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Part III

Commodity Futures Trading Commission

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

17 CFR Parts 23 and 155
RIN 3038–AD25

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

AGENCY: Commodity Futures Trading Commission.

ACTION: Proposed rules.

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

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

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

• Agency Web site, via Its Comments Online process: http://comments.cftc.gov/. Follow the instructions for submitting comments through the Web site.
• Mail: David A. Stawick, Secretary of the Commission, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581.
• Hand Delivery/Courier: Same as mail above.
• Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments. Please submit your comments using only one method.

All comments must be submitted in English, or if not, accompanied by an English translation. Comments will be posted as received to http://www.cftc.gov. You should submit only information that you wish to make available publicly. If you wish the Commission to consider information that you believe is exempt from disclosure under the Freedom of Information Act, a petition for confidential treatment of the exempt information may be submitted according to the procedures established in § 145.9 of the Commission’s Regulations.1 The Commission reserves the right, but shall have no obligation, to review, pre-screen, filter, redact, refuse or remove any or all of your submission from http://www.cftc.gov that it may deem to be inappropriate for publication, such as obscene language. All submissions that have been redacted or removed that contain comments on the merits of the rulemaking will be retained in the public comment file and will be considered as required under the Administrative Procedure Act and other applicable laws, and may be accessible under the Freedom of Information Act.

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

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

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I. Introduction

On July 21, 2010, President Obama signed the Dodd-Frank Act.3 Title VII of the Dodd-Frank Act amended the CEA4 to establish a comprehensive new regulatory framework for swaps and certain security-based swaps. The legislation was enacted to reduce risk, increase transparency, and promote

1 17 CFR 145.9.
2 The proposed swap execution standards § 155.7 would apply to any Commission registrant including a swap dealer or major swap participant, handling an order for a swap that is available for trading on a designated contract market or a swap execution facility.
4 7 U.S.C. 1 et seq., as amended by the Dodd-Frank Act. All references to the CEA are to the CEA as amended by the Dodd-Frank Act.
and adherence to position limits. The proposed rules incorporate the anti-fraud provision for swap dealers and major swap participants contained in Section 4s(h)(4), and also would prohibit swap dealers and major swap participants from disclosing confidential counterparty information, or from running or trading ahead of counterparty transactions. The Commission also proposes to adopt certain counterparty-specific supervisory and compliance duties including a “know your counterparty” requirement and policies and procedures to enforce these business conduct rules and to prevent evasion of the requirements of the CEA and Commission Regulations.

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

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

The Commission proposes to use its rulemaking authority under Section 4s(h) to promulgate several requirements adapted from analogous standards and practices applicable to certain financial market professionals. In drafting the proposed rules, the Commission considered existing requirements for market intermediaries under the CEA, Commission Regulations and the Federal securities laws, as well as self-regulatory requirements on swap dealers and major swap participants.

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


13 The CRMPG III Report identifies the characteristics of high-risk complex bilateral swaps to be: The degree and nature of leverage, the potential for periods of significantly reduced liquidity, and the lack of price transparency. The CRMPG III Report, at 54–57.
commodity trading advisors ("CTAs"), be subject to certain restrictions with respect to political contributions to certain governmental Special Entities ("pay-to-play").

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

Section 4s(h)(4) requires that a swap dealer who "acts as an advisor to a Special Entity" must act in the "best interests" of the Special Entity and undertake "reasonable efforts" to obtain information necessary to determine that a recommended swap is in the best interests of the Special Entity. The Commission proposes to incorporate the statutory text in a proposed rule and to specify that certain swaps-related conduct would be included within the meaning of the term "act as an advisor to a Special Entity."

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

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

C. Consultations With Stakeholders

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

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

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

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

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

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


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

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

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

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

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

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

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

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

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

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

21 See, e.g., Section 4b of the CEA.
22 Separate, the Commission is proposing rules detailing when a counterparty may elect to use the exception to mandatory clearing under section 2(b)(7)(A)(iii) of the CEA.
23 Separate, the Commission is proposing rules detailing the supervision, compliance and risk management obligations for swap dealers and major swap participants. See 75 FR 71397, Nov. 23, 2010. See proposed §§23.600 and 23.602, 75 FR 71397, Nov. 23, 2010.
24 This rule is based in part on NFA Compliance Rule 2-30, Customer Information and Risk Disclosure, which NFA has interpreted to impose “know your customer” duties, and has been a key component of NFA’s customer protection regime. See NFA Interpretive Notice 9013.
25 Separate, the Commission is proposing rules detailing the supervision, compliance and risk management obligations for swap dealers and major swap participants.
26 See, e.g., Section 4b of the CEA.
and relevant with respect to the subsequent swaps.

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

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

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

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

• Should the Commission specify any particular restrictions or prohibitions to further protect against evasion?

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

Section 4s(h)(1) grants the Commission discretionary authority to promulgate rules applicable to swap dealers and major swap participants related to, among other things: Fraud, manipulation and abusive practices. 29 To implement this provision the Commission proposes to adopt the anti-fraud provision in Section 4s(h)(4)(A) as § 23.410, which prohibits fraudulent, deceptive and manipulative practices by swap dealers and major swap participants. 30 While the heading of Section 4s(h)(4) states ‘‘Special Requirements for Swap Dealers Acting as Advisors,’’ the anti-fraud provision that follows in Section 4s(h)(4)(A) is not so limited. The proposed rule follows the statutory text and applies to swap dealers and major swap participants acting in any capacity, e.g., as an advisor, counterparty or other market participant in relation to counterparties generally.

