Swap Dealer and Major Swap Participants—
Business Conduct Requirements-External

Introduction

On Wednesday, August 4, 2010, NFA staff met with CFTC and SEC staff to discuss external business conduct requirements for swap dealers ("SDs") and major swap participants ("MSPs"). At that time, Commission staff indicated that Section 4s(h) of the Commodity Exchange Act ("CEA") establishes the framework for the external business conduct requirements for SDs and MSPs. CFTC and SEC staff requested that NFA staff discuss NFA's business conduct requirements relating to NFA Members engaging in exchange-traded futures and options and the retail OTC forex market. NFA discussed these requirements and provided CFTC and SEC staff with a copy of NFA's Rules and various interpretive notices relating to our business conduct requirements.

After our meeting, NFA internally discussed Section 4s(h)'s separate requirements and, afterwards, prepared this memo to assist Commission staff in connection with drafting its proposed rules regarding external business conduct requirements. For discussion purposes, we followed the CEA framework and analyzed Section 4s(h) by dividing it into the following three broad areas—(1) general business conduct requirements; (2) special requirements for SDs acting as advisors to Special Entities; and (3) special requirements for SDs as counterparties to Special Entities. The term Special Entity is defined in Section 4s(h)(2)(C).

For discussion purposes, we have set forth applicable statutory provisions and suggested principles that the CFTC may want to consider in drafting proposed rules relating to each area. As an overriding principle, as we discussed in Washington D.C., NFA recommends that the CFTC's initial external business conduct requirements be general in nature to the extent possible, with further guidance and requirements adopted as regulators gain experience regulating cleared and uncleared swaps. NFA has used this regulatory philosophy over the years and believes it is extremely effective. For example, NFA's initial regulatory requirements for OTC retail forex began with an anti-fraud rule only, and over the past several years NFA has developed comprehensive requirements governing these retail counterparty transactions.

General Business Conduct Requirements

Section 4s(h)(1) requires that each SD and MSP shall conform with business conduct standards as prescribed in Section 4s(h)(3)(A)-(D) and the Commission may prescribe rules that relate to these standards:

- Subsection (A): Establishes a duty for SDs or MSPs to verify that any counterparty meets the eligibility standards for an eligible contract participant ("ECP").

  Proposed Principles: Although NFA believes that this standard is relatively straightforward, NFA encourages the Commission to propose a rule in this area to further clarify an SD's and MSP's obligations. A proposed rule could be patterned after NFA Compliance Rule 2-30, which permits a Member to discharge its know-your-customer requirements by relying upon certain information provided by a non-ECP customer. Therefore, the Commission could require an SD or MSP to obtain information that allows the SD or MSP to ascertain if a counterparty meets the eligibility standards of an ECP. NFA further recommends that similar to NFA Compliance Rule 2-30's framework the Commission allow flexibility as to the manner in which an SD or MSP can meet this obligation. For example, NFA believes that an SD or MSP could provide its counterparty with the eligibility standards of an ECP and obtain a representation from the counterparty prior to an initial swap transaction that it meets those eligibility standards. This representation could be obtained via the terms of an ISDA master agreement, a confirmation or any other written documentation. The SD or MSP should be permitted to reasonably rely upon the counterparty's representation absent evidence to the contrary. Furthermore, the Commission could permit the use of an express statement that the representation is deemed provided each time a new transaction is entered into absent evidence to the contrary.

- Subsection (B)(i)-(iii): The Commission may adopt requirements relating to disclosure by an SD or MSP to any counterparty to the transaction (other than an SD, MSP, or security-based SD and MSP) of (i) information about the material risks and characteristics of the swap; (ii) any material incentives or conflicts of interest that the SD or MSP may have in connection with the swap; and (iii)(I) for cleared swaps, upon request of the counterparty, receipt of the daily mark of the transaction from the appropriate derivatives clearing organization; and (II) for uncleared swaps, receipt of the daily mark of the transaction from the SD or MSP.

  Proposed Principles: NFA believes that the Commission should propose a rule that further clarifies this standard. At the outset, NFA strongly favors the use of brief, concise, and uniform risk disclosure statements if possible. To that end, with regard to the disclosure items contained in Sections 4s(h)(B)(i) and (ii), NFA suggests that the Commission consider using CFTC Regulation 1.55 as a model

to develop for cleared and uncleared swaps a specific uniform disclosure statement that must be provided by SDs and MSPs to counterparties. NFA recognizes, however, that the disclosure statement's language may differ for cleared and uncleared swaps. If the Commission elects to develop a uniform statement, then perhaps the disclosure obligations contained in NFA's Interpretive Notice entitled "Forex Transactions" regarding the counterparty nature of OTC retail forex transactions would also be helpful. NFA believes any uniform statement should also discuss the material risks of swap transactions, the characteristics of swaps, and the material incentives of SDs and MSPs to enter into these transactions. NFA understands that in the mid-1990s, the Derivatives Policy Group may have attempted to develop a uniform risk disclosure statement for OTC derivatives. If NFA is able to locate a copy of this statement, we will provide it to the Commission.

