as follows:

i. Protection of Market Participants and the Public

The purpose of the business conduct standards rules is to protect market participants and the general public. Final § 23.402(d) furthers that intent by providing clear instruction on how market participants can comply with certain of those rules. The proviso that a swap dealer and major swap participant can only rely on a counterparty's representation in the absence of information that would cause them to question the accuracy of the representation protects swap dealers and major swap participants from the potentially negative consequences of entering into a swap in reliance on false information. This rule also protects counterparties by providing counterparties with control over the amount and type of information provided to a swap dealer or major swap participant.

[964] See SWIB Feb. 22 Letter, at 5. The costs and benefits associated with the ability of swap dealers and major swap participants to reasonably rely on a counterparty's representations are discussed in greater detail under the cost-benefit considerations for the particular requirements to which it applies: § 23.402(c) (True Name and Owner), § 23.430 (Verification of Counterparty Eligibility), § 23.434 (Recommendations to Counterparties–Institutional Suitability), § 23.440 (Requirements for Swap Dealers Acting as Advisors to Special Entities), and § 23.450 (Requirements for Swap Dealers and Major Swap Participants Acting as Counterparties to Special Entities).

ii. Efficiency, Competitiveness and Financial Integrity

This rule gives swap dealers and major swap participants a timely and cost-effective way to comply with their duties to counterparties. This increases the efficiency, competitiveness and financial integrity of the swaps market relative to an alternative that retains a due diligence requirement without an explicit means of compliance. Moreover, the Commission believes that the protection of proprietary information, which also is achieved through this rule, is essential for the competitiveness and integrity of derivatives markets.

iii. Price Discovery

The Commission does not believe that § 23.402(d) will have a material impact on price discovery.

iv. Sound Risk Management Practices

The Commission does not believe that § 23.402(d) will adversely impact sound risk management practices. While the principles based nature of the rules may introduce some uncertainty into the process of complying with the due diligence business conduct standards rules, the compliance roadmap in this particular rule decreases that risk by providing an efficient means for swap dealers and major swap participants to comply with several of their pre-transactional duties.

v. Other Public Interest Considerations

The Commission has not identified any other public interest considerations in connection with § 23.402(d).

4. Section 23.402(e)–Manner of Disclosure; Section 23.402(f)–Disclosures in a Standard Format; Section 23.431–Disclosure of Material Risks, Characteristics, Material Incentives and Conflicts of Interest Regarding a Swap; Section 23.432–Clearing Disclosures; and Section 23.433–

Communications–Fair Dealing

a. Benefits

Final § 23.431, which requires disclosures of material information, and the associated disclosure rules in subpart H of part 23 (the "disclosure rules")[965] contain the disclosure regime for swap dealers and major swap participants. These rules are fundamental to the transparency objectives of Section 4s(h) of the Dodd-Frank Act. The disclosure rules primarily benefit counterparties by requiring that swap dealers and major swap participants disclose material information regarding potential swap transactions, including material risks, characteristics, incentives, conflicts of interest, daily marks and rights relating to clearing of the swap. They also benefit counterparties by providing flexible and reliable means of compliance to take account of the nature of the swaps being offered and to avoid undue interference with the execution process.

In addition, the communications-fair dealing rule in final § 23.433 adopts the statutory language in Section 4s(h)(3)(C) and requires swap dealers and major swap participant "to communicate in a fair and balanced manner based on principles of fair dealing and good faith." The fair dealing rule works in concert with the disclosure rules and the anti-fraud rules in § 23.410 (the "abusive practices rules") to provide transparency to market participants in dealing with swap dealers and major swap participants.[966]

While not readily amenable to quantification, the benefits of the disclosure and fair dealing rules are significant for counterparties. The disclosure rules will allow counterparties to better assess the risks and rewards of a swap and avoid swaps that are inconsistent with their trading

[965] Consistent with Section 4s(h)(3)(B) of the CEA, § 23.431–Disclosures of material information, requires disclosure of material risks, characteristics, material incentives, conflicts of interest and daily mark relating to a swap. Associated rules include: § 23.402(e)–Manner of disclosure; § 23.402(f)–Disclosures in a standard format; and § 23.432–Clearing.

[966] See Section III.F. of this adopting release for a discussion of § 23.433–Communications–Fair Dealing.

objectives. The fair dealing rule ensures that swap dealers' and major swap participants' communications to counterparties are not exaggerated and discussions or presentations of profits or other benefits are balanced with the associated risks. The disclosure and fair dealing regime imposed by Section 4s(h) reverses the caveat emptor environment that permeated the unregulated derivatives marketplace prior to enactment of the Dodd-Frank Act and afforded little transparency or protection for either sophisticated counterparties or Special Entities. Legislative history indicates that the business conduct standards in Section 4s(h) were the result of widespread concerns about sharp practices and significant information asymmetries between swap dealers and their counterparties that created significant imbalances in their respective bargaining power and the assumption of unanticipated risks by counterparties. The disclosure and fair dealing rules implement the statutory objective of transparency for all swap transactions.

With respect to disclosures of the daily mark for uncleared swaps, the rules will provide counterparties, on a daily basis, the mid-market mark for the swap.[967] This information will provide an objective reference mark for counterparties to assist them in valuing open positions on their books for a variety of purposes, including risk management. The standard in the rule is intended to achieve a degree of consistency in the calculation of the daily mark across swap dealers and major swap participants. Such consistency will provide added transparency in pricing transactions and enhance the ability of counterparties to consider daily marks for their own valuation purposes. Counterparties will also receive from the swap dealer or major swap participant a mid-market mark along with the price of any swap prior to entering into the swap. Again, receiving the mid-market mark prior to execution of a swap will assist counterparties in assessing the price of a swap and negotiating swap terms, generally, with swap dealers and major

[967] The mid-market mark will not include amounts for profit, credit reserve, hedging, funding, liquidity or any other costs of adjustments.

swap participants.

The Commission believes that the disclosure rules will secondarily benefit swap dealers, major swap participants and regulators by requiring documentation of swap-related disclosures. While not a quantifiable benefit, documentation will facilitate effective supervision and compliance with required disclosures, which should reduce potential complaints, investigations and litigation. The fair dealing rule also benefits swap dealers and major swap participants by harmonizing the statutory requirements with similar protections that currently apply to registrants in the futures and securities markets.[968]

b. Costs

The primary costs of the disclosure rules are associated with implementing policies and procedures to achieve compliance with the principles based disclosure requirements, preparing and disseminating the disclosures, and maintaining records of the disclosures. The Commission expects that expenses will vary depending on the regulatory status of the swap dealer or major swap participant with financial firms regulated by prudential or securities authorities having relatively less additional costs because of existing regulatory requirements. Costs will also vary depending on the nature of the business conducted by the swap dealer considering that the process of making disclosures may be more streamlined for standardized swaps than, for example, complex bespoke swaps.

Regardless, the Commission believes that any costs associated with the disclosure rules will be incremental for the following reasons. First, as stated above in Section III.D. of this adopting

[968] See NFA Interpretive Notice 9041–Obligations to Customers and other Market Participants ("Communications with the Public–Under NFA Compliance Rules 2-4 and 2-29(a)(1), all communications with the public regarding security futures products must be based on principles of fair dealing and good faith . . . ."); see also NASD Rule 2210(d). Final § 23.433 is also harmonized with the SEC's proposed Fair and Balanced Communications rule for SBS Entities. See proposed 17 CFR 240.15Fh-3(g), SEC's proposed rules, 76 FR at 42455; and SEC's proposed rules Correction, 76 FR 46668, Aug. 3, 2011.

release, many swap dealers and major swap participants subject to this scheme have long been subject to similar disclosure obligations based on informal OTC derivatives industry practice and under the mandates of regulatory authorities in related market sectors, including banking, securities and insurance. As such, the incremental cost of complying with the Commission's final rules is likely to be small relative to the overall costs of operating as a swap dealer or major swap participant.

Second, in response to comments, the Commission elected to promulgate several cost-mitigating alternatives in the final disclosure rules. For example, the Commission made clear that a swap dealer or major swap participant could fulfill its disclosure obligations by any reliable means agreed to in writing by the counterparty. In addition, disclosures applicable to multiple swaps may be made in counterparty relationship documentation or other written agreements rather than on a transaction-by-transaction basis. The scenario analysis rule was revised from mandatory to elective and limited to swaps that are not made available for trading on a DCM or SEF. Further, anonymous transactions initiated on a SEF or DCM are exempt from the pre-transaction disclosure requirements.

Third, the Commission provided additional guidance in response to comments regarding many aspects of the disclosure scheme, including manner of disclosure, disclosures in a standard format, material risks, scenario analysis, material characteristics, material incentives, conflicts of interest, daily mark and clearing issues. Fourth, the Commission made clear that in exercising its prosecutorial discretion for disclosure violations, it would consider whether the swap dealer or major swap participant had complied in good faith with policies and procedures reasonably designed to comply with the particular disclosure requirement. In these and other ways, the Commission believes that it has taken meaningful steps to minimize the risks and costs of

compliance and any ancillary costs associated with, for example, private rights of action by counterparties unhappy with a particular swap transaction.

The Commission is allowing swap dealers and major swap participants to satisfy their disclosure obligations, where appropriate, on a relationship basis, as opposed to a transaction-by-transaction basis as a way of avoiding trading delays and the associated costs. However, in certain instances, consistent with the statutory requirement that swap dealers and major swap participants disclose information about the material risks and characteristics of the swap, the disclosure obligation will require supplements to standardized disclosures that are, to a degree, tailored to the individual transaction under consideration. The costs and benefits of these types of transaction-specific disclosures are considered relative to a case where material risk disclosure, as required under the statute, is accomplished at a level less granular than that which tailors such disclosure to a particular swap type. In addition, since the requirement for scenario analysis, through its value for illustrating material risk, is made at the discretion of the Commission, its associated costs and benefits are discussed relative to the absence of such a requirement.

Commenters also identified costs associated with the fair dealing rule. One commenter asserted that the principles based nature of the proposed fair dealing rule had the potential to impose costs on swap dealers and major swap participants including costs resulting from compliance risk.[969] As discussed in the introduction to this Section VI.C. of this adopting release, such costs are not readily subject to quantification. Another commenter requested that the Commission clarify the standards for communication by reference to existing SRO standards applicable in related market sectors.[970]

In response to commenters, the Commission clarifies in this adopting release that it will

[969] NY City Bar Feb. 22 Letter, at 3.
[970] FHLBanks Feb. 22 Letter, at 6.

consider NFA guidance when interpreting § 23.433.[971] The Commission believes harmonizing with existing SRO rules and precedents in the futures and securities markets diminishes the potential costs associated with legal uncertainty. Furthermore, the Commission clarifies in this adopting release that, in the absence of fraud, the Commission will consider good faith compliance with policies and procedures reasonably designed to comply with the fair dealing rule as a mitigating factor when exercising its prosecutorial discretion in connection with a violation of § 23.433.

c. Section 15(a) of the CEA

In light of the foregoing, the Commission has evaluated the costs and benefits of the final disclosure rules and the fair dealing rule pursuant to the five considerations identified in Section 15(a) of the CEA as follows:

i. Protection of Market Participants and the Public

The principal purpose of the disclosure rules is to protect market participants and the public by making swaps more transparent to enable counterparties to better assess the risks and rewards of entering into a particular transaction. The disclosure rules are a core component of the overall business conduct standards regime imposed in Section 4s(h) of the Dodd-Frank Act.

In determining how to implement the statutory disclosure requirements, the Commission considered certain negative externalities that may be created by requiring swap dealers and major swap participants to provide transaction specific disclosures. One risk is that requiring such disclosures by swap dealers and major swap participants could create disincentives to counterparties for performing their own independent assessments of a transaction under consideration. As a result, there is an increased likelihood that any insufficiencies in the

[971] See Section III.F.3. of this adopting release for a discussion of final § 23.433 and NFA guidance.

information provided by swap dealers and major swap participants that are not easily discernible at the time the disclosure is made could impact an expanded class of market participants in a similar way. For instance, the model risk borne by swap dealers and major swap participants may be transferred onto a broader set of market participants.

In addition, transaction-specific disclosures, generally, and specifically those based on model outputs (e.g., certain scenario analyses) require ongoing validation to ensure their sufficiency, accuracy and relevance. To the extent that the level of these validation efforts varies across swap dealers and major swap participants, the risk of relative insufficiencies or omissions in disclosure borne by the counterparties reliant on this information will vary correspondingly.

Because the disclosure rules are principles based, the quality of policies and procedures adopted by swap dealers and major swap participants will play a significant role in determining the sufficiency, accuracy and relevance of the disclosures made to counterparties. Moreover, some of the disclosures are models-based, whether through disclosures of a given product's sensitivity to certain market risk factors or the performance of the product during different scenario events or episodes. Policies and procedures, generally, and especially those governing models require ongoing validation to ensure their sufficiency, accuracy and relevance. The consequences of varying levels of supervision, to the extent that these levels vary in their ability to preserve the sufficiency, accuracy and relevance of the disclosures, will be borne by counterparties. Any such differences in supervisory efforts, to the extent they are allowed to persist, lessen the degree to which counterparties can rely on the information being provided to them. To mitigate these concerns, the Dodd-Frank Act imposes robust supervision and compliance requirements on swap dealers and major swap participants, which are implemented in subpart J of part 23. In subpart H, and in guidance in this adopting release, the Commission

has endeavored to clarify the relationship between swap dealers and major swap participants, on the one hand, and counterparties on the other to discourage undue reliance and to incentivize counterparties to engage in appropriate due diligence before entering into swaps.

Transaction-specific information is certainly valuable to the counterparty to assess the relative merits of a prospective transaction. Through economies of scale, swap dealers and major swap participants may be better positioned to provide these disclosures (as opposed to the counterparty discovering the information itself). In other words, swap dealers and major swap participants may be the lowest-cost provider of this information. As a result, efficiency gains may be realized by requiring swap dealers and major swap participants to disseminate this information. The fact that commenters point to significant information advantages enjoyed by swap dealers and major swap participants over their counterparties supports this lowest-cost solution.