The first two paragraphs of the rule focus on Special Entities and prohibit swap dealers and major swap participants from (1) employing any device, scheme or artifice to defraud any Special Entity; and (2) engaging in any transaction, practice, or course of business that operates as a fraud or deceit on any Special Entity. The third paragraph is not limited to Special Entities and prohibits swap dealers and major swap participants from engaging in any act, practice, or course of business that is fraudulent, deceptive or manipulative. 31

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

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

30 This language mirrors the language in Section 206(4) of the Investment Advisers Act of 1940 ("Advisers Act") (15 U.S.C. 80b–1 et seq.), which does not require scienter to prove liability. See SEC v. Steadman, 967 F.2d 636, 647 (D.C. Cir. 1992). 29 Section 206(4) uses the more neutral ‘‘act, practice, or course of business’’ language. This is similar to section 17(a)(3) ‘‘transaction, practice, or course of business,’’ which ‘‘quite plainly focuses upon the effect of particular conduct * * * rather than upon the culpability of the person responsible.’’ Accordingly, scienter is not required under section 206(4), and the SEC did not have to prove it in order to establish the appellants’ liability (citations omitted).

31 Senator Lincoln noted in a colloquy that the Commission should adopt rules to ensure that swap dealers maintain the confidentiality of hedging and portfolio information provided by Special Entities, and prohibit swap dealers from using information received from a Special Entity to engage in trades that would take advantage of the Special Entity’s positions or strategies. 156 Cong. Rec. S9523 (daily ed. Jul. 15, 2010) (statement of Sen. Lincoln). In consultations with stakeholders, Commission staff has learned that these concerns are more generally applicable to all counterparties, rather than exclusively to Special Entities. Thus, the Commission proposes that the business conduct rules include prohibitions on these types of activities in all transactions between swap dealers or major swap participants and their counterparties.

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

33 See, e.g., United States v. Dial, 757 F.2d 163, 168 (7th Cir. 1985).
dealer or major swap participant, should there be a limit on the time during which the swap dealer or major swap participant must refrain from trading on or otherwise disclosing the counterparty’s information?

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

**C. Proposed § 23.430—Verification of Counterparty Eligibility**

The Dodd-Frank Act makes it unlawful for any person, other than an eligible contract participant (“ECP”), to enter into a swap unless it is executed on or subject to the rules of a designated contract market.

The Commission contemplates that, in the absence of “red flags,” and as provided in proposed § 23.402(e), a swap dealer or major swap participant would be permitted to rely on reasonable written representations of a potential counterparty to establish its eligibility as an ECP. Proposed § 23.430 would require swap dealers and major swap participants to verify that a counterparty meets the eligibility standards for an ECP. Proposed § 23.430 would require swap dealers and major swap participants to verify that a counterparty meets the definition of an ECP prior to offering or entering into a swap. The proposed rule also would require a swap dealer or major swap participant to determine whether the counterparty is a Special Entity as defined in Section 4s(h)(2) and proposed § 23.401.

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

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

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

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

Section 4s(e)(3)(B) requires swap dealers and major swap participants to disclose to their counterparties material information about the risks, characteristics, incentives and conflicts of interest regarding a swap. The requirements do not apply if both counterparties are any of the following: Swap dealer, major swap participant, security-based swap dealer or major security-based swap participant.

Proposed § 23.431 would implement the statutory disclosure requirements and provide specificity with respect to certain material information that must be disclosed under the rule. Information is material if there is a substantial likelihood that a reasonable counterparty would consider it important in making a swap related decision. 40

**1. Timing and Manner of Disclosures**

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

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

**2. Disclosure of Material Risks**

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

Required risk disclosure would include sufficient information to enable a

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35 “Eligible contract participant” is a defined term in Section 1a(18) of the CEA.

36 See Section 2(e) of the CEA.

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

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

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

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

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

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

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

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

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

46 Liquidity risk is the risk that a counterparty may not be able to, or cannot easily, unwind or offset a particular position at or near the previous market price because of inadequate market depth, unique trade terms or remaining party characteristics or because of disruptions in the marketplace.
counterparty to assess its potential exposure during the term of the swap and at expiration or upon early termination. Consistent with industry “best practices,” information regarding specific material risks must identify the material factors that influence the day-to-day changes in valuation, as well as the factors or events that might lead to significant losses.47 Appropriate disclosures should consider the effect of future economic factors and other material events that could cause the swap to experience such losses. Disclosures should also identify, to the extent possible, the sensitivities of the swap to those factors and conditions, as well as the approximate magnitude of the gains or losses the swap will likely experience.

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

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

• Are there specific material risks that the Commission should require a swap dealer or major swap participant to disclose to a counterparty? Are there specific risks that should be disclosed with respect to particular types of swaps, asset classes and trading venues?

• NFA and SIFMA/ISDA submitted letters that have suggested that the Commission develop a standard form risk disclosure statement for certain generic-type disclosures, similar to those used today for futures, options and retail foreign currency transactions.48 Should the Commission undertake such an effort? Should the Commission encourage the industry or SROs to develop such disclosures, in addition, or instead? If it would be beneficial to have such forms, why has the industry not developed such a standard form to date? Would standard form disclosure be inconsistent with the requirement that disclosures be based on the facts and circumstances presented by each swap and counterparty?

• Are there other ways for the Commission to describe the risk disclosure duty required by the CEA that would provide additional guidance or clarify the obligation?

• Should the rule distinguish explicitly risk disclosure requirements for SEF or DCM traded swaps versus bilateral swaps?

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

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

a. High-Risk Complex Bilateral Swap: Characteristics

The rule’s mandatory scenario analysis delivery requirement would apply only when “high-risk complex bilateral swaps” are offered or recommended. Like the industry “best practice” recommendation, the term “high-risk complex bilateral swap” is not defined in the proposed rule; rather, certain flexible characteristics are identified to avoid over inclusive and under inclusive concerns. The characteristics are: The degree and nature of leverage, the potential for periods of significantly reduced liquidity, and the lack of price transparency.52 The proposed rule would require swap dealers and major swap participants to disclose proprietary information about any pricing models.

The Commission does not propose to define the parameters of the scenario analysis in order to provide flexibility to the parties to design the analyses in accordance with the characteristics of the bespoke swap at issue, as well as any criteria developed in consultations with the counterparty. Further, the proposed rule would require swap dealers and major swap participants to consider relevant internal risk analyses including any new product reviews when designing the analyses.53 As for the format, the proposed rule would require both narrative and tabular expressions of the analyses.