NFA also suggests that if the Commission proposes a uniform disclosure statement, then it also propose a requirement similar to 1.55(g), which provides that Regulation 1.55's disclosure obligations do not relieve an FCM or IB from any other disclosure obligation it may have under applicable law. NFA believes that this type of provision could be tailored to impose an obligation upon SDs and MSPs to disclose any other material unique risks and characteristics of a particular cleared or uncleared swap that may not be covered by the uniform statement. For example, further disclosures may be necessary regarding fees, liquidation rights, and assignment rights applicable to a specific uncleared swap.

With regard to the daily mark disclosure obligations set forth in Section 4s(h)(B)(iii), NFA also encourages the Commission to propose further clarifying requirements in this area and believes that several principles may prove helpful. First, as applicable to both cleared and uncleared swaps, any rule in this area should provide flexibility regarding the method in which SDs and MSPs may provide the daily mark to their counterparties. For example, SDs and MSPs should be permitted to email, post via website, or verbally provide their counterparties with the daily mark. Second, for cleared swaps, the SDs and MSPs disclosure obligation should be conditioned on the derivatives clearing organization calculating a daily mark.

For uncleared swaps, NFA recommends that the Commission consider imposing a requirement upon SDs and MSPs to provide the daily mark but permits the counterparty to opt out of receiving it on a daily basis. For example, given the long-term nature of many of these transactions, the non-SD/MSP counterparty could elect to receive a mark on a monthly or mid-month basis. NFA also believes that the Commission's rules should not prescribe a precise method that SDs and MSPs must use to calculate a daily mark for uncleared swaps. Instead, the rules should require that SDs and MSPs disclose to their counterparties the method used to calculate the daily mark and that the mark does not constitute a tradable price. NFA recommends that the Commission permit SDs and MSPs to satisfy this obligation by developing a generic statement regarding their

calculation methods, including factors that may or may not be included in the daily mark versus a tradable or actionable price. The rules should also require that the SDs or MSPs consistently apply the disclosed methodology and maintain adequate documentation to allow regulators to verify that they have done so. The daily mark provided to the counterparty may differ from the SD's or MSP's internal valuation and that possibility should also be disclosed to the counterparty. The Commission may also consider requiring the SD or MSP to provide the counterparty with additional information, such as the bid/ask spread, upon request.

- Subsection (C): An SD or MSP has a duty to communicate in a fair and balanced manner based on principles of fair dealing and good faith.

  Proposed Principles: If the Commission adopts further rules in this area, then NFA believes that NFA Compliance Rule 2-29 could serve as a model for the Commission in drafting proposed requirements to satisfy this obligation. As noted above, NFA favors general business conduct rules to the extent possible, with further specific guidance and requirements adopted to address particular regulatory issues and abuses as they arise. NFA Compliance Rule 2-29(a) is broadly written and provides, in pertinent part, that no Member or Associate shall make any communication with a member of the public that operates as a fraud or deceit, and subsection (b) states, in part, that no Member or Associate shall use any promotional material which is likely to deceive the public or contains any material misstatement of fact or which the Member or Associate knows omits a fact if the omission makes the promotional material misleading. NFA Compliance Rule 2-29(b) also requires that Members balance any discussion of potential profit with an equally prominent discussion of the risk of loss. NFA Compliance Rules 2-29 and 2-4 have been interpreted to require full disclosure of costs and fees.

- Subsection (D): The Commission may establish such other standards and requirements as the Commission may determine are appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the CEA.

  Proposed Principle: If the Commission elects to propose additional requirements in this area, then NFA recommends that the requirements be general in nature.

Special Requirements for SDs Acting as Advisors to Special Entities

Sections 4s(h)(4)(A)-(C) establish special requirements for SDs acting as advisors to Special Entities, as defined in Section 4s(h)(1)(C).

- Subsection (A): Establishes an anti-fraud standard and states that it shall be unlawful for an SD or MSP to (i) employ any device, scheme, or artifice to defraud any Special Entity or prospective customer who is a Special Entity; (ii)

engage in any transaction, practice, or course of business that operates as a fraud or deceit on any Special Entity or prospective customer who is a Special Entity; or (iii) engage in any act, practice, or course of business that is fraudulent, deceptive or manipulative.