Additionally, the fair dealing rule protects market participants and the public by requiring that communications between swap dealers or major swap participants and their counterparties are conducted based on principles of fair dealing and good faith. The rule raises the standard for communications in the previously unregulated swaps market and encourages confidence in the swap market by market participants and the public. The fair dealing rule, particularly in conjunction with the disclosure rules, ensures that market participants have information necessary to assess the risks and rewards of a swap when dealing with swap dealers and major swap participants, which have had informational advantages over their counterparties by virtue of their roles in the marketplace.

ii. Efficiency, Competitiveness and Financial Integrity

Commenters raised concerns that requiring material information disclosure prior to execution

may delay execution, increase market risk and adversely affect efficiency. Further, the required disclosures may result in proceedings or litigation, which could test the financial integrity of certain swap market participants.

The Commission has designed the disclosure rules to minimize potential inefficiencies and anti-competitive results, and to bolster financial integrity. For example, the rules allow disclosures to be made by any reliable means agreed to by the counterparty. In addition, risk disclosures in a standard format may be included in counterparty relationship documentation or other written agreements between the parties. Scenario analysis is elective rather than mandatory. Moreover, because the disclosure rules are principles based, the Commission will take into account whether reasonably designed policies and procedures are in place prior to exercising its prosecutorial discretion when considering violations of the disclosure rules.

The fair dealing rule principally protects counterparties; however, there are additional benefits for markets. The fair dealing rule, particularly when considered with the abusive practices rules and the disclosure rules, improves transparency and discourages abusive practices, and thereby encourages participation in the market, which contributes to liquidity, efficiency and competitiveness in the marketplace. Furthermore, the fair dealing rule assists market participants to assess potential risk in connection with a swap and make more informed decisions consistent with their trading objectives.

iii. Price Discovery

Transaction specific disclosures may, to a degree, cause delays in execution. These delays may occur either when a counterparty with an established relationship with a given swap dealer or major swap participant elects to begin trading a product outside of that relationship or a counterparty with no such relationship looks to begin trading with a given swap dealer or major

swap participant. These delays may have negative consequences on liquidity, potentially subjecting counterparties to heightened transaction costs. Moreover, these delays may be pro-cyclical, meaning that they increase during times of heightened market volatility. In recognition of the potential for these delays, the Commission adopted several procedural provisions to mitigate adverse consequences, including (1) allowing, where appropriate, disclosures to be made at the relationship level as opposed to the transaction level, (2) allowing certain oral disclosures if agreed to by the counterparty and confirmed in writing, (3) making website-based disclosures (password-protected if for the daily mark) available, and (4) allowing swap dealers and major swap participants to partner with DCMs, SEFs, and/or third-party vendors to make certain disclosures.

To the extent that delays in execution foster a more complete assessment of the merits of a particular transaction, the likelihood of after-the-fact realizations of ill-conceived positions may be reduced as well as any trading activity these realizations encourage. To the extent that this trading activity impacts market volatility, its reduction has positive implications for price discovery. Moreover, since these realizations are more likely to occur during periods of market stress, the corresponding benefit of their reduction may be elevated during such periods.

As stated in the price discovery consideration of final § 23.410, the fair dealing rule benefits counterparties but also provides added benefits for markets.[972] The fair dealing rule requires swap dealer and major swap participant communications to be fair and balanced and restricts misleading or other potentially abusive communications that could undermine the price discovery function of the swap market.

[972] See Section VI.C.5.c.iii. of this adopting release for a discussion of price discovery considerations of final § 23.410–Prohibition on fraud, manipulation and other abusive practices.

iv. Sound Risk Management Practices

Presumably, exercising the opt-in feature for scenario analysis will impart some cost to the counterparty. This cost will depend on the specificity of the analysis being requested and will be paid through some combination of delayed execution and/or higher fees. The rule attempts to mitigate these costs by making scenario analysis optional on the part of the counterparty as it is under current industry practice. Moreover, exercising this feature signals that the counterparty values the information provided by the analysis and, therefore, is willing to bear the associated costs. In contrast, a policy of mandatory scenario analysis forces this cost to be borne, to varying degrees, by all market participants, even though the corresponding benefit to a subset of those participants may be at or near zero. As a result, the final scenario analysis provision furthers a primary objective of the Dodd-Frank Act by encouraging sound risk management practices among market participants without unduly imposing costs.

Consistent with the statutory framework in Section 4s(h), whether standard form or particularized disclosures are sufficient in any given case will depend on the facts and circumstances of the subject transaction. Principles based disclosure rules take into account the various types of swap transactions that are subject to the rules (from highly standardized agreements to complex bespoke swaps), as well as the varied scope of swap related business undertaken by swap dealers and major swap participants. Compliance with principles based rules, like the disclosure rules, is by nature a matter of interpretation by swap dealers or major swap participants in the design of their policies and procedures, as well as by regulators and counterparties in their after-the-fact review of such disclosures, prompted, for example, by performance results that are claimed to be inconsistent with such disclosures. Subjective criteria introduce uncertainty into the compliance process and, in so doing, contribute to heightened risk

costs that, at least in part, may be passed on to counterparties. Depending on how this uncertainty distributes across all swaps products, certain market participants may bear a disproportionate share of the resulting costs. The Commission attempts to dampen these costs, generally, by considering good faith compliance with policies and procedures reasonably designed to comply with the requirements of any particular rule. The rules also supply guidance for complying with these duties as a means for mitigating any uncertainty in regulatory compliance.

To the extent that the disclosure rules contribute to execution delays, for the duration of these delays, market participants will either need to bear certain market risks or be prevented from taking on those risks.[973]

The fair dealing rule does not undermine sound risk management practices for swap dealers or major swap participants and has the potential to enhance risk management practices for counterparties. Counterparties will be able to manage their swap related risks based on more complete and reliable information from swap dealers and major swap participants. Swap dealers and major swap participants will be incentivized to implement policies and procedures reasonably designed to ensure that they make fair and balanced communications that provide their counterparties with a sound basis for evaluating the facts with respect to any swap. Similar to the discussion of the cost-benefit considerations of the anti-fraud rules, such practices will reduce counterparties' risk that they may otherwise enter into a swap that is inconsistent with their trading objectives based on unbalanced or misleading communications.

v. Other Public Interest Considerations

The disclosure rules are designed to address historical information asymmetry between counterparties and swap dealers or major swap participants and should enable counterparties to

[973] See the discussions of price discovery above for a description of the provisions designed to mitigate these delays.

better protect their own interests before assuming the risk of any particular swap transaction. In addition, requiring both the disclosure of material information and fair dealing will enhance transparency and promote counterparty confidence in the previously unregulated swap market, which better enables counterparties to use swaps to assume and manage risk.

5. Section 23.410–Prohibition on Fraud, Manipulation and Other Abusive Practices

a. Benefits

Final § 23.410 prohibits fraud, manipulation and other abusive practices and is applicable to swap dealers and major swap participants. Section 23.410(a) mirrors the language of Section 4s(h)(4)(a) of the CEA. Section 23.410(b) provides an affirmative defense for swap dealers and major swap participants to alleged non-scienter violations of § 23.410(a)(2) and (3). Final § 23.410(c) prohibits swap dealers and major swap participants from disclosing confidential counterparty information or using such confidential information in a manner that would tend to be adverse to the counterparty.

The rule primarily benefits counterparties, including Special Entities, in that it prohibits fraudulent, deceptive and manipulative practices by swap dealers and major swap participants and misuse of confidential information to the detriment of the counterparty. While not readily amenable to quantification, the benefits of the rule are significant. The rule is designed to mitigate the potentially considerable costs associated with a counterparty entering into a swap having been induced by fraudulent, deceptive or manipulative conduct. The rule also reduces the possibility that counterparties will be disadvantaged by manipulative conduct or misuse of confidential information by, among other things, improper disclosure of the counterparty's

trading positions, intentions to trade or financial status.[974] In these ways, the rule is an integral component of the business conduct standards, which are, in large part, designed to ensure that counterparties and swap dealers are on equal footing with respect to understanding the risks and rewards of a particular swap or trading strategy.

The rule also enhances the authority of the Commission to ensure fair and equitable markets. Market participants and the public will benefit substantially from such enhanced prevention and deterrence of fraud and manipulation. Rules protecting the confidential treatment of counterparty information and prohibiting fraud and manipulation encourage market participation, with the ensuing positive implications such participation has on market efficiency and price discovery.

b. Costs

The Commission does not believe that there will be significant costs in connection with final § 23.410. First, § 23.410(a) merely codifies Section 4s(h)(4)(A) of the CEA.[975] To the extent there were any costs to be considered, Congress made that determination in promulgating Section 4s(h)(4)(A). Further, final § 23.410(b) has added an affirmative defense, which mitigates any costs that may have been imposed by the application of non-scienter fraud provisions in final §§ 23.410(a)(2) and (3) to swap dealers and major swap participants. The Commission believes that swap dealers and major swap participants already have in place policies and procedures, and provide training to ensure that their traders and staff do not engage in fraud and manipulation. To the extent there are any costs with respect to final § 23.410(a), such costs will be related to training staff and ensuring that existing compliance procedures are up-to-date. In addition, such policies and procedures are already accounted for by virtue of the Commission's promulgation of

[974] The protections in final § 23.410 also address historical imbalances in negotiating power between swap dealers and counterparties related to sophistication and financial wherewithal. The treatment of confidential counterparty information by swap dealers depended on the relative ability of the parties to negotiate terms in their interest.

final §§ 180.1 and 180.2, which similarly prohibit manipulative or deceptive conduct, as well as the other applicable anti-fraud and manipulation prohibitions in the CEA.

To the extent there are costs with respect to the protection of confidential counterparty information, the primary costs of this rule are associated with implementing policies and procedures designed to protect such information. The design of the final rule, and the Commission guidance in this adopting release, address concerns by commenters that the proposed confidential treatment and trading ahead provisions would have unduly affected the ability of swap dealers and major swap participants to enter into transactions with other counterparties or manage their own risks. The Commission believes that the actual costs to swap dealers and major swap participants will be insubstantial and have been mitigated by the final rules.

First, as stated above, swap dealers and major swap participants subject to final § 23.410(a) are already subject to Section 4s(h)(4)(A) of the CEA, which was added by the Dodd-Frank Act. In addition, as stated above, the Commission believes that swap dealers and major swap participants already have policies and procedures and a compliance regime in place to prevent fraud and manipulation by traders and staff. Further, swap dealers and major swap participants have long been subject to either self-imposed internal business conduct rules or to contractual requirements of confidentiality contained in negotiated swap agreements for individual swaps or in counterparty relationship documentation with counterparties.[976]

The Commission understands that there will be incremental costs associated with adapting existing policies and procedures to the new rules, but believes that these costs would be materially the same regardless of the rules' substance. Final § 23.410(a) imposes no affirmative

[975] See Section 731 of Dodd-Frank Act.
[976] See SIFMA/ISDA Feb. 17 Letter, at 11.

duties, and it is unlikely that it will impose any additional costs beyond the existing costs associated with ensuring that behavior and statements are not fraudulent, deceptive or manipulative.[977] In this regard, the Commission believes it will not be necessary for firms that currently have adequate compliance programs to hire additional staff or significantly upgrade their systems to comply with the new rules, although firms may incur some compliance costs such as the cost associated with training traders and staff about the new rules.

Finally, in response to comments regarding proposed §23.410(a), the Commission elected to revise the proposed rule by adding a cost-mitigating section. Final § 23.410(b) provides that a swap dealer or major swap participant may establish an affirmative defense against allegations of violations of final § 23.410(a)(2) and (3) by demonstrating that it did not act intentionally or recklessly and complied in good faith with written policies and procedures reasonably designed to meet the particular requirement that is the basis for the alleged violation. With respect to the confidential treatment of counterparty information, the Commission provided that such confidential information may be disclosed or used for effective execution of the swap with the counterparty, to hedge or mitigate exposure created by the swap, or to comply with requests from regulators or as required by law, or as agreed by the counterparty. In these and other ways, the Commission believes that it has taken appropriate steps to minimize the risks and costs of compliance and any ancillary costs associated with final § 23.410 (e.g., vexatious litigation by a counterparty experiencing buyer's remorse).

c. Section 15(a) of the CEA

[977] See Prohibition on Manipulative and Deceptive Devices, 76 FR at 41408-41409, for a discussion of the costs and benefits of final §§ 180.1 and 180.2.

In light of the foregoing, the Commission has evaluated the costs and benefits of final § 23.410 pursuant to the five considerations identified in Section 15(a) of the CEA as follows:

i. Protection of Market Participants and the Public

The purpose of final § 23.410 is to protect market participants and the public by prohibiting fraud, manipulation and other abusive practices. Final § 23.410(a) codifies Section 4s(h)(4)(A) of the CEA and appropriately extends the protections intended under the Dodd-Frank Act. Final § 23.410(c) provides protection for counterparties by prohibiting disclosure and misuse of their confidential information. As such, § 23.410(c), although discretionary, is a central element in the business conduct standards regime that Congress mandated the Commission implement by imposing standards on swap dealers and major swap participants in their dealings with counterparties. The rule is also guided by Section 3(b) of the CEA, which explicitly includes among the purposes of the CEA ". . . to protect all market participants from fraudulent or other abusive sales practices . . . ." In addition, the rule implements the discretionary authority provided by Congress in Section 4s(h)(1)(A) of the CEA, which authorizes the Commission to prescribe rules that relate to "fraud, manipulation, and other abusive practices involving swaps (including swaps that are offered but not entered into . . .)." As provided by Sections 3 and 4s(h)(1)(A) of the CEA, the rule protects market participants, generally, and Special Entities, particularly (which, when victims of fraud, manipulation or abuse, can have significant negative implications for taxpayers, pensioners and charitable institutions).