To ensure fair and balanced communications and to avoid misleading counterparties, swap dealers and major swap participants also would complex and thus require the special treatment outlined in this section. CRMPG III Report, at 56. 54 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.

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

50 CRMPG III Report, at 60–61.

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

52 CRMPG III Report states that:

The aforementioned characteristics are neither an exhaustive list nor should they be assumed to provide a strict definition of high-risk complex instruments, which the Policy Group believes should be avoided. Instead, market participants should establish procedures for determining, based on the key characteristics discussed above, whether an instrument is to be considered high-risk and

See CRMPG III Report, at 60.

See NFA Letter, at 2; SIFMA/ISDA Letter, at 12.
be required to state the limitations of the scenario analysis, including cautions about the predictive value of the scenario analysis, and any limitations on the analysis based on the assumptions used to prepare it. The Commission’s proposed rule is aligned with longstanding industry best practice recommendations, and indeed, several large swap dealers told Commission staff that they provide scenario analysis upon request and without separate charge to counterparties today.

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

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

4. Material Characteristics

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

5. Material Incentives and Conflicts of Interest

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

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

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

6. Daily Mark

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

a. Cleared Swaps

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

b. Uncleared Swaps

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

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

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

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

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

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

**E. Proposed § 23.432—Clearing**

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

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

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

**F. Proposed § 23.433—Communications—Fair Dealing**

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

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

- Should the Commission specify in its final rule any additional

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62 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 among the public."); NFA ADR Committee of Rule 2-9: Communications with the Public and Promotional Material; NFA Interpretive Notice 9041—Obligations to Customers and Other Market Participants.
63 See, e.g., NFA Compliance Rule 2-29(b)(2), (5); see also NFA Interpretive Notice 9043—NFA Compliance rule 2-29: Use of Past or Projected Performance: Disclosing Conflicts of Interest for Security Futures Products (performance must be presented in a balanced manner).
64 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 * * ").
65 See, e.g., NFA Compliance Rule 2-29(b)(4)–(5).
requirements necessary to satisfy the duty? If so, what?

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

G. Proposed § 23.434
Recommendations to Counterparties—Institutional Suitability

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

In light of its broad application in other markets and jurisdictions, the Commission proposes an institutional suitability obligation for any recommendation a swap dealer or major swap participant makes to a counterparty in connection with a swap or swap trading strategy. The Commission recognizes that futures market professionals have not been subject to an explicit “suitability” obligation.73 Instead, such professionals have been required to meet a variety of related requirements, including NFA “know your customer” duties,74 mandatory standard form risk disclosure,75 NFA’s fair and balanced communication rules and just and equitable principles,76 and general anti-fraud provisions.77 These requirements developed to address the risks and characteristics of standardized exchange-traded futures and options contracts. Because the definition of swap includes a variety of different types of financial instruments and those instruments can be customized to have a wide range of risk/reward profiles, the Commission believes that standard risk disclosure, alone, may not be sufficient to ensure that counterparties understand their potential exposure. The Commission also has considered that many swap dealers and major swap participants already are, or will be, subject to institutional suitability obligations by virtue of their status as banks, broker-dealers or security-based swap dealers. Thus, to promote regulatory consistency78 and to take account of the nature of swaps, the Commission proposes to adopt an institutional suitability obligation for swap dealers and major swap participants, modeled, in part, on existing obligations for banks and broker-dealers dealing with institutional clients.

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

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

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

The Commission notes that swap dealers and major swap participants are likely to be acting as CTAs83 when they...
make recommendations, particularly recommendations tailored to the needs of their counterparty. As such, they would be subject to any additional duties that might be applicable to CTAs under the CEA and Commission Regulations, including registration requirements and Section 4a of the CEA, the anti-fraud provision that applies to CTAs and commodity pool operators.\footnote{84 Request for Comment: The Commission requests comments generally on the proposed rules regarding recommendations and the following specific issues:}

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

- Should swap dealers be subject to an explicit fiduciary duty when making a recommendation to a counterparty?

**H. Proposed § 155.7—Execution Standards**

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

- Commission registrants, with respect to any swap that is available for trading on a DCM or SEF, to execute the swap on terms that have a “reasonable relationship” to the best terms available.

The term “reasonable relationship” has been used in evaluating execution standards over several decades in the securities industry. In an early securities law case, the Second Circuit stated that “[i]n [its] interpretation of Sec. 17(a) of the Securities Act, the Commission has consistently held that a dealer cannot charge prices not reasonably related to the prevailing market price without disclosing that fact.” Charles Hughes & Co. v. SEC, 139 F.2d 434, 437 (2d Cir. 1943). The SEC issued a release in 1987, “Notice to broker-dealers concerning disclosure requirements for mark-ups on zero-coupon securities,” which includes the implied representation that the price a firm charges bears a reasonable relationship to the prevailing market price.\footnote{86 The duty under the proposed rule would apply whether the Commission registrant was acting as agent or principal in the transaction. This is consistent with existing duties for broker-dealers under the Federal securities laws. See Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266, 270 n. 1 (3d Cir. 1998) (“[T]he best execution duty ‘does not dissolve when the broker/ dealer acts in its capacity as a principal.’”) (citations omitted). Accord E.F. Hutton & Co., Release No. 34–25887, 49 S.E.C. 829, 832 (1988); NASD Rule 2120(e).}

The proposed execution standard rule would apply to swaps available for trading on a DCM or SEF to ensure fair dealing and protect against fraud and other abusive practices. The proposed execution standard rule would require Commission registrants, with respect to any swap that is available for trading on a DCM or SEF, to execute the swap on terms that have a “reasonable relationship” to the best terms available.\footnote{87 Supra at footnote 85. The “duty of fair dealing includes the implied representation that the price a firm charges bears a reasonable relationship to the prevailing market price.” 52 FR 15575, 15576, Apr. 21, 1987 (citing Charles Hughes & Co. v. SEC, 139 F.2d at 437). In IM–2440–1 related to OTC transactions, FINRA expanded the principle to include fees charged in exchange-traded transactions. See FINRA Regulatory Notice 06–36.}
likely to affect how Commission registrants determine whether the terms they offer their customers are reasonably related to the “best terms available” for purposes of satisfying the proposed execution standards. For example, registrants’ survey obligations may be satisfied by consulting, where available, information aggregators that facilitate the collection of information about current trading activity across markets. The proposed rule is intended to be sufficiently flexible to take account of such innovations and developments which should further the quality of executions.

