Commodity Futures Trading Commission
Office of Public Affairs
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581
www.cftc.gov

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

What is the goal of the final rulemaking?

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

Will the final rules change the ways in which swap dealers and major swap participants deal with their counterparties?

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

What duties do swap dealers and major swap participants have to counterparties, generally, under the final rules?

SDs/MSPs must implement policies and procedures to ensure compliance with the final rules and to prevent evasion of the Commodity Exchange Act (CEA), and retain a record of their compliance with the final rules. In general, the final rules require SDs/MSPs to disclose material information about a swap to allow the counterparty to assess the material risks, characteristics, incentives and conflicts of interest of the swap. SDs also have certain due diligence obligations, including to obtain essential information about their counterparties, have a reasonable basis to believe that recommended swaps are suitable for the counterparty, and verify the ECP and/or Special Entity status of its counterparties. SDs/MSPs have additional due diligence duties when dealing with Special Entities.

What types of conduct are swap dealers and major swap participants prohibited from engaging in?

The final rules adopt the anti-fraud prohibition applicable to SDs/MSPs in new Section 4s(h)(4) of the CEA, under which SDs/MSPs are prohibited from engaging in fraudulent, deceptive, manipulative practices. The final rules also prohibit SDs/MSPs from disclosing and otherwise misusing a counterparty's material confidential information. There is an affirmative defense to alleged violations of the non-scienter fraud provisions where SDs/MSPs establish that they complied in good faith with relevant policies and procedures.

What are some of the principal requirements for swap dealers and major swap participants dealing with counterparties, generally, under the final rules?

Verification. SDs/MSPs must verify that the counterparty is an eligible contract participant (ECP) as defined in Section 1a(18) of the CEA and whether the counterparty is a Special Entity.

Disclosures of Material Information. SDs/MSPs must disclose information concerning the swap in a manner reasonably designed to allow the counterparty to assess the material risks and characteristics of the swap and the material incentives and conflicts of interest that the SD/MSP may have in connection with the particular swap.

Scenario analysis. As part of the duty to disclose the material risks of a swap, prior to entering into a swap that is not made available for trading on a DCM or SEF, an SD (but not MSPs) must notify its counterparty of its right to request and consult on a scenario analysis for swaps that are not made available for trading on a SEF or DCM.

Daily mark. For uncleared swaps, SDs/MSPs must provide counterparties with a daily mark that is the mid-market mark of the swap.

Communications—fair dealing. SDs/MSPs must communicate with their counterparties in a fair and balanced manner based on principles of fair dealing and good faith.

Recommendations to counterparties—institutional suitability. An SD who recommends a swap must conduct reasonable diligence to understand the potential risks and rewards of the recommendation and have a reasonable basis to believe that the recommendation is suitable for the counterparty. The final rule provides a safe harbor under which an SD may fulfill its suitability obligation if (1) it reasonably determines that the counterparty is capable of independently evaluating the recommendation, (2) the counterparty represents in writing that it is exercising independent judgment, (3) the SD represents in writing that it is acting as a counterparty and not evaluating the suitability of the recommendation for the counterparty, and (4), where the counterparty is a Special Entity and the recommendation would cause the SD to "act as an advisor," the SD complies with the requirements for SDs who "act as an advisor to a Special Entity" described below.

Will swap dealers be acting as CTAs when they make recommendations to counterparties?

No. The Commission has determined to exercise its authority to add a new exclusion from the CTA definition for SDs whose recommendations or advice are solely incidental to their business as SDs.

Are there any requirements for swap dealers under the final rules that do not apply to major swap participants?

Yes, certain rules do not apply to MSPs. They include: know your counterparty, scenario analysis, "acting as an advisor to a Special Entity," suitability, and restrictions on certain political contributions.

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

Yes. For example, for swaps executed on a SEF or DCM and the SD/MSP does not know the identity of the counterparty prior to execution, the SD/MSP does not have to verify the eligibility of the counterparty or make disclosures of material information, other than the daily mark. In addition, the requirements to disclose material information regarding a swap do not apply when the counterparty is another SD/MSP or a security-based swap dealer or major security-based swap participant.

What is a Special Entity under the final rules?

A Special Entity under the final rules is defined as: 1) a Federal agency; 2) a State, State agency, city, county, municipality, or other political subdivision of a State, or any instrumentality, department, or a corporation of or established by a State or political subdivision of a State; 3) any employee benefit plan subject to Title I of the Employee Retirement Income Security Act of 1974 (ERISA) (29 U.S.C. 1002); 4) any governmental plan, as defined in Section 3 of ERISA; 5) any endowment, including an endowment that is an organization described in Section 501(c)(3) of the Internal Revenue Code of 1986; or 6) any employee benefit plan defined in Section 3 of ERISA, not otherwise defined as a Special Entity, that

elects to be a Special Entity by notifying an SD/MSP of its election prior to entering into a swap with the particular SD/MSP.

What additional duties do swap dealers and major swap participants have to satisfy when their counterparty is a Special Entity?