In addition, the requirements that dealers disclose counterparty information only on a "need to know" basis and establish policies and procedures to protect confidential counterparty information, together with the other important requirements set forth in this rulemaking, ameliorate the risks associated with disclosure of confidential information to a swap dealer or

major swap participant. The above-acknowledged diligence costs do not diminish these benefits.

ii. Efficiency, Competitiveness and Financial Integrity

While final § 23.410 is aimed at protecting counterparties, there are ancillary benefits for markets. Markets that are free of fraud, manipulation and other abusive practices encourage participation, which adds to liquidity, efficiency and competitiveness. The final rule enhances these benefits by appropriately restricting abusive conduct by swap dealers and major swap participants. In addition, protections against fraud, manipulation and misuse of counterparty information promote the financial integrity of counterparties by reducing the likelihood of (1) their being victims of fraud (and needing to bear the costs associated with such fraud) or manipulation in the value of their positions, and (2) their confidential information being used in ways that are adverse to their investment objectives. These protections look to reduce the level of risk to which counterparties are exposed when conducting business in the swaps markets.

iii. Price Discovery

As stated in the previous section, while final § 23.410 is aimed at protecting counterparties from abusive conduct by swap dealers and major swap participants, there are ancillary benefits for markets. These benefits are key to providing "a means for managing and assuming price risks, discovering prices, or disseminating pricing information through trading in liquid, fair and financially secure trading facilities."[978] Indeed, it is an explicit purpose of the CEA "to deter and prevent price manipulation or any other disruptions to market integrity."[979] The final rule appropriately restricts abusive conduct by swap dealers and major swap participants without unduly chilling legitimate trading that could undermine the price discovery function of the market.

[978] Section 3(a) of the CEA (7 U.S.C. 5(a)).
[979] Section 3(b) of the CEA (7 U.S.C. 5(b)).

iv. Sound Risk Management Practices

Final § 23.410 supports sound risk management practices for swap dealers and major swap participants by incentivizing them to expand their policies and procedures to avoid misuse of confidential counterparty information. This will reduce the risks faced by counterparties that their proprietary information will be misappropriated, while concomitantly mitigating litigation risks for swap dealers and major swap participants. The above-acknowledged diligence costs do not diminish these benefits.

v. Other Public Interest Considerations

Final § 23.410 is consistent with prohibitions against fraudulent and manipulative practices in other market sectors, including futures, securities and banking. It is also consistent with market abuse prohibitions that are generally in effect in foreign markets. Harmonization reduces compliance costs and enhances protections for market participants whose trading strategies cross market sectors and international borders.

6. Section 23.430–Verification of Counterparty Eligibility

a. Benefits

Final § 23.430–Verification of counterparty eligibility, is a due diligence business conduct requirement for swap dealers and major swap participants that is mandated by Section 4s(h) of the CEA. The final rule implements congressional intent that only ECPs have access to swaps that are traded bilaterally or on a SEF (where the swap dealer or major swap participant knows the identity of the counterparty). The final rule also ensures that swap dealers and major swap participants determine prior to offering to enter into or entering into a swap whether its counterparty is a Special Entity, which would trigger additional protections under Sections 4s(h)

and subpart H of part 23.[980] To avoid interfering with the efficient execution of transactions, the rule provides a safe harbor that allows swap dealers and major swap participants to rely on counterparty representations, which can be contained in counterparty relationship documentation. The rule specifies the content of the written representations on which the swap dealer or major swap participant can reasonably rely.

While not readily amenable to quantification, the benefits of the verification rule are material. The principal benefit is the implementation of congressional intent that certain swaps be available only to ECPs and that retail customers be limited to swaps trading only on a DCM. The rule also fosters compliance with the Special Entity rules by verifying Special Entity status early in the relationship between the swap dealer or major swap participant and the Special Entity counterparty. Swap dealers and major swap participants benefit from the rule to the extent that verification of eligibility will assist them in avoiding non-ECP counterparties that would seek to avoid liability for unprofitable swaps based on ineligibility. The requirement to verify the Special Entity status of a counterparty is implicit in the provisions that afford heightened protections for Special Entities.[981]

b. Costs

As discussed above, Congress required the Commission to implement a counterparty eligibility verification rule. The Commission is not required to consider the costs and benefits of Congress' mandate; rather Section 15(a) of the CEA requires the Commission to consider the costs and benefits of its regulatory actions. In this case, the primary costs of final § 23.430 are associated with obtaining information necessary to verify that a counterparty is an ECP, and where relevant a Special Entity or counterparty able to elect Special Entity protections as

[980] See Section 4s(h)(4) and (5) of the CEA and §§ 23.440 and 23.450.
[981] Id.

provided in § 23.401(c)(6), and maintaining records regarding the verification. The Commission believes that its implementing regulation mitigates these costs by closely adhering to the existing industry best practices, which provide that professional intermediaries, prior to entering into any transaction, evaluate counterparty legal capacity, transactional authority and credit. In addition, the Commission's regulation is similar to swap counterparty restrictions under the Commodity Futures Modernization Act amendments to the CEA.[982] Given existing OTC derivatives market practice and historical restrictions on market access, the Commission expects the cost of complying with final § 23.430 will be insignificant. In addition, the final rule specifically allows swap dealers and major swap participants to rely on written representations by the counterparty to satisfy the verification rule for both ECP and Special Entity status and such representations can be made in counterparty relationship documentation. The rule also specifies the content of representations that would provide a reasonable basis for reliance, and the Commission confirmed that a change in a counterparty's ECP status during the term of a swap will not affect the enforceability of the swap. Based on the foregoing, the Commission believes that it has taken meaningful and appropriate steps to minimize the risks and costs of compliance with Congress' directive to implement a counterparty eligibility verification rule as mandated in Section 4s(h) of the CEA.

c. Section 15(a) of the CEA

In light of the foregoing, the Commission has evaluated the costs and benefits of final § 23.430 pursuant to the five considerations identified in Section 15(a) of the CEA as follows:

i. Protection of Market Participants and the Public

Congress has determined that swap market participation, except on a DCM, should be limited

[982] See Sections 2(g) and 2(h) of the CEA prior to the Dodd-Frank Act amendments.

to ECPs, and final § 23.430 furthers that determination by establishing a procedure for restricting access by unqualified persons. In this way, the rule provides protection for market participants and the public by limiting access to qualified persons. The due diligence costs associated with this rulemaking are incremental and do not diminish the benefits.

ii. Efficiency, Competitiveness and Financial Integrity

The final verification rule mitigates negative effects on efficiency, competitiveness and financial integrity by addressing costs associated with execution delays. In addition, the financial integrity of the market may be enhanced by requiring due diligence by swap dealers and major swap participants to restrict participation by non-ECPs that generally have limited ability to evaluate and assume the risk of complex bilateral swaps.

iii. Price Discovery

By virtue of the compliance mechanisms built into the rule, the Commission believes that it will not unduly interfere with the price discovery function of the market that could result from execution delays. Section 4s(h) limits market participation to ECPs, which could negatively affect liquidity and price discovery, but the final rule does not exacerbate such potential consequences by limiting market access. Indeed, by ensuring that only ECPs (the CEA proxy for sophistication and financial wherewithal) can participate, other ECPs may be encouraged to participate, thereby enhancing liquidity and price discovery.

iv. Sound Risk Management Practices

The final rule addresses counterparty risk, which is one of the primary risks in the swaps market. As indicated above, the final rule codifies OTC derivatives industry best practice by requiring swap dealers and major swap participants to verify that the potential counterparty is an ECP and, where relevant, a Special Entity. This verification supplements the industry best

practice requirement advising that, prior to trading, market professionals should check a counterparty's legal capacity, transactional authority and credit. Therefore, the rule complements existing market practice and sound risk management practices.

v. Other Public Interest Considerations

The Commission has not identified any other public interest considerations.

7. Section 23.440–Requirements for Swap Dealers Acting as Advisors to Special Entities; Section 23.450–Requirements for Swap Dealers and Major Swap Participants Acting as Counterparties to Special Entities; and Section 23.451–Political Contributions by Certain Swap Dealers

a. Benefits

Final §§ 23.401(c), 23.440, 23.450 and 23.451 (the "Special Entity rules") provide heightened protections to a particular class of swap market participant when dealing with swap dealers and major swap participants. Special Entities play an important public interest role by virtue of their responsibility for managing taxpayer funds, the assets of public and private employee pension plans and endowments of charitable institutions. The Special Entity rules implement the congressional mandate to establish a higher standard of care for swap dealers that act as advisors to Special Entities and to ensure that Special Entities are represented by knowledgeable, independent advisors when dealing with swap dealers and major swap participants.

The Special Entity rules also prohibit swap dealers from entering into swaps with a governmental Special Entity[983] if the swap dealer makes certain political contributions to

[983] Final § 23.451(a)(3) defines "governmental Special Entity" as State and municipal Special Entities defined in § 23.402(c)(2) and governmental plans as defined in § 23.402(c)(4); see also Section IV.D. of this adopting release at fn. 904.

officials of that governmental Special Entity to prevent what is known as "pay-to-play." The Commission believes that the pay-to-play rule in § 23.451 is a necessary and appropriate prohibition to prevent swap dealers and others from engaging in fraudulent practices. Given the competitive nature of the swaps market, the incentives to engage in pay-to-play may be significant. The rule also harmonizes with existing pay-to-play restrictions applicable to certain swap dealers who are also subject to pay-to-play rules in the securities sector to promote regulatory consistency across related market sectors.

The Special Entity rules provide substantial benefits to Special Entities and the general public. Swaps may have complex terms or employ leverage that can expose counterparties to significant financial risks, and unanticipated losses from a swap transaction can be financially devastating. Because financial losses in connection with a swap depend on the facts and circumstances regarding the particular swap and the particular Special Entity, the costs of such losses are not reliably quantifiable and, therefore, the benefits of preventing such losses are also not reliably quantifiable.

Although the costs of the Special Entity rules are not readily quantifiable, the benefits to Special Entities are significant. Ensuring that Special Entities are represented by independent advisors that have sufficient knowledge to evaluate the transaction and risks of a swap is a vitally important protection for Special Entities. Independent and knowledgeable advice will benefit Special Entities, and those whose interests they represent, by creating a more level playing field when negotiating with swap dealers and major swap participants. Final § 23.450 mitigates the likelihood that a Special Entity will assume risks and any consequent losses based on (1) inadequate advice due to a lack of understanding of the risks, or (2) biased advice that is not in the best interests of the Special Entity.

Final § 23.440 benefits Special Entities by restricting swap dealers from providing advice that is not in the Special Entity's best interests. A swap dealer that markets a swap to counterparties has an inherent conflict of interest, but is often in the best position to know the risks and characteristics of a complex swap, and the incentives for a swap dealer to provide conflicted advice that is not in the best interests of the Special Entity are substantial. The Commission believes that § 23.440 will provide important protections to make sure that a swap dealer's communications that are the most susceptible to being misleading or abusive are subject to the statutory "best interests" standard.

Commenters were in general agreement that pay-to-play is a serious issue that should be addressed by the Commission. As discussed in this adopting release, the Commission expects that final § 23.451 will yield several important, if unquantifiable, benefits. Overall, the rule is intended to address pay-to-play relationships that interfere with the legitimate process by which a governmental Special Entity decides to enter into swaps with a particular swap dealer. Such a process should be determined on the merits rather than on contributions to political officials. The potential for fraud to invade the various, intertwined relationships created by pay-to-play arrangements has been documented in notorious cases of abuse. The Commission believes that the prohibition will reduce the occurrence of fraudulent conduct resulting from pay-to-play and, as a result, will achieve its goals of protecting market participants and the public from the resulting harms.

By addressing pay-to-play practices, § 23.451 helps to ensure that governmental Special Entities consider the merits of any particular transaction with a swap dealer and not the size of a swap dealer's political contributions. These benefits, although difficult to quantify, could result in substantial savings to government institutions, public pension plans and their beneficiaries,

resulting in better performance for taxpayers. Efficiencies are enhanced when government counterparties competitively award business based on price, performance and service and not the influence of pay-to-play, which in turn enables firms to compete on merit, rather than their ability or willingness to make contributions.[984]

Finally, the Special Entity rules protect U.S. taxpayers, the retirement savings of U.S. private and public employees and pensioners, and beneficiaries of charitable endowments ("Special Entity beneficiaries"). Losses to a company that assumes significant risk through swaps are typically limited to its investors and creditors. However, Special Entities that assume risk through the use of swaps also expose Special Entity beneficiaries to such risks. When a Special Entity suffers losses in connection with a swap, the Special Entity beneficiaries ultimately bear such losses. Certain swaps can create significant risk exposure that may result in substantial losses. And in the wake of the 2008 financial crisis, significant or even catastrophic losses have been proven not to be merely theoretical. In the case of Special Entities, such losses could result in taxpayer bailouts of public institutions or devastating losses to vulnerable members of the public including pensioners and beneficiaries of charitable endowments. Additionally, taxpayers and public employees and pensioners may benefit from § 23.451 because they might otherwise bear the financial burden of bailing out a public institution or governmental pension plan that has ended up with a shortfall due to poor performance or excessive fees that might result from pay-to-play. Therefore, the Special Entity rules provide significant protections for Special Entity

[984] In addition to § 23.451, which prohibits swap dealers from engaging in pay-to-play practices with governmental Special Entities, § 23.450(b)(1)(vii) similarly requires a swap dealer or major swap participant to have a reasonable basis to believe that a governmental Special Entity's representative (other than an employee) is subject to pay-to-play prohibitions imposed by the Commission, SEC or an SRO subject to the jurisdiction of the Commission or the SEC. The Commission believes that § 23.450(b)(1)(vii) will create substantially similar benefits to those described regarding § 23.451. Therefore, the Commission believes governmental Special Entities and their beneficiaries will benefit from advisers that are selected based on the quality of their advisory services and not the size of their political contributions. See Section IV.C.3.d.viii. of this adopting release for a discussion of final § 23.450(b)(1)(vii).

beneficiaries and the public at large by ensuring that Special Entities have independent and knowledgeable representatives, are afforded a higher standard of care from swap dealers that act as advisors and, in the case of governmental Special Entities, are not unduly influenced by political contributors. The Commission has considered a number of regulatory alternatives proposed by commenters and has revised some of the proposed rules in response to commenters' suggestions.[985]

b. Costs

As identified by commenters,[986] the proposed Special Entity rules had the potential to impose costs including: (1) Reduced access to swap markets for Special Entities if swap dealers and major swap participants decline to act as their counterparties, (2) limited flow of information from swap dealers to Special Entities, (3) litigation risk for swap dealers and major swap participants, (4) compliance obligations on swap dealers and major swap participants, (5) and delays in swap execution.[987] As discussed in the introduction to this Section IV.C. of this adopting release, such costs are difficult and costly to quantify and, in some cases, are not subject to reliable quantification. Additionally, some commenters asserted that conflicting federal regulatory regimes could impose costs, such as penalties for violating ERISA's prohibited transaction provisions.[988] Any penalty for violation of another federal law in connection with a swap will depend on the facts and circumstances regarding the particular swap

[985] See, e.g., Section IV.B.3.b. and d. of this adopting release for a discussion of commenters' alternative approaches to § 23.440 and Section IV.C.3 of this adopting release for a discussion of alternative approaches to § 23.450.
[986] The Commission requested comment on the costs and benefits of the proposed Special Entity rules and invited commenters to provide data or other information to support their views on the proposal's costs and benefits. The Commission received general comments on costs and benefits but no verifiable data. See proposing release, 75 FR at 80657.
[987] See, e.g., Section IV.C.2.g. of this adopting release for a summary of comments regarding transaction costs and risks related to the Special Entity rules.
[988] See Section II of this adopting release for a discussion of regulatory intersections with the Commission's business conduct standards rules.

and the particular Special Entity; therefore, the costs of such penalties are not reliably quantifiable.