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

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

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

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

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

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

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

Section 4s(h)(2)(C) defines a “Special Entity” as: (i) A Federal agency; (ii) a State, State agency, city, county, municipality, or other political subdivision of a State; (iii) any employee benefit plan, as defined in Section 3 of ERISA;90 or (v) any endowment, including an endowment that is an organization described in Section 501(c)(3) of the Internal Revenue Code of 1986.91

The Commission has received a number of letters from stakeholders identifying a variety of ambiguities in the definition of Special Entity in Section 4s(h)(2)(C) and suggesting clarifications. For example, under Section 4s(h)(2)(C)(iii), the term Special Entity includes employee benefit plans as defined in but not subject to ERISA.92 Industry representatives have raised issues concerning whether the definition requires “looking through” investment vehicles to determine whether the vehicle is a Special Entity, including master trusts holding the assets of one or more pension plans of a single employer, and collective investment vehicles in which Special Entities invest.93

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

Under Section 4s(h)(2)(C)(v), the term Special Entity includes any endowment, including an endowment that is an organization described in Section 501(c)(3) of the Internal Revenue Code of 1986.96 Non-profit organizations that enter into swaps have asked whether they will be treated as Special Entities if their endowment is pledged as collateral or is used to make payments on those swaps or whether the definition of endowment is limited to those endowments that are the named counterparty to the swap.97 Others have suggested that the phrase “any endowment” be limited to endowments that are non-profit organizations described in Section 501(c) of the Internal Revenue Code or are established for the benefit of such an organization.

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

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

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

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

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

• Should the Commission “look through” an entity to determine whether it is a Special Entity for the purposes of these rules? If so, why? If not, why not?

If so, should the Commission clarify that master trusts, or similar entities, that hold assets of more than one pension plan from the same plan sponsor are within the definition of Special Entity?

• Should the Commission clarify in any way the definition of governmental plan under Section 4s(h)(2)(C)?

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

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

90 29 U.S.C. 1002. The term “Special Entities” includes employee benefit plans defined in section governmental plan, as defined in Section 3 of ERISA;90 or (v) any endowment, including an endowment that is an organization described in Section 501(c)(3) of the Internal Revenue Code of 1986.91

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

92 26 U.S.C. 501(c)(3). Section 501(c)(3) lists tax exempt organizations including: “Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes * * * .”
B. Proposed § 23.440—Requirements for Swap Dealers Acting as Advisors to Special Entities

Section 4s(h)(4) provides that a swap dealer that “acts as an advisor to a Special Entity” must act in the “best interests” of the Special Entity and undertake “reasonable efforts” to obtain information necessary to determine that a recommended swap is in the best interests of the Special Entity. These terms are not defined in the statute. The Commission’s proposed rules incorporate the statutory language and clarify that “acts as an advisor to a Special Entity” includes to make a swap recommendation to a Special Entity.

1. Act as an Advisor to a Special Entity

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

2. Best Interests

The proposed rule would not define the term “best interests.” These are established in this way under the CEA, with respect to the duties of advisors which will inform the meaning of the term on a case-by-case basis. The Commission believes that those best interest principles, in the context of a recommended swap or swap trading strategy, would impose affirmative duties to act in good faith and make full and fair disclosure of all material facts and conflicts of interest, and to employ reasonable care that any recommendation given to a Special Entity desists from further the purposes of the Special Entity. The Commission’s proposal is guided by the statutory language in Sections 4s(h)(4) and (5) and Congressional intent that

swap dealers could act both as an advisor to a Special Entity when recommending a swap and then as a counterparty by entering into the same swap with the Special Entity, where the Special Entity has a representative independent of the swap dealer on which it can rely. The proposed rules are intended to allow existing business relationships to continue, albeit subject to the new, higher statutory standards of care. Thus, the proposed rule is not intended to preclude, per se, a swap dealer from both recommending a swap to a Special Entity and entering into that swap with the same Special Entity where the parties abide by the requirements of Sections 4s(h)(4) and (5) and the Commission’s proposed regulations.

3. Reasonable Efforts

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

4. Reasonable Reliance To Satisfy the “Reasonable Efforts” Obligation

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

To rely, the swap dealer must have a reasonable basis to believe that the representations of the Special Entity are reliable based on the facts and
circumstances of the particular swap and the Special Entity. The representations themselves must be detailed and include information regarding the Special Entity’s ability to: evaluate the recommended transaction; exercise independent judgment; and absorb potential losses associated with the swap. The Special Entity also would have to have a representative that meets the criteria in Section 4s(h)(5) and proposed § 23.450. This mechanism would not relieve a swap dealer of its duty to act in the “best interests” of the Special Entity.

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

- Is the proposed clarification of the term “best interests” appropriate? Should the Commission further define the term?
- Should the Commission define “best interests” in this context, and if so, what should the definition be?
- Because a swap dealer has an inherent conflict of interest when it acts as both an advisor and a counterparty to Special Entity, are there additional disclosures that a swap dealer should have to make that could mitigate the conflicts of interest?
- When acting as both an advisor and a counterparty to a Special Entity, should a swap dealer have to disclose any positions it holds from which it may profit should the swap in question move against the Special Entity?
- Should swap dealers have to disclose to a Special Entity the profit it expects to make on swaps it enters into with the Special Entity?
- Should swap dealers be subject to an explicit fiduciary duty when acting as an advisor to a Special Entity?
- Would the proposed rule preclude swap dealers from continuing their current practice of both recommending and entering into swaps with Special Entities? If so, why?
- Should the Commission prescribe additional information that would be relevant to a swap dealer’s “reasonable efforts” and “best interests” duties under the proposed rule?