Any SD/MSP that offers to or enters into a swap with a Special Entity, other than a Special Entity that is an employee benefit plan subject to ERISA, must have a reasonable basis to believe that the Special Entity has a representative that (i) has sufficient knowledge to evaluate the transaction and risks; (ii) is not subject to a statutory disqualification; (ii) is independent of the SD/MSP; (iv) undertakes a duty to act in the best interests of the Special Entity it represents; (v) makes appropriate and timely disclosures to the Special Entity; (vi) evaluates, consistent with any guidelines provided by the Special Entity, fair pricing and the appropriateness of the swap; and (vii) in the case of a governmental Special Entity, is subject to restrictions on certain political contributions (except if the representative is an employee of the governmental Special Entity).

For Special Entities that are employee benefit plans subject to ERISA, an SD/MSP must have a reasonable basis to believe that the Special Entity has a representative that is an ERISA fiduciary.

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

Safe harbors. For Special Entities other than employee benefit plans subject to ERISA, the final rule provides a safe harbor under which the SD/MSP will be deemed to have a reasonable basis that the Special Entity has a qualified independent representative if the Special Entity represents that it has complied in good faith with policies and procedures reasonably designed to ensure that it has an independent representative who satisfies the applicable criteria, and the representative represents in writing that it also has policies and procedures reasonably designed to ensure that it satisfies the applicable criteria. The final rule also provides a safe harbor to establish that a representative is independent of the SD/MSP. A representative will be deemed to be independent if: it was not an associated person of the SD/MSP within a year of the representation; does not have a principal relationship with the SD/MSP; discloses, manages and mitigates material conflicts of interest that would compromise its duties to the Special Entity; is not under common control with SD/MSP, and the SD/MSP does not refer or recommend the representative to the Special Entity within a year of the representation.

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

An SD "acts as an advisor to a Special Entity" when it recommends a swap or trading strategy involving a swap that is tailored to the particular needs of the Special Entity. An SD that acts as an advisor to a Special Entity must have a reasonable basis to believe that recommendations are in the best interests of the Special Entity.

Safe harbor. With respect to an employee benefit plan subject to ERISA, an SD will not be acting as an advisor to a Special Entity for purposes of this rule if the Special Entity represents in writing that it has an ERISA fiduciary, the fiduciary represents in writing that it will not rely on the SD's recommendations, and the Special Entity represents in writing that it has policies and procedures reasonably designed to ensure that any recommendation the Special Entity receives from the SD materially affecting a swap transaction is evaluated by a fiduciary before the transaction occurs.

For any Special Entity (including ERISA Plans): the SD will not be subject to a best interests duty if it does not express an opinion as to whether the Special Entity should enter into a recommended swap that is tailored to the particular needs or characteristics of the Special Entity; the Special Entity represents that it will not rely on the SD and will rely on advice of its independent representative; and the SD discloses that it is not acting in Special Entity's best interests.

What duty must a swap dealer satisfy when it "acts as an advisor to a Special Entity?"

An SD that "acts as an advisor to a Special Entity" must make a reasonable determination that any swap it recommends to the Special Entity is in the Special Entity's best interests and make reasonable efforts to obtain such information as is necessary to make a reasonable determination that any swap it recommends is in the Special Entity's best interest. An SD may reasonably rely on a Special Entity's written representations to satisfy the "reasonable efforts" requirement.

What does it mean to act in the best interests of a Special Entity and how can a swap dealer satisfy this duty?

An SD that "acts as an advisor to a Special Entity" will comply with its duty to act in the Special Entity's best interests where the SD complies with the "reasonable efforts" requirement, acts in good faith and makes full and fair disclosure of all material facts and conflicts of interest with respect to the recommended swap, and employs reasonable care that any recommendation made to a Special Entity is designed to further the Special Entity's stated objectives. "Best interests" is not a fiduciary duty under this rule.

May swap dealers and major swap participants provide disclosures in a standard format?

Rule 23.402(e) provides flexibility to SDs, MSPs and their counterparties to agree to a reliable means for making disclosures of material information. Furthermore, § 23.402(f) allows SDs/MSPs to use, where appropriate, standardized formats to make certain required disclosures of material information to their counterparties, and to include such standardized disclosures in counterparty relationship documentation 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.

May swap dealers and major swap participants satisfy some of their obligations by relying on their counterparties' representations?

Yes. As provided in final rule 23.402(d), an SD/MSP may rely on the written representations of a counterparty unless it has information that would cause a reasonable person to question the accuracy of the representation.

Are the final rules harmonized with SEC's municipal advisor regulatory regime?

Yes. Independent representatives that advise State and municipal Special Entities on swaps and related activities may be subject to registration with both the Commission as CTA and the SEC as a municipal advisor. Commission staff is coordinating with SEC, National Futures Association and Municipal Securities Rulemaking Board to harmonize requirements for CTAs and municipal advisors. Commission staff continues to consult with SEC staff regarding the proposed municipal advisor registration requirements to address the treatment of SDs and MSPs that comply with the Commission's business conduct standards rules.

Are the final rules harmonized with ERISA and DOL regulations?

Yes. The Commission understands from DOL that compliance with the business conduct standards statutory provisions and Commission rules will not, alone, cause SDs/MSPs to be ERISA fiduciaries to an ERISA plan.