Proposed Principle: Subsection (A)'s broad anti-fraud standards are straightforward and since they are contained in the statute NFA believes that the Commission may not have to adopt a rule in this area. If the Commission does propose a rule, however, then NFA suggests that the rule's language be identical to the statutory language.

- Subsections (B) and (C): Subsection (B) provides that an SD that acts as an advisor to a Special Entity shall have a duty to act in the best interests of the Special Entity. Additionally, Subsection (C) provides that any SD that acts as an advisor to a Special Entity shall make reasonable efforts to obtain information necessary to make a reasonable determination that any swap recommended by the swap dealer is in the best interests of the Special Entity, including information relating to the Special Entity's (i) financial status; (ii) tax status; (iii) investment or financing objectives; and (iv) any other information prescribed.

  Proposed Principle: With the significant exception discussed below, NFA believes that these statutory requirements are straightforward and if the Commission elects to propose rules in this area, then the statutory language could be replicated. NFA believes, however, that the Commission needs to develop a clear definition of the term "acts as an advisor" so SDs can avoid inadvertently acting in this capacity. ERISA standards for what constitutes providing investment advice could be a helpful source for the Commission on this issue. Additionally, the Commission should consider whether it is appropriate for an SD to perform limited advisory services solely incidental to its function as an SD.

Special Requirements for SDs as Counterparties to Special Entities

Sections 4s(h)(5)(A)-(B) establish special requirements for SDs and MSPs acting as counterparties to Special Entities, as defined in Section 4s(h)(1)(C).

- Subsection (A)(i): Any SD or MSP that offers to enter or enters into a swap with a Special Entity shall comply with any duty established by the CFTC for an SD or MSP, with respect to a counterparty that is an ECP, as defined in Section 1a(18)(vii)(I) and (II), that requires the SD or MSP to have a reasonable basis to believe that the Special Entity counterparty has an independent representative that (I) has sufficient knowledge to evaluate the transaction and risks; (II) is not subject to a statutory disqualification; (III) is independent of the SD or MSP; (IV) undertakes a duty to act in the best interests of the counterparty it represents; (V) makes appropriate disclosures; (VI) will provide written representations to the Special Entity regarding fair pricing and the appropriateness of the transaction;

and (VII) in the case of employee benefit plans subject to ERISA, is a fiduciary as defined in section 3 of that Act. The ECP definition in Section 1a(18)(vii)(I) and (II) covers a governmental entity or political subdivision of a governmental entity (including the United States, a State, or a foreign government) or a multinational or supernational government entity.

- Subsection (A)(ii): Any SD or MSP that offers to enter or enters into a swap with a Special Entity shall before the initiation of the transaction disclose in writing to the Special Entity the capacity in which the swap dealer is acting.

- Subsection (B): The Commission may establish such other standards and requirements as the Commission may determine are appropriate in the public interest, or otherwise in furtherance of the CEA's purposes.

  Proposed Principles: Similar to Section 4s(h)(4)'s requirements, Section 4s(h)(5)'s specific requirements are relatively straightforward. NFA believes that an SD should be able to satisfy its obligation under Section 4s(h)(5) by reasonably relying upon a written representation from the Special Entity's independent representative that the representative meets Section 4s(h)(4)'s qualification requirements. The Commission could also consider whether it is appropriate for the Special Entity to affirm receipt to the SD of the Independent Representative's written representation. NFA also recommends that the Commission appropriately define "independent" for purposes of serving as a representative. In our view, the focus should be on the advisor's independence from the SD, not from the special entity. NFA assumes qualified pension asset managers under ERISA are independent representatives, and believes in-house asset managers under ERISA should also be considered independent representatives for purposes of this section provided they remain compliant with ERISA standards.

  Again, NFA does not recommend that the CFTC prescribe a specific method for SDs and MSPs to obtain the required representation recognizing that it could be obtained via the terms of an ISDA master agreement, confirmation or any other written documentation. Lastly, Subsection (A)(i)(VII) requires an SD and MSP to obtain a representation that the independent representative is a fiduciary as defined in section 3 of ERISA if the Special Entity counterparty is an employee benefit plan subject to ERISA. However, it is unclear if this subsection applies to both foreign and domestic employee benefit plans, and consistent with Section 2(i)'s limitation on the extraterritorial application of the CEA's swaps provision NFA believes that the Commission should clarify that Subsection (A)(i)(VII) should only apply to domestic plans.