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

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

1. Qualifications of the Independent Representative

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

2. Statutory Disqualification

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

3. Independent

Proposed § 23.450(b) would require that a swap dealer or major swap participant “have a reasonable basis to believe a Special Entity has a representative that satisfies the enumerated criteria. The criteria for an independent representative based generally on the statute and under proposed § 23.450 would be: (1) Sufficient knowledge to evaluate the transaction and risks; (2) not subject to a statutory disqualification; (3) independent of the swap dealer or major swap participant; (4) undertakes a duty to act in the best interests of the Special Entity it represents; (5) makes appropriate and timely disclosures to the Special Entity; (6) evaluates, consistent with any guidelines provided by the Special Entity, fair pricing and the appropriateness of the swap; (7) in the case of employee benefit plans subject to ERISA, is a fiduciary as defined in Section 3 of ERISA (29 U.S.C. 1002); and (8) in the case of a municipal entity as defined in proposed § 23.451, whether the representative is subject to restrictions on certain political contributions imposed by the Commission, the SEC, or a self- regulatory organization subject to the jurisdiction of the Commission.

The proposed rule provides that relevant considerations would include: (1) The nature of the Special Entity—representative relationship; (2) the representative’s capability of making hedging or trading decisions; (3) use of consultants or, with respect to employee benefit plans subject to ERISA, use of a Qualified Professional Asset Manager or In-House Asset Manager; 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.

104 Although the title of Section 4s(h)(5) refers only to swap dealers, the specific requirements in Section 4s(h)(5)(A) are imposed on both swap dealers and major swap participants. 105 The criteria for an independent representative based generally on the statute and under proposed § 23.450 would be: (1) Sufficient knowledge to evaluate the transaction and risks; (2) not subject to a statutory disqualification; (3) independent of the swap dealer or major swap participant; (4) undertakes a duty to act in the best interests of the Special Entity it represents; (5) makes appropriate and timely disclosures to the Special Entity; (6) evaluates, consistent with any guidelines provided by the Special Entity, fair pricing and the appropriateness of the swap; (7) in the case of employee benefit plans subject to ERISA, is a fiduciary as defined in Section 3 of ERISA (29 U.S.C. 1002); and (8) in the case of a municipal entity as defined in proposed § 23.451, whether the representative is subject to restrictions on certain political contributions imposed by the Commission, the SEC, or a self- regulatory organization subject to the jurisdiction of the Commission.

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

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

108 See H.R. Rep. No. 111–517, at 869 (June 29, 2010) (Conf. Rep.) (“When acting as counterparties to a pension fund, endowment fund, or state or local government, dealers are to have a reasonable basis to believe a Special Entity has a representative that satisfies the enumerated criteria.”). See, e.g., Ropes & Gray Letter, at 4; ABC/CIBA Letter, at 2; SIFMA/ISDA Letter, at 11. Stakeholders have asserted that, even if Congress did intend for Section 4s(h)(5)(A) to apply to non-governmental Special Entities, it did not intend for it to apply to ERISA plans. Stakeholders further assert that, even if Section 4s(h)(5)(A) applies to ERISA plans, swap dealers and major swap participants should only be expected to verify that the independent representative satisfies the criteria of Section 4s(h)(5)(A)(II)—that the independent representative is a fiduciary as defined in Section 3 of ERISA (29 U.S.C. 1002)—and not the criteria of Section 4s(h)(5)(A)(II)–(VI). They contend that verification of the duty under Section 4s(h)(5)(A)(II) is the equivalent of verification of Section 4s(h)(5)(A)(II)–(VI) and that to require verification of all the criteria would lead to regulatory conflicts under ERISA and the CEA.

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

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


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

4. Best Interests

The Commission is not proposing to define what “best interests” means in this context. As the Commission explained regarding proposed § 23.440, the scope of the duty will be related to the nature of the relationship between the independent representative and the Special Entity. There are established principles in case law which will inform the meaning of the term on a case-by-case basis. We would expect that, at a minimum, the swap dealer or major swap participant would have a reasonable basis for believing that the representative could assess: (1) How the proposed swap fits within the Special Entity’s investment policy; (2) what role the particular swap plays in the Special Entity’s portfolio; and (3) the Special Entity’s potential exposure to losses. The swap dealer or major swap participant would also need to have a reasonable basis for believing that the representative has sufficient information to understand and assess the appropriateness of the swap prior to the Special Entity’s entering into the transaction.

5. Makes Appropriate and Timely Disclosures

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

6. Evaluates Fair Pricing and the Appropriateness of the Swap

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

7. ERISA Fiduciary

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

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

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

9. Unqualified Independent Representative

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

10. Disclosure of Capacity

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

11. Inapplicability

Proposed § 23.450 would not apply with respect to a swap that is initiated on a DCM or SEF where the swap dealer or major swap participant does not know the Special Entity’s identity. Request for Comment: The Commission requests comment generally on all of the proposed rules regarding swap dealers and major swap participants that act as counterparties to Special Entities, and on the following specific issues:

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

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

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

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120 For example, CTAs are required to maintain books and records for 5 years pursuant to § 1.31 of the Commission’s regulations. (17 CFR 1.31).
121 29 U.S.C. 1002.
124 The Commission proposes this requirement pursuant to its discretionary authority in Section 4s(h) of the CEA, including in particular Section 4s(h)(5)(B).
125 See, e.g., SEC Rule 206(4)–5 under the Advisers Act (17 CFR 275.206(4)–5); MSRB Rule G–37: Political Contributions and Prohibitions on Municipal Securities Business. The Commission proposes to impose comparable requirements on swap dealers and major swap participants that act as advisors or counterparties to Special Entities. See proposed § 23.432. In a separate release, the Commission will also propose comparable requirements on registered commodity trading advisors when they advise municipal entities.
127 E.g., ABC Letter, at 8.