One commenter provided an example to quantify potential costs to the sponsor of a fully-funded ERISA plan that could not hedge its interest rate risk in the swap markets.[989] The commenter stated that an ERISA plan with $15 billion in assets and liabilities "whose interest rate sensitivity is somewhat higher than average," would be exposed to a 13% increase in liabilities with a 1% decrease in interest rates.[990] According to the commenter, the 1% decrease in interest rates would result in a $1.46 billion shortfall in plan assets to liabilities, amortized over seven years, and the ERISA plan sponsor would owe approximately $248 million in annual contributions to cover the shortfall.[991] The commenter's example, however, illustrates that the costs to a Special Entity that cannot access the swap markets will depend on the particular facts and circumstances of the particular Special Entity. Therefore, quantification of such costs to Special Entities as a class is not feasible.

The heightened standard of care for swap dealers that act as advisors to Special Entities, which § 23.440 implements, may, to a degree, reduce the level of information swap dealers are willing to share with Special Entities regarding swaps products and strategies out of a concern over triggering advisory status and the best interests duty attached to that status. Final § 23.440 attempts to mitigate these costs by providing safe harbors that effectively exclude from the swap dealer's best interests duty (1) communications between swap dealers and ERISA plans and (2) communications to a Special Entity where the swap dealer does not express an opinion as to whether the Special Entity should enter into a recommended swap or swap trading strategy that

[989] ABC/CIEBA Feb. 22 Letter, at 4.
[990] Id.
[991] Id.

is tailored to the particular needs or characteristics of the Special Entity.

The safe harbor for a swap dealer dealing with any Special Entity in § 23.440(b)(2) preserves the ability of the swap dealer to communicate a wide range of information about swaps, including communications where a swap dealer provides trading ideas for swaps or swap trading strategies that are tailored to the needs or characteristics of a Special Entity, without being subject to the best interests duty. Moreover, to provide additional clarity on the types of communications that would not cause a swap dealer to "act as an advisor," the Commission offers in Appendix A to subpart H a non-exclusive list of communications not subject to the best interests duty as guidance for swap dealers that elect to operate within the safe harbor. Additionally, the types of communications and information not subject to the best interests duty under the safe harbor in § 23.440(b)(2) are the types information that many commenters found to be most valuable.[992] The types of communications and information included in the scope of the safe harbor also facilitates swap dealers' ability to engage in normal course of business communications, including sales, marketing and trading ideas, with Special Entities without being subject to the best interests duty and potential litigation risks attendant to such a duty.

Final § 23.450 also establishes a safe harbor for a swap dealer or major swap participant to satisfy its duty to have a reasonable basis to believe that a Special Entity has a qualified independent representative. The safe harbor under § 23.450(d)(2) harmonizes the independent representative requirements for ERISA plans. A swap dealer or major swap participant will have a reasonable basis to believe that an ERISA plan has a qualified independent representative whenever the ERISA plan represents in writing that it has an ERISA fiduciary. This safe harbor alleviates concerns raised by some commenters that compliance with the proposed rule could

[992] See Section IV.B.2.a. of this adopting release at fn. 624 and accompanying text.

cause a swap dealer or major swap participant to become an ERISA fiduciary that would impose costs, including private litigation liabilities, costs associated with violations of ERISA's prohibited transaction rules or costs to ERISA plans that may be unable to find swap dealers or major swap participants willing to enter into swaps with them.

With respect to all Special Entities other than ERISA plans, the safe harbor under § 23.450(d)(1) permits a swap dealer or major swap participant to rely on written representations from the Special Entity and its representative that each, respectively, has complied in good faith with written policies and procedures reasonably designed to ensure that the representative satisfies the applicable requirements in Section 4s(h)(5) and § 23.450. Additionally, the Commission revised § 23.450 to address commenters' concerns regarding the proposed "material business relationship" prong of the independence test.[993]

Many commenters expressed concern that the proposed independence test would create costly and burdensome compliance requirements and that the proposed material relationship prong was duplicative of or not harmonized with other independence standards.[994] The revised independence test mitigates commenters' concerns that the "material business relationship" was unadministrable by deleting the requirement to identify and disclose all compensation that a swap dealer or major swap participant paid to the Special Entity's representative within the previous 12 months.[995] The revised standard under which a representative will be deemed independent replaced the "material business relationship" prong with three requirements: (1) The representative discloses material conflicts of interest to the Special Entity and complies with policies and procedures designed to manage and mitigate such conflicts; (2) the representative is

[993] See Section IV.C.3.d.iv. of this adopting release for a discussion of the final independence standard in § 23.450.
[994] See Section IV.C.2.c.ii. of this adopting release for a summary of comments regarding the independence tests under proposed § 23.450 at fn. 779.
[995] See proposing release, 75 FR at 80660.

not controlled by, in control of or under common control with the swap dealer or major swap participant; and (3) the swap dealer or major swap participant did not refer, recommend or introduce the representative to the Special Entity. Any costs that arise due to a representative disclosing, managing and mitigating conflicts of interest will be incremental because third-party advisors, generally, will be regulated entities such as CTAs, investment advisers or municipal advisors, and will be subject to similar requirements. In addition, representatives that are in-house employees will likely be subject to conflict of interest restrictions by virtue of their employment agreement.

The safe harbor under § 23.450(d) reduces litigation risk concerns raised by some commenters asserting that a swap dealer or major swap participant may be held liable to a Special Entity for "approving" an unqualified representative or may be liable to a representative that was found to be unqualified.[996] Under the safe harbor, a swap dealer or major swap participant may rely on written representations that the representative is qualified thereby relieving the swap dealer or major swap participant of engaging in extensive due diligence to make its own determination.

Special Entities may incur additional costs to retain the services of a representative and to develop policies and procedures to ensure that the representative is qualified and independent. The Commission believes that any additional costs will be incremental and relatively minimal because, according to commenters, many Special Entities already employ in-house or third-party expert advisors.[997] Furthermore, the independent representative rules implement the statutory requirement that Special Entities have qualified independent representatives. Therefore, Congress made the determination that the additional costs are justified by the benefits that such a

[996] See, e.g., ABC/CIEBA Feb. 22 Letter, at 9-10; HOOPP Feb. 22 Letter, at 2; ABC Aug. 29 Letter, at 7.
[997] See, e.g., ERIC Feb. 22 Letter, at 12; VRS Feb. 22 Letter, at 2 and fn. 3; U. Tex. System Feb. 22 Letter, at 4.

protection provides to Special Entities and Special Entity beneficiaries. However, the final rules implement the statutory requirements in such a way as to minimize any additional costs associated with the concerns expressed by commenters.

To mitigate and reduce any due diligence costs imposed under Sections 4s(h)(4) and (5), both §§ 23.440 and 23.450 permit reliance on representations to satisfy such due diligence obligations. Furthermore, such representations may be made on a relationship basis to reduce or eliminate execution delays that could otherwise result from transaction-by-transaction compliance. Commission staff has also extensively consulted with the SEC and DOL staffs to ensure that the final rules are appropriately harmonized and so that compliance with the Special Entity rules will not result in violation of other federal laws.[998]

The Commission has clarified, in response to commenters, that the definition of Special Entity under § 23.402(c) does not include collective investment vehicles in which a Special Entity invests.[999] Some commenters asserted that adopting a look-through test for the Special Entity definition would create unnecessary and duplicative compliance costs and execution delays for collective investment vehicles and their investors.[1000] This adopting release clarifies that the Commission will not look-through a collective investment vehicle to its investors to determine whether an entity is a Special Entity and thereby eliminates these cost concerns.

The pay-to-play prohibition in § 23.451 is designed to prevent fraud. A prohibition on fraud should not, in the Commission's judgment, impose significant costs. Nevertheless, the Commission is cognizant that its pay-to-pay prohibition will involve some compliance costs. At

[998] See Section II of this adopting release for a discussion of regulatory intersections and harmonization with the SEC and DOL.
[999] See Section IV.A.3.e. of this adopting release for a discussion of the Commission's determination regarding collective investment vehicles and the definition of Special Entity.
[1000] See, e.g., AMG-SIFMA Feb. 22 Letter, at 12-13.

the same time, such costs are expected to be incremental and minimal because the Commission anticipates that many of the persons subject to § 23.451 will already be subject to similar prohibitions imposed by the MSRB or SEC.[1001] In an effort to mitigate these costs, the Commission has adopted a practical, cost-effective means to comply with the rule without requiring a swap dealer to impose a blanket ban on all political contributions by its covered associates. Further, based on comments received, the Commission modified its proposed rule to achieve the goal of discouraging swap dealer participation in pay-to-play practices while seeking to limit the burdens imposed by the rule. In this regard, the Commission highlights its efforts to harmonize its rule with the prohibition proposed by the SEC,[1002] the exceptions for certain de minimis contributions, automatic exemptions and safe harbors.[1003]

c. Section 15(a) of the CEA

In light of the foregoing, the Commission has evaluated the costs and benefits of the final Special Entity rules pursuant to the five considerations identified in Section 15(a) of the CEA as follows:

i. Protection of Market Participants and the Public

At the core of the Special Entity rules is the protection of a specific class of market participants that are central to the public interest. Final § 23.440 ensures that swap dealers that act as advisors to Special Entities are subject to a best interests duty. Conversely, where the swap

[1001] The Commission also believes that § 23.450(b)(1)(vii) may impose similar costs, including compliance costs. See supra fn. 984for a discussion of § 23.450(b)(1)(vii)'s benefits. However, the Commission also believes that the cost mitigating features of § 23.450 and the incremental nature of the requirements also limit any burdens or costs imposed by the rule. The costs are incremental because some independent representatives to governmental Special Entities may be SEC-registered investment advisers subject to SEC Advisers Act Rule 206(4)-5 on pay-to-play or registered municipal advisors subject to the MSRB's pay-to-play prohibitions. See Section II.C. of this adopting release for a discussion of Special Entity representatives that are also municipal advisors; see also supra fn. 880 and accompanying text.

[1002] See proposed 17 CFR 240.15Fh-6, SEC's proposed rules, 76 FR at 42457-58.

[1003] See Section IV.D.3. of this adopting release for a discussion of the pay-to-play prohibitions under final § 23.451.

dealer elects to operate within the safe harbor, the rule facilitates open communications with Special Entities to afford them the benefits of the swap dealer's access to valuable swap related information.

Final § 23.450 seeks to ensure that any Special Entity that enters into swaps with swap dealers or major swap participants has a sufficiently knowledgeable representative to evaluate the risks inherent in the transaction and to provide unbiased, independent advice that is in the best interests of the Special Entity. The pay-to-play prohibition protects market participants and the public from fraud. Government business allocated on the basis of political contributions exposes the public to several hazards, including noncompetitive pricing and unnecessary assumption of risk.

The Commission believes that the Special Entity rules protect the public from, among other things, taxpayer bailouts and unnecessary losses to U.S. retirement savings and charitable endowments. To the extent the rules impose increased costs on swap dealers or major swap participants that may be passed on to Special Entities or may serve as an incentive for swap dealers or major swap participants to decline to transact with Special Entities, the Commission believes it has provided for reasonable and practicable means of compliance that mitigate any such costs.

ii. Efficiency, Competitiveness and Financial Integrity of Futures Markets

The Special Entity rules do impose costs that impact efficiency. However, the rules have been designed to mitigate the impact. For example, the rules allow for reliance on representations on a relationship basis to mitigate due diligence costs or transaction-by-transaction compliance that may delay execution. In addition, Congress made the determination that Special Entities need additional protections by enacting Section 4s(h), and the Commission has furthered

congressional intent by mitigating the attendant costs of such protections without materially diminishing their benefits. Furthermore, the public interest is served and markets function more efficiently when swap dealers compete for governmental Special Entity business based on price and the overall utility of the swap to the Special Entity and not on the swap dealers' willingness to make political contributions.

iii. Price Discovery

In the event that advisory status is triggered, compliance with the best interests duty by the affected swap dealer may lead to execution delays. The cumulative effect of these delays may, to a degree, adversely impact liquidity resulting in higher transaction costs for counterparties that trade swaps. In recognition of this potential impact, the best interests duty is limited to certain recommendations of swaps that are tailored to the particular needs or characteristics of the Special Entity, and the swap dealer may rely on representations from the Special Entity to satisfy the "reasonable efforts" duty for determining whether a recommended swap or swap trading strategy is in the best interests of that Special Entity.

Final rule § 23.450 provides several means to mitigate the costs of satisfying the "reasonable basis" requirement. First, if the representative to an ERISA plan is an ERISA fiduciary, then the reasonable basis is established. Second, certain representations made by the Special Entity will be deemed to provide such a reasonable basis, and these representations, where appropriate, are allowable at the relationship level as opposed to the transaction level. Third, in the absence of such representations, the Commission has provided a list of factors as guidance for establishing this reasonable basis.[1004]

[1004] See Section IV.C.3.d. of this adopting release for a discussion of the factors used as guidance for the requirements of § 23.450(b).

iv. Sound Risk Management Practices

The Special Entity rules foster sound risk management practices by ensuring that Special Entities have representatives and advisors that are capable of evaluating the risks and rewards of swap transactions and that they evaluate each transaction considering the best interests of the Special Entity. The independent representative provisions, coupled with the disclosure rules, provide important tools for Special Entities to enhance their risk management practices to avoid unnecessary and inappropriate risk.

Nevertheless, execution delays, to the extent that they may result from the Special Entity rules, force market participants to either bear certain market risks or be prevented from earning the premiums associated with bearing those risks over the duration of the delay. The design of the Special Entity rules permit reliance on representations on a relationship basis to mitigate these delays.