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

The existing restrictions on pay-to-play practices are contained in SEC Rule 206(4)–5 under the Investment Advisers Act of 1940, and under the Municipal Securities Rule Making Board ("MSRB") Rules G–37 and G–38, which impose pay-to-play restrictions on municipal securities dealers and broker-dealers engaging or seeking to engage in the municipal securities business. The proposed rule is intended to deter swap dealers and major swap participants from engaging in pay-to-play practices.

1. Prohibitions

Proposed § 23.451, generally, would make it unlawful for a swap dealer or major swap participant to offer to enter into or enter into a swap with a municipal entity for a two-year period after the swap dealer or major swap participant or any of its covered associates makes a contribution to an official of the municipal entity. The proposed rule also would prohibit a swap dealer or major swap participant from paying a third-party to solicit municipal entities to enter into a swap, unless the third-party is a "regulated person" that is itself subject to a pay-to-play restriction under applicable law.

The proposed rule also would ban a swap dealer or major swap participant from soliciting or coordinating contributions to an official of a municipal entity with which the swap dealer or major swap participant is seeking to enter into, or has entered into, a swap, or payments to a political party of a state or locality with which the swap dealer or major swap participant is seeking to enter into, or has entered into a swap. These proposed prohibitions are similar to those contained in SEC Advisers Act Rule 206(4)–5 and MSRB Rules G–37 and G–38.

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

a. Two-Year "Time Out"

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

b. Covered Associates

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

2. Exceptions

a. De Minimis Contributions

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

b. New Covered Associates

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

c. Exchange and SEF Transactions

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

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

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

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

- Is the term “municipal entity” appropriately defined? If not, should the Commission refer to “a State, State agency, city, county, municipality, or other political subdivision of a State, or any governmental plan, as defined in Section 3 of [ERISA] (29 U.S.C. 1002)” within the meaning of Section 4s(h)(2)(C)? Should the Commission use the definition of “government entity” from SEC Advisers Act Rule 206(4)–5? Should the Commission instead follow the approach of MSRB Rule G–37?
- Should the proposed rule apply not to all swap dealers and major swap participants, but instead to only swap dealers? If so, why?

IV. Request for Comment

A. Generally

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

- Should any proposed requirements be modified or deemed satisfied with respect to swaps that are traded and/or cleared on a registered entity? If so, which requirements should be modified or deemed satisfied, and why?
- Should the Commission use its discretionary authority, where applicable, to distinguish among swap dealers depending on their size and the nature of their business? If so, under what circumstances and how?
- Should any additional business conduct requirements be imposed on swap dealers and/or major swap participants? If so, which requirements should be imposed, and why?
- Should the Commission delay the effective date of all of the proposed requirements to allow additional time to comply with the requirements? If so, which requirements, and what is the compliance burden that should merit a delay?

B. Consistency With SEC Approach

The SEC is proposing rules related to business conduct standards for swap dealers and major swap participants as required under Section 764 of the Dodd-Frank Act. Understanding that the Commission and the SEC regulate different products and markets and, appropriately may have different levels of regulation and, if so, how do commenters believe that such duplication, inconsistencies, or gaps should be minimized?

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

V. Related Matters

A. Regulatory Flexibility Act

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

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

134 Proposed § 23.451(d).
135 As used in SEC Advisers Act Rule 206(4)–5(f)(5) (17 CFR 275.206(4)–5(f)(5)), the term “government entity” means any State or political subdivision of a State, including:
(i) Any agency, authority, or instrumentality of the State or political subdivision;
(ii) A pool of assets sponsored or established by the State or political subdivision or any agency, authority or instrumentality thereof, including, but not limited to a “defined benefit plan” as defined in section 414(i) of the Internal Revenue Code (26 U.S.C. 414(i)), or a State general fund;
(iii) A plan or program of a government entity; and
(iv) Officers, agents, or employees of the State or political subdivision or any agency, authority or instrumentality thereof, acting in their official capacity.
136 MSRB Rule G–37(g)(ii) references “the governmental issuer specified in section 3(a)(29) of the [Exchange] Act” which includes “a State or any political subdivision thereof, or any agency or instrumentality of a State or any political subdivision thereof, or any municipal corporate instrumentality of one more States” (15 U.S.C. 78c(29)).
137 5 U.S.C. 601 et seq.
138 Id.
This rulemaking contains collections of information, notably the proposed rules that will require swap dealers and major swap participants to make records, document processes, and make disclosures to counterparties with whom they propose to enter into swaps. OMB has not yet assigned a control number to the new collections. OMB has not yet assigned a control number to the new collection.

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

C. Cost-Benefit Analysis

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

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

Costs. The Commission’s proposed rules implement new Section 4s(h) and enhance transparency, protect counterparties from fraud and abuse, bolster confidence in markets, reduce risk, and allow regulators to better monitor and manage our financial system. With respect to efficiency, the Commission has determined that adhering to the new requirements under the proposed rules will not be unduly burdensome for swap dealers and major swap participants. Indeed, the proposed rules, in part, reflect existing regulatory requirements in other markets as well as current industry practices in the swaps market. In addition, the Commission has determined that the cost to market participants and the public if these rules are not adopted could be substantial.

B. Paperwork Reduction Act

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

The Business Conduct Standard–Internal Rulemakings are: Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants, 75 FR 71397, Nov. 23, 2010; Designation of a Chief Compliance Officer, Required Compliance Policies, and Annual Report of a Futures Commission Merchant, Swap Dealer, Major Swap Participant, 75 FR 70681, Nov. 19, 2010; and Implementation of Conflict-of-Interest Standards by Swap Dealers and Major Swap Participants, 75 FR 71391, Nov. 23, 2010. In addition, the Commission will be issuing proposed rules regarding recordkeeping, reporting and daily trading records for swap transactions consistent with §1.31 of the Commission’s Regulations. (17 CFR § 1.31).

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

Sec. 23.400 Scope.

23.401 Definitions.

23.402 General provisions.

23.403—23.409 [Reserved]

23.410 Prohibition on fraud, manipulation and other abusive practices.

23.411—23.429 [Reserved]

23.430 Verification of counterparty eligibility.

23.431 Disclosures of material information.

23.432 Clearing.

23.433 Communications—fair dealing.

23.434 Recommendations to counterparties—institutional suitability.

23.435—23.439 [Reserved]

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

23.441—23.449 [Reserved]

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

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

§ 23.400 Scope.