Any uncertainty over the triggers for advisory status, through an increase in the risk exposure of the swap dealer, may translate into higher fees charged to counterparties as compensation for that increased exposure. Guidance provided by the Commission clarifying the instances and communications that are exempt from this status mitigates this uncertainty.

v. Other Public Interest Considerations

The Special Entity rules promote public trust in swap markets by striving to ensure that Special Entities are adequately represented and treated fairly. When a Special Entity incurs substantial losses due to inadequate advice, biased advice or unfair access such as through pay-to-play schemes, the public loses confidence in the markets. Additionally, the pay-to-play prohibition fosters public confidence in the integrity of the means and manner in which its elected officials handle government finances.

8. Section 4.6–Exclusion for Certain Otherwise Regulated Persons from the Definition of the Term "Commodity Trading Advisor"

a. Benefits

Final § 4.6(a)(3) is an exclusion from the definition of CTA for swap dealers and, correspondingly, from the application of the CTA registration requirement, any relevant duties under part 4 of the Commission's Regulations and Section 4o of the CEA, the anti-fraud provision for CTAs. The Commission believes the exclusion furthers the regulatory approach that underlies the Dodd-Frank Act by facilitating the flow of market-related information between swap dealers and counterparties without undermining the robust protections provided by the business conduct standards provisions. The exclusion benefits both swap dealers and counterparties that claimed that their communications could be chilled, and trading stifled, if swap dealers were deemed to be CTAs and subject to a higher standard of care when providing services that are "solely incidental" to their business as a swap dealer. The exclusion clarifies the role of swap dealers and reduces ambiguity in the trading relationship between swap dealers and counterparties.

While not readily amenable to quantification, the benefits of the rule are significant. The rule is designed to avoid the potential costs associated with a swap dealer being deemed a CTA. In addition to CTA registration fees for a swap dealer and its associated persons, CTAs are generally held to a fiduciary standard under case law,[1005] a standard that was rejected by Congress for swap dealers when it adopted Section 4s(h).[1006] Therefore, excluding swap dealers

[1005] See, e.g., Savage v. CFTC, 548 F.2d 192 at 197.

[1006] See Section IV.B.3.c. at fn. 706 and accompanying text for a discussion of the legislative history of fiduciary duties for swap dealers; see also Sections II.D. and IV.B. of this adopting release for a discussion of Regulatory Intersections–Commodity Trading Advisor Status for Swap Dealers and § 23.440–Final Rules for Swap Dealers and

from the definition of CTA when engaging in certain swap dealing activities that overlap with CTA activities is consistent with congressional intent.

Commenters raised concerns that if a swap dealer were deemed to be a CTA then it would increase the potential that they also would be deemed an ERISA fiduciary when dealing with ERISA plans. That would subject the swap dealer to a principal transaction prohibition and to substantial penalties under ERISA. Such risks could dissuade swap dealers from engaging in swaps with pension plans that are subject to ERISA.[1007] Similar risks could potentially adversely affect other counterparties that are regulated under similar state regulatory regimes. These counterparties could face increased costs because swap dealers could charge more to assume the higher duties, fewer swap dealers would be willing to do business with them or swap dealers would offer a narrower range of services.

The rule benefits counterparties by reducing burdens on communications and broadening the range of services available from swap dealers, as well as increasing the number of swap dealers with which a Special Entity may enter into swaps. While not a quantifiable benefit, a greater number of swap dealers should encourage competition and reduce prices for counterparties. Having access to a wider range of services will allow counterparties to more effectively hedge their exposure to market risks and to take advantage of investment opportunities using swaps.

b. Costs

As a result of final § 4.6(a)(3) relieving a burden rather than imposing one, the Commission does not believe that there are any costs associated with the exclusion from the definition of CTA for swap dealers whose advice is solely incidental to its swap dealing activities. This is

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Major Swap Participants Dealing with Special Entities–Requirements for Swap Dealers Acting as Advisors to Special Entities, respectively.

[1007] See Section II.B. of this adopting release for a discussion of Regulatory Intersections–Department of Labor ERISA Fiduciary Regulations.

particularly true because the business conduct standards viewed as a whole provide important protections for counterparties that are not diminished by clarifying the status of swap dealers that make recommendations to counterparties.

c. Section 15(a) of the CEA

In light of the foregoing, the Commission has evaluated the costs and benefits of final § 4.6(a)(3) pursuant to the five considerations identified in Section 15(a) of the CEA as follows:

i. Protection of Market Participants and the Public

The objective of § 4.6(a)(3) is to allow a freer flow of information and ideas between a swap dealer and its counterparties, albeit subject to the disclosure and due diligence requirements of subpart H, among other provisions. Allowing swap dealers to provide limited advice necessary to design bespoke instruments will benefit market participants by offering them a broader range of products to meet their particular hedging requirements and trading objectives. The exclusion will reduce the potential for vexatious litigation by providing certainty regarding the applicable standard of care to be applied to these transactions.

The exclusion is consistent with the goal of protecting market participants and the public when considered together with the business conduct standards in Section 4s(h) and subpart H of part 23. The exclusion does not diminish protections for market participants and the public in those rules, but rather furthers the intent of Congress that swap dealers not be held to a fiduciary standard.[1008] Moreover, the exclusion for swap dealers from the CTA definition does not apply to all advisory activities, but only the swap dealer's advisory activities that are solely incidental to its business as a swap dealer. As such, the Commission has designed these rules to be as targeted as possible to achieve the intended statutory benefits, namely to enable the flow of accurate and

[1008] See Section II.D. of this adopting release for a discussion of Regulatory Intersections–Commodity Trading Advisor Status for Swap Dealers.

timely information between swap dealers and their counterparties, and to continue to allow the marketplace to develop and provide opportunities for swap dealers and counterparties to transact. However, swap dealers will be CTAs if they provide advisory services beyond those that are solely incidental to their swap dealing activities, thereby preserving counterparty protections afforded by the rules that apply to CTAs.

Accordingly, in the Commission's judgment, this rule alleviates a burden, which reduces rather than imposes costs, in such a way that the final rule will achieve the intended benefits of protecting market participants and the public.

ii. Efficiency, Competitiveness and Financial Integrity of Futures Markets

Because swap dealers may not be willing to perform certain functions, like custom tailoring a swap to meet a counterparty's needs if such activities would cause the swap dealer to be deemed to be a CTA, excluding them from the CTA definition for certain activities could broaden the range of services that a swap dealer may offer a counterparty. It could also increase the number of swap dealers that are willing to perform such functions. While not a quantifiable benefit, a greater number of swap dealers and available products should enhance efficiency and competition and reduce prices for counterparties. Because the rule alleviates a burden, rather than imposing costs, the Commission concludes that § 4.6(a)(3) will not impede swap market efficiency, competitiveness or financial integrity.

iii. Price Discovery

Relative to not applying this exclusion to swap dealers, the final rule encourages more swap dealers to offer a wider range of products to counterparties, which promotes competition and facilitates price discovery. Accordingly, the exclusion does not adversely affect price discovery and potentially enhances it.

iv. Sound Risk Management Practices

While not creating material incentives for swap dealers to alter how they manage risk, the exclusion from the CTA definition will assist swap dealers in reducing the level of risk associated with their counterparty interactions. The exclusion clarifies the duties owed to counterparties and reduces the potential for litigation. Because the standard of care for swap dealers acting as CTAs is higher than the standard of care when they act as counterparties in principal to principal transactions, disagreements could arise based on misunderstandings concerning the respective roles of the parties. By acting within the scope of the exclusion in compliance with the final rule, swap dealers will reduce the risk of undue reliance by counterparties and any resulting litigation.

v. Other Public Interest Considerations

The Commission has not identified any other public interest considerations.

List of Subjects in 17 CFR Part 4

Advertising, Brokers, Commodity futures, Commodity pool operators, Commodity trading advisors, Customer protection, Reporting and recordkeeping requirements, Swaps.

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.

For the reasons presented above, the Commission hereby amends part 4 and part 23 (as added by FR Doc [Registration of Swap Dealers and Major Swap Participants will publish on 1/19/12], published on January 19, 2012 of Title 17 of the Code of Federal Regulations as follows:

PART 4–COMMODITY POOL OPERATORS AND COMMODITY TRADING

ADVISORS

Authority and Issuance

1. The authority citation for part 4 shall be revised to read as follows:

Authority: 7 U.S.C 1a, 2, 4, 6(c), 6b, 6c, 6l, 6m, 6n, 6o, 12a and 23, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

2. In § 4.6, add new paragraph (a)(3) to read as follows:

§ 4.6 Exclusion for certain otherwise regulated persons from the definition of the term "commodity trading advisor."

(a) * * *

(3) A swap dealer registered with the Commission as such pursuant to the Act or excluded or exempt from registration under the Act or the Commission's regulations; Provided, however, That the commodity interest and swap advisory activities of the swap dealer are solely incidental to the conduct of its business as a swap dealer.

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PART 23–SWAP DEALERS AND MAJOR SWAP PARTICIPANTS

Authority and Issuance

3. 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).

4. 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 disclosures.
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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.
Appendix A–Guidance on the application of §§ 23.434 and 23.440 for swap dealers that make recommendations to counterparties or Special Entities

§ 23.400 Scope.

The sections of this subpart shall apply to swap dealers and, unless otherwise indicated, 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.

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

(b) Major swap participant. The term "major swap participant" means any person defined in Section 1a(33) of the Act and § 1.3 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.

(c) Special Entity. The term "Special Entity" means:

(1) A Federal agency;

(2) A State, State agency, city, county, municipality, other political subdivision of a State, or any instrumentality, department, or a corporation of or established by a State or political subdivision of a State;

(3) Any employee benefit plan subject to Title I 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);

(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)); or

(6) Any employee benefit plan defined in Section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002), not otherwise defined as a Special Entity, that elects to be a Special Entity by notifying a swap dealer or major swap participant of its election prior to entering into a swap with the particular swap dealer or major swap participant.

(d) Swap dealer. The term "swap dealer" means any person defined in Section 1a(49) of the Act and § 1.3 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.

(1) Swap dealers and major swap participants shall have written 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) Know your counterparty. Each swap dealer shall implement policies and procedures reasonably designed to obtain and retain a record of the essential facts concerning each counterparty whose identity is known to the swap dealer prior to the execution of the transaction that are necessary for conducting business with such counterparty. For purposes of this section, the essential facts concerning a counterparty are:

(1) Facts required to comply with applicable laws, regulations and rules;

(2) Facts required to implement the swap dealer's credit and operational risk management policies in connection with transactions entered into with such counterparty; and

(3) Information regarding the authority of any person acting for such counterparty.

(c) True name and owner. Each swap dealer or major swap participant shall obtain and retain a record which shall show the true name and address of each counterparty whose identity is known to the swap dealer or major swap participant prior to the execution of the transaction, 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.

(d) Reasonable reliance on representations. A swap dealer or major swap participant may rely on the written representations of a counterparty to satisfy its due diligence requirements

under this subpart, unless it has information that would cause a reasonable person to question the accuracy of the representation. If agreed to by the counterparties, such representations may be contained in counterparty relationship documentation and may satisfy the relevant requirements of this subpart for subsequent swaps offered to or entered into with a counterparty, provided however, that such counterparty undertakes to timely update any material changes to the representations.

(e) 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; provided however, for transactions initiated on a designated contract market or swap execution facility, written agreement by the counterparty regarding the reliable means of disclosure is not required.

(f) 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 counterparty relationship documentation or other written agreement between the counterparties.

(g) Record retention. Swap dealers and major swap participants shall create a record of their compliance with the requirements of this subpart and shall retain 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) Affirmative defense. It shall be an affirmative defense to an alleged violation of paragraph (a)(2) or (3) of this section for failure to comply with any requirement in this subpart if a swap dealer or major swap participant establishes that the swap dealer or major swap participant:

(1) Did not act intentionally or recklessly in connection with such alleged violation; and

(2) Complied in good faith with written policies and procedures reasonably designed to meet the particular requirement that is the basis for the alleged violation.

(c) Confidential treatment of counterparty information.

(1) It shall be unlawful for any swap dealer or major swap participant to:

(i) Disclose to any other person any material confidential information provided by or on behalf of a counterparty to the swap dealer or major swap participant; or

(ii) Use for its own purposes in any way that would tend to be materially adverse to the interests of a counterparty, any material confidential information provided by or on behalf of a counterparty to the swap dealer or major swap participant.

(2) Notwithstanding paragraph (c)(1) of this section, a swap dealer or major swap participant may disclose or use material confidential information provided by or on behalf of a counterparty to the swap dealer or major swap participant if such disclosure or use is authorized in writing by the counterparty, or is necessary:

(i) For the effective execution of any swap for or with the counterparty;

(ii) To hedge or mitigate any exposure created by such swap; or

(iii) To comply with a request of the Commission, Department of Justice, any self-regulatory organization designated by the Commission, or an applicable prudential regulator, or is otherwise required by law.

(3) Each swap dealer or major swap participant shall implement written policies and procedures reasonably designed to protect material confidential information provided by or on behalf of a counterparty from disclosure and use in violation of this section by any person acting for or on behalf of the swap dealer or major swap participant.

§§ 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 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) Special Entity election. In verifying the eligibility of a counterparty pursuant to paragraph (a) of this section, a swap dealer or major swap participant shall verify whether a counterparty is eligible to elect to be a Special Entity under § 23.401(c)(6) and, if so, notify such counterparty of its right to make such an election.

(d) Safe harbor. A swap dealer or major swap participant may rely on written

representations of a counterparty to satisfy the requirements of this section as provided in § 23.402(d). A swap dealer or major swap participant will have a reasonable basis to rely on such written representations for purposes of the requirements in paragraphs (a) and (b) of this section if the counterparty specifies in such representations the provision(s) of Section 1a(18) of the Act or paragraph(s) of § 1.3 of this chapter that describe its status as an eligible contract participant and, in the case of a Special Entity, the paragraph(s) of the Special Entity definition in § 23.401(c) that define its status as a Special Entity.

(e) This section shall not apply with respect to:

(1) A transaction that is initiated on a designated contract market; or

(2) A transaction initiated on a swap execution facility, if the swap dealer or major swap participant does not know the identity of the counterparty to the transaction prior to execution.