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

(b) Counterparty. The term “counterparty,” as appropriate in this subpart, includes any person who is a prospective counterparty to a swap.

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

§ 23.401 Definitions.

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

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

§ 23.402 General provisions.

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

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

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

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

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

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

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

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

(2) Effectively service the counterparty;

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

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

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

(e) Reasonable Reliance on Representations. A swap dealer or major swap participant that seeks to rely on the written representations of a counterparty with respect to any requirements under this subpart must have a reasonable basis to believe that the representations are reliable and that the counterparty is reasonably designed to allow the counterparty to assess—

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

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

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

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

(A) The degree and nature of leverage;
(B) The potential for periods of significantly reduced liquidity; and
(C) The lack of price transparency.

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

(v) In designing the scenario analysis required by paragraphs (a)(1)(i) and (a)(1)(ii) of this section, a swap dealer or major swap participant shall consider any relevant analyses that it undertakes for its own risk management purposes, including analyses performed as part of its “New Product Policy” specified in §23.600(c)(3).
(2) The material characteristics of the particular swap, which shall include the material economic terms of the swap, the terms relating to the operation of the swap and the rights and obligations of the parties during the term of the swap; and

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

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

(ii) Any compensation or other incentive from any source other than the counterparty that the swap dealer or major swap participant does not know the identity of the counterparty to the transaction.

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

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

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

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

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

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

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

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

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

§ 23.432 Clearing.

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

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

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

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

§ 23.433 Communications—fair dealing.

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

§ 23.434 Recommendations to counterparties—institutional suitability.

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

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

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

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

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

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

(c) This section shall not apply:

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

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

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

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

§§ 23.435–23.439 [Reserved]

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

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

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

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

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

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

(2) Reasonable Efforts. Any swap dealer that acts as an advisor to a
Special Entity shall make reasonable efforts to obtain such information as is necessary to make a reasonable determination that any swap or trading strategy involving a swap recommended by the swap dealer is in the best interests of the Special Entity. This information shall include information relating to:

(i) The authority of the Special Entity to enter into a swap;
(ii) The financial status of the Special Entity, as well as future funding needs;
(iii) The tax status of the Special Entity;
(iv) The investment or financing objectives of the Special Entity (including review of any written derivatives, financing and investment policies, plans or similar documents);
(v) The experience of the Special Entity with respect to entering into swaps, generally, and swaps of the type and complexity being recommended;
(vi) Whether the Special Entity has an independent representative that meets the criteria enumerated in § 23.450(b);
(vii) Whether the Special Entity has the financial capability to withstand potential market-related changes in the value of the swap during the term of the swap; and
(viii) Such other information as is relevant to the particular facts and circumstances of the Special Entity, market conditions and the type of swap recommended.

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

(1) The swap dealer has a reasonable basis to believe that the representations are reliable taking into consideration the facts and circumstances of a particular swap dealer-Special Entity relationship, assessed in the context of a particular transaction; and
(2) The representations include information sufficiently detailed for the swap dealer to reasonably conclude that the Special Entity is:
   (i) Capable of evaluating independently the material risks inherent in the recommendation;
   (ii) Exercising independent judgment in evaluating the recommendation; and
   (iii) Capable of absorbing potential losses related to the recommended swap; and
(3) The swap dealer has a reasonable basis to believe that the Special Entity has a representative that meets the criteria enumerated in § 23.450(b).

§§ 23.441–23.449 [Reserved]

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

(a) Definitions. For purposes of this section:

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

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

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

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

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

(2) Is not subject to a statutory disqualification;

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

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

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

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

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

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

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

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

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

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

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

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

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

(i) The authority of the Special Entity to act in the best interests of the Special Entity it represents;

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

(iii) The tax status of the Special Entity; and

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

(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).
representative to make informed decisions;
(iii) The use by the representative of
one or more consultants;
(iv) The general level of experience of
the representative in financial markets
and specific experience with the type of
instruments, including the specific asset
class, under consideration;
(v) The representative’s ability to
understand the economic features of the
swap involved;
(vi) The representative’s ability to
evaluate how market developments
would affect the swap; and
(vii) The complexity of the swap or
swaps involved.
(e) Unqualified representative. If a
swap dealer or major swap participant
determines that the representative of a
Special Entity does not meet the criteria
established in this section, the swap
dealer or major swap participant shall
make a written record of the basis for
such determination and submit such
determination to its Chief Compliance
Officer for review to ensure that the
swap dealer or major swap participant has a substantial, unbiased basis for the
determination.
(f) Before the initiation of a swap, a
swap dealer or major swap participant
shall disclose to the Special Entity in
writing:
(1) The capacity in which it is acting
in connection with the swap; and
(2) If the swap dealer or major swap
participant engages in business with the
Special Entity in more than one
capacity, the swap dealer or major swap
participant shall disclose the material
differences between such capacities in
connection with the swap and any other
financial transaction or service
involving the Special Entity.
(g) This section shall not apply with
respect to a transaction that is:
(1) Initiated on a designated contract
market or swap execution facility; and
(2) One in which the swap dealer or
major swap participant does not know
the identity of the counterparty to the
transaction.