§ 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;

(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 a particular swap, which shall include:

(i) With respect to disclosure of the price of the swap, the price of the swap and the mid-market mark of the swap as set forth in paragraph (d)(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) Scenario Analysis. Prior to entering into a swap with a counterparty (other than a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant) that is not made available for trading, as provided in Section 2(h)(8) of the Act, on a designated contract market or swap execution facility, a swap dealer shall:

(1) Notify the counterparty that it can request and consult on the design of a scenario analysis to allow the counterparty to assess its potential exposure in connection with the swap;

(2) Upon request of the counterparty, provide a scenario analysis, which is designed in consultation with the counterparty and done over a range of assumptions, including severe downside stress scenarios that would result in a significant loss;

(3) Disclose all material assumptions and explain the calculation methodologies used to perform any requested scenario analysis; provided however, that the swap dealer is not required to disclose confidential, proprietary information about any model it may use to prepare the scenario analysis; and

(4) In designing any requested scenario analysis, consider any relevant analyses that the swap dealer undertakes for its own risk management purposes, including analyses performed as part of its "New Product Policy" specified in § 23.600(c)(3).

(c) Paragraphs (a) and (b) 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 prior to execution.

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

(1) For cleared swaps, notify a counterparty (other than a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant) of the counterparty's right to receive, upon request, the daily mark from the appropriate derivatives clearing organization.

(2) For uncleared swaps, provide the counterparty (other than a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant) with a daily mark, which shall be the mid-market mark of the swap. The mid-market mark 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 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 however, 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; and

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

(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 disclosures.

(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 swap dealer, major swap participant, securities-based swap dealer, or major securities-based swap participant) with which it entered 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 swap dealer, major swap participant, securities-based swap dealer, or major securities-based swap participant) with which it entered 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 that recommends a swap or trading strategy involving a swap to a counterparty, other than a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant, must:

(1) Undertake reasonable diligence to understand the potential risks and rewards associated with the recommended swap or trading strategy involving a swap; and

(2) Have a reasonable basis to believe that the recommended swap or trading strategy involving a swap is suitable for the counterparty. To establish a reasonable basis for a recommendation, a swap dealer must have or obtain information about the counterparty, including the counterparty's investment profile, trading objectives, and ability to absorb potential losses associated with the recommended swap or trading strategy involving a swap.

(b) Safe Harbor. A swap dealer may fulfill its obligations under paragraph (a)(2) of this section with respect to a particular counterparty if:

(1) The swap dealer reasonably determines that the counterparty, or an agent to which the counterparty has delegated decision-making authority, is capable of independently evaluating investment risks with regard to the relevant swap or trading strategy involving a swap;

(2) The counterparty or its agent represents in writing that it is exercising independent judgment in evaluating the recommendations of the swap dealer with regard to the relevant swap or trading strategy involving a swap;

(3) The swap dealer discloses in writing that it is acting in its capacity as a counterparty and is not undertaking to assess the suitability of the swap or trading strategy involving a swap for the counterparty; and

(4) In the case of a counterparty that is a Special Entity, the swap dealer complies with § 23.440 where the recommendation would cause the swap dealer to act as an advisor to a

Special Entity within the meaning of § 23.440(a).

(c) A swap dealer will satisfy the requirements of paragraph (b)(1) of this section if it receives written representations, as provided in § 23.402(d), that:

(1) In the case of a counterparty that is not a Special Entity, the counterparty has complied in good faith with written policies and procedures that are reasonably designed to ensure that the persons responsible for evaluating the recommendation and making trading decisions on behalf of the counterparty are capable of doing so; or

(2) In the case of a counterparty that is a Special Entity, satisfy the terms of the safe harbor in § 23.450(d).

§§ 23.435–23.439 [Reserved]

§ 23.440 Requirements for swap dealers acting as advisors to Special Entities.

(a) Acts as an advisor to a Special Entity. For purposes of this section, a swap dealer "acts as an advisor to a Special Entity" when the swap dealer recommends a swap or trading strategy involving a swap that is tailored to the particular needs or characteristics of the Special Entity.

(b) Safe harbors. A swap dealer will not "act as an advisor to a Special Entity" within the meaning of paragraph (a) of this section if:

(1) With respect to a Special Entity that is an employee benefit plan as defined in § 23.401(c)(3):

(i) The Special Entity represents in writing that it has a fiduciary as defined in Section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002) that is responsible for representing the Special Entity in connection with the swap transaction;

(ii) The fiduciary represents in writing that it will not rely on recommendations provided by the swap dealer; and

(iii) The Special Entity represents in writing:

(A) That it will comply in good faith with written policies and procedures reasonably designed to ensure that any recommendation the Special Entity receives from the swap dealer materially affecting a swap transaction is evaluated by a fiduciary before the transaction occurs; or

(B) That any recommendation the Special Entity receives from the swap dealer materially affecting a swap transaction will be evaluated by a fiduciary before that transaction occurs; or

(2) With respect to any Special Entity:

(i) The swap dealer does not express an opinion as to whether the Special Entity should enter into a recommended swap or trading strategy involving a swap that is tailored to the particular needs or characteristics of the Special Entity;

(ii) The Special Entity represents in writing that:

(A) The Special Entity will not rely on recommendations provided by the swap dealer; and

(B) The Special Entity will rely on advice from a qualified independent representative within the meaning of § 23.450; and

(iii) The swap dealer discloses to the Special Entity that it is not undertaking to act in the best interests of the Special Entity as otherwise required by this section.

(c) A swap dealer that acts as an advisor to a Special Entity 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 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.

(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, including information relating to:

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

(ii) The tax status of the Special Entity;

(iii) The hedging, investment, financing, or other objectives of the Special Entity;

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

(v) Whether the Special Entity has the financial capability to withstand changes in market conditions during the term of the swap; and

(vi) Such other information as is relevant to the particular facts and circumstances of the Special Entity, market conditions, and the type of swap or trading strategy involving a swap being recommended.

(d) Reasonable reliance on representations of the Special Entity. As provided in § 23.402(d), the swap dealer may rely on written representations of the Special Entity to satisfy its requirement in paragraph (c)(2) of this section to make "reasonable efforts" to obtain necessary information.

§§ 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 "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. The term “principal” means any person listed in § 3.1(a)(1)-(3) of this chapter.

(2) 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)(1) Any swap dealer or major swap participant that offers to enter or enters into a swap with a Special Entity, other than a Special Entity defined in § 23.401(c)(3), shall have a reasonable basis to believe that the Special Entity has a representative that:

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

(ii) Is not subject to a statutory disqualification;

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

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

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

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

(vii) In the case of a Special Entity as defined in § 23.401(c)(2) or (4), 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 however, that this paragraph (b)(1)(vii) of this section shall not apply if the representative is an employee of the Special Entity.

(2) Any swap dealer or major swap participant that offers to enter or enters into a swap

with a Special Entity as defined in § 23.401(c)(3) shall have a reasonable basis to believe that the Special Entity has a representative that is a fiduciary as defined in Section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002).

(c) Independent. For purposes of paragraph (b)(1)(iii) 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 of representing the Special Entity in connection with the swap, 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;

(3) The representative:

(i) Provides timely and effective disclosures to the Special Entity of all material conflicts of interest that could reasonably affect the judgment or decision making of the representative with respect to its obligations to the Special Entity; and

(ii) Complies with policies and procedures reasonably designed to manage and mitigate such material conflicts of interest;

(4) The representative is not directly or indirectly, through one or more persons, controlled by, in control of, or under common control with the swap dealer or major swap participant; and

(5) The swap dealer or major swap participant did not refer, recommend, or introduce the representative to the Special Entity within one year of the representative's representation of the Special Entity in connection with the swap.

(d) Safe Harbor.

(1) A swap dealer or major swap participant shall be deemed to have a reasonable basis to believe that the Special Entity, other than a Special Entity defined in § 23.401(c)(3), has a representative that satisfies the applicable requirements of paragraph (b)(1) of this section, provided that:

(i) The Special Entity represents in writing to the swap dealer or major swap participant that it has complied in good faith with written policies and procedures reasonably designed to ensure that it has selected a representative that satisfies the applicable requirements of paragraph (b) of this section, and that such policies and procedures provide for ongoing monitoring of the performance of such representative consistent with the requirements of paragraph (b) of this section; and

(ii) The representative represents in writing to the Special Entity and swap dealer or major swap participant that the representative:

(A) Has policies and procedures reasonably designed to ensure that it satisfies the applicable requirements of paragraph (b) of this section;

(B) Meets the independence test in paragraph (c) of this section; and

(C) Is legally obligated to comply with the applicable requirements of paragraph (b) of this section by agreement, condition of employment, law, rule, regulation, or other enforceable duty.

(2) A swap dealer or major swap participant shall be deemed to have a reasonable basis to believe that a Special Entity defined in § 23.401(c)(3) has a representative that satisfies the applicable requirements in paragraph (b)(2) of this section, provided that the Special Entity provides in writing to the swap dealer or major swap participant the representative's name and contact information, and represents in writing that the representative is a fiduciary as defined in

Section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002).

(e) Reasonable reliance on representations of the Special Entity. A swap dealer or major swap participant may rely on written representations of a Special Entity and, as applicable under this section, the Special Entity's representative to satisfy any requirement of this section as provided in § 23.402(d).

(f) Chief compliance officer review. If a swap dealer or major swap participant initially determines that it does not have a reasonable basis to believe that the representative of a Special Entity meets 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.

(g) 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.

(h) 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 prior to execution.

§ 23.451 Political contributions by certain swap dealers.

(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 federal, 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 federal, 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 governmental Special Entity for the swap dealer and any person who supervises, directly or indirectly, such employee; and

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

(3) The term “governmental Special Entity” means any Special Entity defined in § 23.401(c)(2) or (4).

(4) The term “official” of a governmental Special 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 governmental Special Entity, if the office:

(i) Is directly or indirectly responsible for, or can influence the outcome of, the selection of a swap dealer by a governmental Special 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 by a governmental Special 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 governmental Special Entity for the swap dealer 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 governmental Special 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 shall offer to enter into or enter into a swap or a trading strategy involving a swap with a governmental Special Entity within two years after any contribution to an official of such governmental Special Entity was made by the swap dealer or by any covered associate of the swap dealer; provided however, that:

(2) This prohibition does not apply:

(i) If the only contributions made by the swap dealer to an official of such governmental Special 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 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, provided that this exclusion shall not apply if the natural person, after becoming a covered associate, solicits the governmental Special Entity on behalf of the swap dealer to offer to enter into or to enter into a swap or trading strategy involving a swap; or

(iii) to a swap that is:

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

(B) One in which the swap dealer does not know the identity of the counterparty to the transaction prior to execution.

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

(i) Provide or agree to provide, directly or indirectly, payment to any person to solicit a governmental Special Entity to offer to enter into, or to enter into, a swap with that swap dealer 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 governmental Special Entity with which the swap dealer 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 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 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 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:

(i) Before the contribution resulting in the prohibition was made, 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 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 if:

(i) The swap dealer 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.

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

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

5. Appendix A to subpart H is added to part 23 to read as follows:

Appendix A–Guidance on the application of §§ 23.434 and 23.440 for swap dealers that make recommendations to counterparties or Special Entities

The following provides guidance on the application of §§ 23.434 and 23.440 to swap dealers that make recommendations to counterparties or Special Entities.

§ 23.434–Recommendations to counterparties–institutional suitability

A swap dealer that recommends a swap or trading strategy involving a swap to a counterparty, other than a swap dealer, major swap participant, security-based swap dealer or

major security-based swap participant, must undertake reasonable diligence to understand the potential risks and rewards associated with the recommended swap or trading strategy involving a swap – general suitability (§ 23.434(a)(1)) – and have a reasonable basis to believe that the recommended swap or trading strategy involving a swap is suitable for the counterparty – specific suitability (§ 23.434(a)(2)). To satisfy the general suitability obligation, a swap dealer must undertake reasonable diligence that will vary depending on, among other things, the complexity of and risks associated with the swap or swap trading strategy and the swap dealer's familiarity with the swap or swap trading strategy. At a minimum, a swap dealer's reasonable diligence must provide it with an understanding of the potential risks and rewards associated with the recommended swap or swap trading strategy.

Recommendation. Whether a communication between a swap dealer and a counterparty is a recommendation will turn on the facts and circumstances of the particular situation. There are, however, certain factors the Commission will consider in reaching such a determination. The facts and circumstances determination of whether a communication is a "recommendation" requires an analysis of the content, context, and presentation of the particular communication or set of communications. The determination of whether a "recommendation" has been made, moreover, is an objective rather than a subjective inquiry. An important factor in this regard is whether, given its content, context, and manner of presentation, a particular communication from a swap dealer to a counterparty reasonably would be viewed as a "call to action," or suggestion that the counterparty enter into a swap. An analysis of the content, context, and manner of presentation of a communication requires examination of the underlying substantive information transmitted to the counterparty and consideration of any other facts and circumstances, such as any accompanying explanatory message from the swap dealer. Additionally, the more

individually tailored the communication to a specific counterparty or a targeted group of counterparties about a swap, group of swaps or trading strategy involving the use of a swap, the greater the likelihood that the communication may be viewed as a "recommendation."

Safe harbor. A swap dealer may satisfy the safe harbor requirements of § 23.434(b) to fulfill its counterparty-specific suitability duty under § 23.434(a)(2) if: (1) The swap dealer reasonably determines that the counterparty, or an agent to which the counterparty has delegated decision-making authority, is capable of independently evaluating investment risks with regard to the relevant swap or trading strategy involving a swap; (2) the counterparty or its agent represents in writing that it is exercising independent judgment in evaluating the recommendations of the swap dealer; (3) the swap dealer discloses in writing that it is acting in its capacity as a counterparty and is not undertaking to assess the suitability of the recommendation; and (4) in the case of a counterparty that is a Special Entity, the swap dealer complies with § 23.440 where the recommendation would cause the swap dealer to act as an advisor to a Special Entity within the meaning of § 23.440(a).

To reasonably determine that the counterparty, or an agent to which the counterparty has delegated decision-making authority, is capable of independently evaluating investment risks of a recommendation, the swap dealer can rely on the written representations of the counterparty, as provided in § 23.434(c). Section 23.434(c)(1) provides that a swap dealer will satisfy § 23.434(b)(1)'s requirement with respect to a counterparty other than a Special Entity if it receives representations that the counterparty has complied in good faith with the counterparty's policies and procedures that are reasonably designed to ensure that the persons responsible for evaluating the recommendation and making trading decisions on behalf of the counterparty are capable of doing so. Section § 23.434(c)(2) provides that a swap dealer will satisfy

§ 23.434(b)(1)'s requirement with respect to a Special Entity if it receives representations that satisfy the terms of § 23.450(d) regarding a Special Entity's qualified independent representative.

Prong (4) of the safe harbor clarifies that § 23.434's application is broader than § 23.440–Requirements for Swap Dealers Acting as Advisors to Special Entities. Section 23.434 is triggered when a swap dealer recommends any swap or trading strategy that involves a swap to any counterparty. However, § 23.440 is limited to a swap dealer's recommendations (1) to a Special Entity (2) of swaps that are tailored to the particular needs or characteristics of the Special Entity. Thus, a swap dealer that recommends a swap to a Special Entity that is tailored to the particular needs or characteristics of the Special Entity may comply with its suitability obligation by satisfying the safe harbor in § 23.434(b); however, the swap dealer must also comply with § 23.440 in such circumstances.

<u>§ 23.440–Requirements for swap dealers acting as advisors to Special Entities</u>

A swap dealer "acts as an advisor to a Special Entity" under § 23.440 when the swap dealer recommends a swap or trading strategy involving a swap that is tailored to the particular needs or characteristics of the Special Entity. A swap dealer that "acts as an advisor to a Special Entity" has a duty to make a reasonable determination that a recommendation is in the "best interests" of the Special Entities and must undertake "reasonable efforts" to obtain information necessary to make such a determination.

Whether a swap dealer "acts as an advisor to a Special Entity" will depend on: (1) Whether the swap dealer has made a recommendation to a Special Entity; and (2) whether the recommendation concerns a swap or trading strategy involving a swap that is tailored to the particular needs or characteristics of the Special Entity. To determine whether a communication between a swap dealer and counterparty is a recommendation, the Commission will apply the

same factors as under § 23.434, the suitability rule. However, unlike the suitability rule, which covers recommendations regarding any type of swap or trading strategy involving a swap, the "acts as an advisor rule" and "best interests" duty will be triggered only if the recommendation is of a swap or trading strategy involving a swap that is "tailored to the particular needs or characteristics of the Special Entity."

Whether a swap is tailored to the particular needs or characteristics of the Special Entity will depend on the facts and circumstances. Swaps with terms that are tailored or customized to a specific Special Entity's needs or objectives, or swaps with terms that are designed for a targeted group of Special Entities that share common characteristics, e.g., school districts, are likely to be viewed as tailored to the particular needs or characteristics of the Special Entity. Generally, however, the Commission would not view a swap that is "made available for trading" on a designated contract market or swap execution facility, as provided in Section 2(h)(8) of the Act, as tailored to the particular needs or characteristics of the Special Entity.

Safe harbor. Under § 23.440(b)(2), when dealing with a Special Entity (including a Special Entity that is an employee benefit plan as defined in § 23.401(c)(3)),[1] a swap dealer will not "act as an advisor to a Special Entity" if: (1) The swap dealer does not express an opinion as to whether the Special Entity should enter into a recommended swap or swap trading strategy that is tailored to the particular needs or characteristics of the Special Entity; (2) the Special Entity represents in writing, in accordance with § 23.402(d), that it will not rely on the swap dealer's recommendations and will rely on advice from a qualified independent representative within the meaning of § 23.450; and (3) the swap dealer discloses that it is not undertaking to act in the best

[1] The guidance in this appendix regarding the safe harbor to § 23.440 is limited to the safe harbor for any Special Entity under § 23.440(b)(2). A swap dealer may separately comply with the safe harbor under § 23.440(b)(1) for its communications to a Special Entity that is an employee benefit plan as defined in § 23.401(c)(3).

interests of the Special Entity.

A swap dealer that elects to communicate within the safe harbor to avoid triggering the "best interests" duty must appropriately manage its communications. To clarify the type of communications that they will make under the safe harbor, the Commission expects that swap dealers may specifically represent that they will not express an opinion as to whether the Special Entity should enter into a recommended swap or trading strategy, and that for such advice the Special Entity should consult its own advisor. Nothing in the final rule would preclude such a representation from being included in counterparty relationship documentation. However, such a representation would not act as a safe harbor under the rule where, contrary to the representation, the swap dealer does express an opinion to the Special Entity as to whether it should enter into a recommended swap or trading strategy.

If a swap dealer complies with the terms of the safe harbor, the following types of communications would not be subject to the "best interests" duty:[2] (1) providing information that is general transaction, financial, educational, or market information; (2) offering a swap or trading strategy involving a swap, including swaps that are tailored to the needs or characteristics of a Special Entity; (3) providing a term sheet, including terms for swaps that are tailored to the needs or characteristics of a Special Entity; (4) responding to a request for a quote from a Special Entity; (5) providing trading ideas for swaps or swap trading strategies, including swaps that are tailored to the needs or characteristics of a Special Entity; and (6) providing marketing materials upon request or on an unsolicited basis about swaps or swap trading strategies, including swaps

[2] Communications on the list that are not within the meaning of the term "acts as an advisor to a Special Entity" are outside the requirements of § 23.440. By including such communications on the list, the Commission does not intend to suggest that they are "recommendations." Thus, a swap dealer that does not "act as an advisor to a Special Entity" within the meaning of § 23.440(a) is not required to comply with the safe harbor to avoid the "best interests" duty with respect to its communications.

that are tailored to the needs or characteristics of a Special Entity. This list of communications is not exclusive and should not create a negative implication that other types of communications are subject to a "best interests" duty.

The safe harbor in § 23.440(b)(2) allows a wide range of communications and interactions between swap dealers and Special Entities without invoking the "best interests" duty, including discussions of the advantages or disadvantages of different swaps or trading strategies. The Commission notes, however, that depending on the facts and circumstances, some of the examples on the list could be "recommendations" that would trigger a suitability obligation under § 23.434. However, the Commission has determined that such activities would not, by themselves, prompt the "best interests" duty in § 23.440, provided that the parties comply with the other requirements of § 23.440(b)(2). All of the swap dealer's communications, however, must be made in a fair and balanced manner based on principles of fair dealing and good faith in compliance with § 23.433.

Swap dealers engage in a wide variety of communications with counterparties in the normal course of business, including but not limited to the six types of communications listed above. Whether any particular communication will be deemed to be a "recommendation" within the meaning of §§ 23.434 or 23.440 will depend on the facts and circumstances of the particular communication considered in light of the guidance in this appendix with respect to the meaning of the term "recommendation." Swap dealers that choose to manage their communications to comply with the safe harbors provided in §§ 23.434 and 23.440 will be able to limit the duty they owe to counterparties, including Special Entities, provided that the parties exchange the appropriate representations.

By the Commission, this 11th day of January 2012.

David A. Stawick,

Secretary.

Appendices to the Final Rules for Implementing the Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties–Table of Comment Letters, Statement of the Department of Labor, Commission Voting Summary, and Statements of Commissioners

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

Appendix 1–Table of Comment Letters

ABA/ABASA June 3 Letter	American Bankers Association and the ABA Securities Association letter dated June 3, 2011
ABA/ABC Feb. 22 Letter	Davis & Harman LLP, on behalf of the American Bankers Association, American Benefits Council, the Committee on the Investment of Employee Benefit Assets, The ERISA Industry Committee, Financial Executives International's Committee on Corporate Treasury, Financial Services Roundtable, Insured Retirement Institute, National Association of Insurance and Financial Advisors, National Association of Manufacturers and Securities Industry and Financial Markets Association letter dated Feb. 22, 2011
ABC/CIEBA Feb. 22 Letter	American Benefits Council and the Committee on the Investment of Employee Benefit Assets letter dated Feb. 22, 2011
ABC/CIEBA June 3 Letter	American Benefits Council and the Committee on the Investment of Employee Benefit Assets letter dated June 3, 2011
ABC Aug. 29 Letter	American Benefits Council letter dated Aug. 29, 2011
ACM June 15 Submission	ACM Capital Management submission dated June 15, 2011
AFSCME Feb. 22 Letter	American Federation of State, County and Municipal Employees letter dated Feb. 22, 2011
AGA June 3 Letter	American Gas Association letter dated June 3, 2011
AMG-SIFMA Jan. 18 Letter	The Asset Management Group of the Securities Industry and Financial Markets Association letter dated Jan. 18, 2011
AMG-SIFMA Feb. 22 Letter	The Asset Management Group of the Securities Industry and Financial Markets Association letter dated Feb. 22, 2011
APGA Feb. 22 Letter	American Public Gas Association letter dated Feb. 22, 2011

APPA/LPPC Feb. 22 Letter	American Public Power Association and the Large Public Power Council letter dated Feb. 22, 2011
ASF Feb. 22 Letter	American Securitization Forum letter dated Feb. 22, 2011
ATA Feb. 22 Letter	Air Transport Association of America, Inc. letter dated Feb. 22, 2011
Bank of America Merrill Lynch Apr. 5 Letter	Cleary Gottlieb Steen & Hamilton LLP, for Bank of America Merrill Lynch, Barclays Capital, BNP Paribas, Citi, Crédit Agricole Corporate and Investment Bank, Credit Suisse Securities (USA), Deutsche Bank AG, HSBC, Morgan Stanley, Nomura Securities International Inc., Societe Generale, UBS Securities LLC and Wells Fargo & Company letter dated Apr. 5, 2011
Bank of Tokyo May 6 Letter	The Bank of Tokyo-Mitsubishi UFJ, Ltd., Mizuho Corporate Bank, Ltd. and Sumitomo Mitsui Banking Corporation letter dated May 6, 2011
Barclays Jan. 11 Letter	Barclays Bank PLC, BNP Paribas S.A., Deutsche Bank AG, Royal Bank of Canada, Royal Bank of Scotland Group PLC, Societe Generale and UBS AG letter dated Jan. 11, 2011
Barclays Feb. 17 Letter	Barclays Bank PLC, BNP Paribas S.A., Credit Suisse AG, Deutsche Bank AG, HSBC, Nomura Securities International Inc., Rabobank Nederland, Royal Bank of Canada, The Royal Bank of Scotland Group PLC, Societe Generale, The Toronto-Dominion Bank, and UBS AG letter dated Feb. 17, 2011
Barnard May 23 Letter	Chris Barnard letter dated May 23, 2011
BDA Feb. 22 letter	Bond Dealers of America letter dated Feb. 22, 2011
Better Markets Feb. 22 Letter	Better Markets Inc. letter dated Feb. 22, 2011
Better Markets June 3 Letter	Better Markets Inc. letter dated June 3, 2011
Better Markets Aug. 29 Letter	Better Markets Inc. letter dated Aug. 29, 2011
BlackRock Feb. 22 Letter	BlackRock Inc. letter dated Feb. 22, 2011
BlackRock Apr. 12 Letter	BlackRock Inc. letter dated Apr. 12, 2011
BlackRock June 3 Medero and Prager Letter	BlackRock Inc. letter dated June 3, 2011, executed by Joanne Medero and Richard Prager
BlackRock June 3 Medero, Prager and VedBrat Letter	BlackRock Inc. letter dated June 3, 2011, executed by Joanne Medero, Richard Prager, and Supurna VedBrat
BlackRock Aug. 29 Letter	BlackRock Inc. letter dated Aug. 29, 2011
Bloomberg June 3 Letter	Bloomberg LP letter dated June 3, 2011
Calhoun Feb. 22 Letter	Calhoun, Baker Inc., Program Administrator for the Delaware Valley Regional Finance Authority letter dated Feb. 22, 2011

CalPERS Feb. 18 Letter	California Public Employees' Retirement System ("CalPERS"), Missouri State Employees' Retirement System ("MOSERS"), Public School & Education Employees' Retirement System of Missouri, Pennsylvania Public School Employees' Retirement System, Virginia Retirement System ("VRS"), New Jersey Division of Investments, Utah Retirement Systems, South Carolina Retirement System Investment Commission, State of Wisconsin Investment Board ("SWIB"), Colorado Public Employees' Retirement Association ("Colorado PERA"), and Teacher Retirement System of Texas ("TRS") letter dated Feb. 18, 2011
CalPERS Aug. 29 Letter	CalPERS, Colorado PERA, MOSERS, SWIB, VRS and TRS letter dated August 29, 2011
CalPERS Oct. 4 Letter	CalPERS, Colorado PERA, MOSERS, SWIB and TRS letter dated October 4, 2011
CalSTRS Feb. 28 Letter	California State Teachers' Retirement System letter dated Feb. 28, 2011
CEF Feb. 22 Letter	Hunton & Williams LLP on behalf of the Working Group of Commercial Energy Firms letter dated Feb. 22, 2011
CEF June 3 Letter	Hunton & Williams LLP on behalf of the Working Group of Commercial Energy Firms letter dated June 3, 2011
CFA/AFR Feb. 22 Letter	Consumer Federation of America and Americans for Financial Reform letter dated Feb. 22, 2011
CFA/AFR Aug. 29 Letter	Consumer Federation of America and Americans for Financial Reform letter dated Aug. 29, 2011
CFA/AFR Nov. 3 Letter	Consumer Federation of America and Americans for Financial Reform letter dated Nov. 3, 2011
Church Alliance Feb. 22 Letter	Church Alliance letter dated Feb. 22, 2011
Church Alliance Aug. 29 Letter	Church Alliance letter dated Aug. 29, 2011
Church Alliance Oct. 4 Letter	Church Alliance letter dated Oct. 4, 2011
CII Feb. 10 Letter	Council of Institutional Investors letter dated Feb. 10, 2011
Citadel June 3 Letter	Citadel LLC letter dated June 3
Cityview Feb. 22 Submission	Cityview Capital Solutions, LLC electronic submission dated Feb. 22, 2011
CME Feb. 22 Letter	CME Group Inc. letter dated Feb. 22, 2011
CME June 3 Letter	CME Group Inc. letter dated June 3, 2011
Comm. Cap. Mkts. May 3 Letter	Committee on Capital Markets Regulation letter dated May 3, 2011
Comm. Cap. Mkts. June 10 Letter	Committee on Capital Markets Regulation letter dated June 10, 2011
Comm. Cap. Mkts. June 24 Letter	Committee on Capital Markets Regulation letter dated June 24, 2011