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

(a) Definitions. For the purposes of
this section:
(1) The term “contribution” means any
gift, subscription, loan, advance, or
deposit of money or anything of value
made:
(i) For the purpose of influencing any
election for state or local office;
(ii) For payment of debt incurred in
connection with any such election; or
(iii) For transition or inaugural
expenses incurred by the successful
candidate for state or local office.
(2) The term “covered associate”
means:
(i) Any general partner, managing
member or executive officer, or other
person with a similar status or function;
(ii) Any employee who solicits a
municipal entity for the swap dealer or
major swap participant and any person
who supervises, directly or indirectly,
such employee; and
(iii) Any political action committee
controlled by the swap dealer or major
swap participant or by any person
described in paragraphs (a)(2)(i) and
(a)(2)(ii) of this section.
(3) The term “municipal entity” means
any State, political subdivision of a
State, or municipal corporate
instrumentality of a State, including—
(i) Any agency, authority, or
instrumentality of the State, political
subdivision, or municipal corporate
instrumentality;
(ii) Any plan, program, or pool of
assets sponsored or established by the
State, political subdivision, or
municipal corporate instrumentality or
any agency, authority, or
instrumentality thereof; and any other
issuer of municipal securities.
(4) The term “official” of a municipal
entity means any person (including any
election committee for such person)
who was, at the time of the contribution,
an incumbent, candidate or successful
candidate for elective office of a
municipal entity, if the office:
(i) Is directly or indirectly responsible
for, or can influence the outcome of, the
selection of a swap dealer or major swap
participant by a municipal entity;
(ii) Has authority to appoint any
person who is directly or indirectly
responsible for, or can influence the
outcome of, the selection of a swap
dealer or major swap participant by a
municipal entity.
(5) The term “payment” means any
gift, subscription, loan, advance, or
deposit of money or anything of value.
(6) The term “regulated person”
means:
(i) A person that is subject to
restrictions on certain political
contributions imposed by the
Commission, the Securities and
Exchange Commission or a self-
regulatory agency subject to the
jurisdiction of the Commission or the
Securities and Exchange Commission;
(ii) A general partner, managing
member or executive officer of such
person, or other individual with a
similar status or function; or
(iii) An employee of such person who
solicits a municipal entity for the swap
dealer or major swap participant and
any person who supervises, directly or
indirectly, such employee.
(7) The term “solicit” means a direct
or indirect communication by any
person with a municipal entity for the
purpose of obtaining or retaining an
engagement related to a swap.
(b) Prohibitions and Exceptions.
(1) As a means reasonably designed to
prevent fraud, no swap dealer or major
swap participant shall offer to enter into
or enter into a swap or a trading strategy
involving a swap with a municipal
entity within two years after any
contribution to an official of such
municipal entity was made by the swap
dealer or major swap participant, or by
any covered associate of the swap dealer
or major swap participant, provided
however, that:
(2) This prohibition does not apply:
(i) If the only contributions made by the
swap dealer or major swap
participant to an official of such
municipal entity were made by a
covered associate;
(A) To officials for whom the covered
associate was entitled to vote at the time
of the contributions, provided that the
contributions in the aggregate do not
exceed $350 to any one official per
election; or
(B) To officials for whom the covered
associate was not entitled to vote at the
time of the contributions, provided that
the contributions in the aggregate do not
exceed $150 to any one official, per
election;
(ii) To a swap dealer or major swap
participant as a result of a contribution
made by a natural person more than six
months prior to becoming a covered
associate of the swap dealer or major
swap participant, provided that this
exclusion shall not apply if the natural
person, after becoming a covered
associate, solicits the municipal entity on
behalf of the swap dealer or major
swap participant to offer to enter into or
to enter into a swap or trading strategy
involving; or
(iii) With respect to a swap that is
initiated on a designated contract
market or swap execution facility if the
swap dealer or major swap participant
does not know the identity of the
counterparty to the transaction at the
time of the transaction.
(3) No swap dealer or major swap
participant or any covered associate of
the swap dealer or major swap
participant shall:
(i) Provide or agree to provide,
directly or indirectly, payment to any
person to solicit a municipal entity to
offer to enter into, or to enter into, a
swap with that swap dealer or major
swap participant unless such person is a
regulated person; or
(ii) Coordinate, or solicit any person or political action committee to make, any:
(A) Contribution to an official of a municipal entity with which the swap dealer or major swap participant is offering to enter into, or has entered into, a swap; or
(B) Payment to a political party of a state or locality with which the swap dealer or major swap participant is offering to enter into or has entered into a swap or a trading strategy involving a swap.

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

d) Requests for Exemption. The Commission, upon application, may conditionally or unconditionally exempt a swap dealer or major swap participant from the prohibition under paragraph (b) of this section. In determining whether to grant an exemption, the Commission will consider, among other factors:
(1) Whether the exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes of the Act;
(2) Whether the swap dealer or major swap participant:
(i) Before the contribution resulting in such prohibition was made, had taken all available steps to implement policies and procedures reasonably designed to prevent violations of this section;
(ii) Prior to or at the time of the contribution which resulted in such prohibition, had taken such other remedial or preventive measures as may be appropriate under the circumstances; 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) The character of the market for the swap or the swap execution facilities, trading such swap.

PART 155—TRADING STANDARDS

Authority and Issuance

3. The authority citation for part 155 shall be revised to read as follows:
Authority: 7 U.S.C. 6b, 6c, 6g, 6j, 6s, and 12a as amended by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376 (Jul. 21, 2010).

4. Add § 155.7 to read as follows:

§ 155.7 Execution standards.
(a) In connection with any customer order to enter into a swap where such swap is available for trading on one or more designated contract markets or swap execution facilities, a Commission registrant shall:
(1) Prior to execution of the swap, disclose to the customer:
(i) The designated contract markets and swap execution facilities on which the swap is available for trading; and
(ii) The designated contract markets and swap execution facilities on which the registrant has trading privileges.
(2) Execute the order on terms that have a reasonable relationship to the best terms available for such swap on designated contract markets or swap execution facilities trading such swap.
(b) As part of the execution requirements in paragraph (a) of this section, the registrant shall use reasonable diligence to ascertain the best terms available. Among the factors that will be considered in determining whether a Commission registrant has used “reasonable diligence” are:
(1) The character of the market for the swap, including price, volatility, speed, certainty of execution, and liquidity;
(2) The size and type of transaction;
(3) The number of markets checked;
(4) Accessibility of quotations; and
(5) The terms and conditions of the order which results in the transaction, as communicated to the Commission registrant.

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

David A. Stawick,
Secretary.

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

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

Appendix 1—Commission Voting Summary

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

Appendix 2—Statement of Chairman Gary Gensler

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

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

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

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