Comm. Cap. Mkts. Aug. 26 Letter	Committee on Capital Markets Regulation letter dated Aug. 26, 2011
COPE Feb. 22 Letter	Coalition of Physical Energy Companies letter dated Feb. 22, 2011
COPE June 3 Letter	Coalition of Physical Energy Companies letter dated June 3, 2011
Copping Jan. 12 Submission	Jason Copping Submission dated Jan. 12, 2011
CPPIB Feb. 22 Letter	Canada Pension Plan Investment Board letter dated Feb. 22, 2011
Davis & Harman Mar. 25 Letter	Davis & Harman LLP letter dated Mar. 25, 2011
Davis & Harman May 3 Email	Davis & Harman LLP email dated May 3, 2011
Davis & Harman May 19 Email	Davis & Harman LLP email dated May 19, 2011
Davis & Harman June 6 Email	Davis & Harman LLP email dated June 6, 2011
Davis & Harman Sept. 15 Email	Davis & Harman LLP email dated Sept. 15, 2011
DC Energy June 3 Letter	DC Energy LLC letter dated June 3, 2011
DOL Apr. 28 Letter	U.S. Department of Labor letter dated Apr. 28, 2011
DOL Statement	U.S. Department of Labor Statement on the final Business Conduct Standards rules dated Jan. 17, 2012
EEI June 3 Letter	Edison Electric Institute letter dated June 3, 2011
Encana Feb. 22 Letter	Encana Marketing (USA) Inc. letter dated Feb. 22, 2011
ERIC Feb. 22 Letter	The ERISA Industry Committee letter dated Feb. 22, 2011
Eris June 3 Letter	Eris Exchange LLC letter dated June 3, 2011
ETA May 4 Letter	Electric Trade Associations, on behalf of the National Rural Electric Cooperative Association, American Public Power Association, Large Public Power Council, Edison Electric Institute, and Electric Power Supply Association letter dated May 4, 2011 on the May 3 CFTC-SEC Staff Roundtable Discussion on Dodd-Frank Implementation
ETA June 3 Letter	Electric Trade Associations, on behalf of the National Rural Electric Cooperative Association, American Public Power Association, Large Public Power Council, Edison Electric Institute, and Electric Power Supply Association letter dated June 3, 2011
Exelon Feb. 22 Letter	Exelon Corporation letter dated Feb. 22, 2011
FHLBanks Feb. 22 Letter	Sutherland Asbill & Brennan LLP, on behalf of The Federal Home Loan Banks letter dated Feb. 22, 2011
FHLBanks June 3 Letter	Sutherland Asbill & Brennan LLP, on behalf of The Federal Home Loan Banks dated June 3, 2011

FIA/ISDA/SIFMA Aug. 26 Letter	Futures Industry Association, International Swaps and Derivatives Association and Securities Industry and Financial Markets Association letter dated Aug. 26, 2011
FIA/ISDA/SIFMA Sept. 14 Letter	Futures Industry Association, International Swaps and Derivatives Association, and Securities Industry and Financial Markets Association letter dated Sept. 14, 2011
Financial Serv. Roundtable Apr. 6 Letter	Financial Services Roundtable letter dated Apr. 6, 2011
Financial Assns. May 4 Letter	Futures Industry Association, Financial Services Forum, International Swaps and Derivatives Association, and Securities Industry and Financial Markets Association letter dated May 4, 2011
Financial Assns. May 26 Letter	Futures Industry Association, Financial Services Roundtable, Institute of International Bankers , Insured Retirement Institute, International Swaps and Derivatives Association, Securities Industry and Financial Markets Association, and the U.S. Chamber of Commerce letter dated May 26, 2011
Financial Assns. June 10 Letter	Futures Industry Association, Institute of International Bankers, International Swaps and Derivatives Association, Investment Company Institute, and Securities Industry and Financial Markets Association letter dated June 10, 2011
Fleming Feb. 21 Submission	Richard H. Fleming submission dated Feb. 21, 2011
GFOA Feb. 22 Letter	Government Finance Officers Association letter dated Feb. 22, 2011
GreenX June 3 Letter	Green Exchange LLC letter dated June 3, 2011
HETCO Feb. 22 Letter	Hess Energy Trading Company LLC letter dated Feb. 22, 2011
HOOPP Feb. 22 Letter	Healthcare of Ontario Pension Plan letter dated Feb. 22, 2011
ISDA June 2 Letter	International Swaps and Derivatives Association letter dated June 2, 2011
Markit Feb. 22 Letter	Markit letter dated Feb. 22, 2011
Markit June 3 Letter	Markit letter dated June 3, 2011
MarkitSERV June 3 Letter	MarkitSERV letter dated June 3, 2011 (subject line referencing Reopening and Extension of Comment Periods, Core Principles for Swap Execution Facilities, etc.)
MarkitSERV June 3 Letter	MarkitSERV letter dated June 3, 2011 (subject line referencing Reopening and Extension of Comment Periods, Swap Data Repositories, Swap Data Recordkeeping, etc.)
MetLife Feb. 22 Letter	MetLife letter dated Feb. 22, 2011
MFA Feb. 22 Letter	Managed Funds Association letter dated Feb. 22, 2011
MFA Mar. 24 Letter	Managed Funds Association letter dated Mar. 24, 2011
MGEX June 3 Letter	Minneapolis Grain Exchange Inc. letter dated June 3, 2011
MHFA Feb. 22 Letter	Minnesota Housing Finance Agency letter dated Feb. 22, 2011

NACUBO Feb. 22 Letter	National Association of College and University Business Officers letter dated Feb. 22, 2011
NERA Dec. 20 Letter	National Economic Research Associates on behalf of the Working Group of Commercial Energy Firms letter dated Dec. 20, 2011
NextEra Mar. 11 Letter	NextEra Energy Inc. letter dated Mar. 11, 2011
NFA Aug. 25, 2010 Letter	National Futures Association letter dated Aug. 25, 2010
NFA Aug. 31 Letter	National Futures Association letter dated Aug. 31, 2011
NFP Energy End Users, Ex Parte Communication, Jan. 19, 2011	Ex Parte Communication with the Not-For-Profit Energy End Users, including the National Rural Electric Cooperative Association, American Public Power Association, American Public Gas Association, Large Public Power Council and ACES Power Marketing, on Jan. 19, 2011, citing Not-For-Profit Energy End Users letter dated Sept. 9, 2010 on the Commission's Advanced Notice of Proposed Rulemaking on Definitions contained in Title VII of Dodd-Frank, 75 FR 51429, Aug. 20, 2010
Noble July 7 Letter	Noble Energy Inc. letter dated July 7, 2011
NY City Bar Feb. 22 Letter	New York City Bar Association - Committee on Futures and Derivatives Regulation letter dated Feb. 22, 2011
NY City Bar June 13 Letter	New York City Bar Association - Committee on Futures and Derivatives Regulation letter dated June 13, 2011
Ohio STRS Feb. 18 Letter	State Teachers Retirement System of Ohio letter dated Feb. 18, 2011
OneChicago June 3 Letter	OneChicago LLC letter dated June 3, 2011
OTPP Feb. 22 Letter	Ontario Teachers' Pension Plan Board letter dated Feb. 22, 2011
Rep. Bachus Mar. 15 Letter	Chairman Spencer Bachus, House Committee on Financial Services; Chairman John Kline, House Committee on Education and the Workforce; and Chairman Frank D. Lucas, House Committee on Agriculture letter dated March 15, 2011
Rep. Smith July 25 Letter	Members of Congress, including Rep. Adam Smith, Rep. Kurt Schrader, Rep. Dan Boren, Rep. Terri Sewell, Rep. Rick Larsen, Rep. Laura Richardson, and Rep. Jim Himes letter dated July 25, 2011
Riverside Feb. 22 Letter	Riverside Risk Advisors LLC letter dated Feb. 22, 2011
Ropes & Gray Feb. 22 Letter	Ropes & Gray LLP letter dated Feb. 22, 2011
Russell Feb. 18 Letter	Russell Investments letter dated Feb. 18, 2011

Sen. Harkin May 3 Letter	Members of Congress, including Chairman Tom Harkin, Senate Committee on Health, Education, Labor & Pensions; Chairman Max Baucus, Senate Committee on Finance; Chairman Tim Johnson, Senate Committee on Banking, Housing & Urban Affairs; Chairman Debbie Stabenow, Senate Committee on Agriculture, Nutrition & Forestry; Senator Jeff Bingaman; Senator Bob Casey, Jr.; Senator Claire McCaskill; Senator Jon Tester; and Senator Kirsten Gillibrand letter dated May 3, 2011
Sen. Johnson Oct. 4 Letter	Senator Johnson and Rep. Barney Frank letter dated Oct. 4, 2011
Sen. Kerry May 18 Letter	Senator John F. Kerry and Senator Jeanne Shaheen letter dated May 18, 2011
Sen. Levin Aug. 29 Letter	Senator Carl Levin letter dated Aug. 29, 2011
SFG Feb. 22 Letter	Swap Financial Group, LLC letter dated Feb. 22, 2011
Shell June 3 Letter	Shell Energy North America letter dated June 3, 2011
SIFMA/ISDA Oct. 22, 2010 Letter	Securities Industry and Financial Markets Association and International Swaps and Derivatives Association letter dated Oct. 22, 2010
SIFMA/ISDA Feb. 17 Letter	Securities Industry and Financial Markets Association and International Swaps and Derivatives Association letter dated Feb. 17, 2011
Societe Generale Feb. 18 Letter	Societe Generale letter dated Feb. 18, 2011 (citing enclosed Societe Generale Nov. 23, 2010 Letter).
State Street Feb. 22 Letter	State Street Corporation letter dated Feb. 22, 2011
SWIB Feb. 22 Letter	State of Wisconsin Investment Board letter dated Feb. 22, 2011
Texas VLB Feb. 22 Letter	Texas General Land Office - The Veterans' Land Board of the State of Texas letter dated Feb. 22, 2011
Tradeweb June 3 Letter	Tradeweb Markets LLC letter dated June 3, 2011
U. Tex. System Feb. 22 Letter	The University of Texas System letter dated Feb. 22, 2011
VRS Feb. 22 Letter	Virginia Retirement System letter dated Feb. 22, 2011
Wells Fargo May 11 Letter	Sullivan & Cromwell LLP, for Wells Fargo Bank N.A., Branch Banking and Trust Company, East West Bank, Fifth Third Bank, The PrivateBank and Trust Company, Regions Bank, SunTrust Bank, and U.S. Bank National Association letter dated May 11, 2011
WMBAA June 3 Letter	Wholesale Markets Brokers' Association Americas letter dated June 3, 2011
Wright Feb. 16 Submission	Sam Wright submission dated Feb. 16, 2011

Appendix 2—Statement of the Department of Labor

U.S. Department of Labor

Assistant Secretary for
Employee Benefits Security Administration
Washington, D.C. 20210

JAN 17 2012

Honorable Gary Gensler
The Honorable Jill Sommers
The Honorable Bart Chilton
The Honorable Scott D. O'Malia
The Honorable Mark Wetjen
U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Final Business Conduct Standards Rules Adopted January 11, 2012

Dear Chairman Gensler and Commissioners Sommers, Chilton, O'Malia and Wetjen:

The Department of Labor has reviewed the final draft of the Commodity Futures Trading Commission's ("CFTC's") rules to implement Section 4s(h) of the Commodity Exchange Act pursuant to Section 731 of Title VII of the Dodd-Frank Wall Street Reform and The Consumer Protection Act of 2010. These rules prescribe external business conduct standards for swap dealers and major swap participants and will have a direct impact on ERISA-covered plans and plan fiduciaries. I very much appreciate the care that the CFTC has taken to coordinate its work on this project with the Department of Labor in light of the Department's regulatory and enforcement responsibilities with respect to ERISA fiduciaries. As we have worked with your staff, we have paid particular attention to the interaction between the original business conduct proposal and the Department's own fiduciary regulations and proposals.

The Department of Labor has reviewed these final business conduct standards and concluded that they do not require swap dealers or major swap participants to engage in activities that would make them fiduciaries under the Department of Labor's current five-part test defining fiduciary advice 29 C.F.R. § 2510.3-21(c). In the Department's view, the CFTC's final business conduct standards neither conflict with the Department's existing regulations, nor compel swap dealers or major swap participants to engage in fiduciary conduct. Moreover, the Department states that it is fully committed to ensuring that any changes to the current ERISA fiduciary advice regulation are carefully harmonized with the final business conduct standards, as adopted by the CFTC and the SEC, so that there are no unintended consequences for swap dealers and major swap participants who comply with these business conduct standards.

We look forward to continuing to work with you on these important projects and are grateful for your staff's thoughtful efforts to harmonize our work.

Sincerely,

Phyllis C. Borzi
Assistant Secretary, Employee Benefits Security Administration

Appendix 3—Commission Voting Summary

On this matter, Chairman Gensler and Commissioners Chilton, O'Malia and Wetjen voted in the affirmative; Commissioner Sommers voted in the negative.

Appendix 4—Statement of Chairman Gensler

I support the final rules to establish business conduct standards for swap dealers and major swap participants in their dealings with counterparties, or external business conduct. Today's final rules implement important new authorities in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) for the Commodity Futures Trading Commission to establish and enforce robust sales practices in the swaps markets. Dealers will have to tell their counterparties the mid-market mark of their outstanding bilateral swaps every day, bringing transparency to the markets and helping to level the playing field for market participants.

The rules prohibit fraud and certain other abusive practices. They also implement requirements for swap dealers and major swap participants to deal fairly with customers, provide balanced communications, and disclose material risks, conflicts of interest and material incentives before entering into a swap.

The rules include restrictions on certain political contributions from swap dealers to municipal officials, known as "pay to play" prohibitions.

The rules also 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 rules were carefully tailored to include safe harbors to ensure that special entities, such as pension plans subject to the Employee Retirement Income Security Act, will continue to be able to access these markets and hedge their risks.

The final rules benefitted substantially from the input of members of the public who met with staff and Commissioners and those who submitted thoughtful, detailed letters. The Securities and Exchange Commission, prudential regulators and the Department of Labor also provided helpful feedback.