Client Advisory

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# CFTC Adopts Final Business Conduct Standards for Swap Dealers and Major Swap Participants

## I. INTRODUCTION

On January 11, the Commodity Futures Trading Commission approved final rules (the Final Rules) under Section 4s(h) of the Commodity Exchange Act (CEA) (added by Section 731 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act)) that set forth general antifraud prohibitions and establish detailed business conduct standards that must be observed by CFTC-registered swap dealers (Swap Dealers or SDs) and major swap participants (MSPs) (together, Swap Entities) when they are entering into swaps with counterparties other than other Swap Entities (End Users).[1]

The Final Rules have softened some of the most onerous and widely criticized provisions of the original conduct standards proposed by the CFTC (the Proposed Rules) by providing conduct safe harbors and allowing reliance on counterparty representations. Nevertheless, the Final Rules still contain many provisions that drastically alter the way an uncleared swap must be negotiated and executed between a Swap Entity and an End User, particularly if the Swap Entity's counterparty falls within a special subset of End Users known as "Special Entities," which includes pension plans, governmental entities and certain other entities that receive enhanced protections under the Final Rules. Swap Entities will accordingly need to make significant modifications to their current ordinary course of business for swaps in order to be able to comply with the new rules when they become effective.

## II. EXECUTIVE SUMMARY

The Final Rules impose the following 12 significant requirements on Swap Entities:[2]

1. ***Prohibition on Fraud, Manipulation and Other Abusive Practices.*** A Swap Entity may not engage in any act, practice or course of business with any counterparty that is fraudulent, deceptive or manipulative. In addition, there are special provisions prohibiting a Swap Entity from defrauding a Special Entity.
2. ***Confidential Treatment of Counterparty Information.*** A Swap Entity may not disclose any material confidential information provided by an End User or use it "in any way that would tend to be materially adverse to the interests of" the End User except as is authorized in writing by the End User or is necessary to hedge or mitigate risk exposures created by transactions between the parties.

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[1] The text of the Final Rules, which are set out in Sections 23.400 to 23.451 of Part 23 of the CFTC Rules, is available here. The CFTC's original proposal was published for comment in the *Federal Register* on December 22, 2010.

[2] A diagram illustrating these requirements can be found at the end of this Client Advisory.

3. ***Know-Your-Counterparty and Counterparty Verification Requirements.*** A Swap Entity must verify the status of each End User as an eligible contract participant (ECP), and each Special Entity as a Special Entity, but may rely on representations from its counterparty for that verification (unless it has information that would cause a reasonable person to doubt the accuracy of the representation).[3] The Swap Entity must also obtain and retain a record of certain enumerated "essential facts" about each End User.
4. ***Disclosure of Material Transaction Information.*** "At a reasonably sufficient time prior to entering into a swap," a Swap Entity must disclose to each End User counterparty a) all material risks and characteristics of the proposed swap; b) all of its material incentives and conflicts of interest in engaging in the transaction; and c) both the "price" of the Swap and its mid-market mark.[3]
5. ***Scenario Analysis Requirement for Swap Dealers.*** A Swap Dealer, but not an MSP, must notify each End User considering a swap that is not "made available for trading" (as provided in Section 2(h)(8) of the CEA) that the End User has the right to receive, and consult on the design for, a scenario analysis to help it assess the risks of the proposed swap. If the End User requests a scenario analysis, the Swap Dealer must disclose all material assumptions underlying, and explain the calculation methodologies used in, the scenario analysis.[3]
6. ***Delivery of Daily Marks.*** A Swap Entity must a) notify each End User counterparty that it has the right to request a daily mark for any cleared swap from the relevant derivatives clearing organization (DCO), and b) must provide each End User counterparty to an uncleared swap with a daily mark for the swap.
7. ***Clearing Notifications to End Users.*** A Swap Entity must notify an End User that it a) has the sole right to select the DCO at which a proposed swap subject to mandatory or voluntary clearing will be cleared, and b) also has the right to elect to clear a swap that is not subject to mandatory clearing.
8. ***Fair and Balanced Communications Requirement.*** A Swap Entity must communicate in a fair and balanced manner based on principles of good faith and fair dealing.
9. ***Requirement to Scrutinize Representatives for Special Entities.*** A Swap Entity that proposes to enter into a swap with a Special Entity other than an ERISA Plan must have a reasonable basis to believe that the Special Entity has a representative (who may be an employee) dealing on its behalf that has certain enumerated qualities.[3] A Swap Entity that proposes to enter into a swap with a Special Entity that is an ERISA Plan must have a reasonable basis to believe that the Special Entity has a representative that is a fiduciary for ERISA purposes. The Final Rules provide safe harbors with respect to both of these obligations whereby a Swap Entity can establish the necessary reasonable basis to proceed by obtaining representations from the End User and related parties.
10. ***Recommendations Made by Swap Dealers.*** A Swap Dealer, but not an MSP, that wants to make a recommendation to an End User may only do so if it a) understands the risks and rewards of the recommended swap or strategy involving a swap, and b) has a reasonable basis to believe that the recommendation is suitable for the End User. The Final Rules include a safe harbor in which a Swap Dealer may establish a reasonable basis that a recommendation is suitable for an End User through a combination of representations from the End User, the representative of the End User and itself. If the counterparty is a Special Entity and a Swap Dealer recommends a swap or swap strategy that is "tailored to the particular needs and characteristics of the Special Entity," the Swap Dealer must determine that the swap or swap strategy "is in the best interests of the Special Entity."
11. ***Prohibitions on Political Contributions.*** A Swap Dealer, but not an MSP, is prohibited from offering a swap to, or executing a swap with, a governmental Special Entity within two years after a prohibited type of monetary contribution was made to an official of such governmental Special Entity by the Swap Dealer or a covered associate.[3]
12. ***Requirement for Written Policies and Procedures.*** The Final Rules require each Swap Entity to have written policies and procedures reasonably designed to ensure compliance with the Final Rules and to prevent evasion of <u>any</u> provision of the CEA.

Surprisingly, for all their specificity the Final Rules do not provide any guidance on whether there are extraterritorial limits on the application of these requirements to transactions between a non-U.S. Swap Entity and a non-U.S. Person. Since the Final Rules have not been jointly adopted with the SEC, there are also concerns about whether the final SEC standards for business conduct rules will be consistent with the Final Rules.

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[3] This requirement does not apply if a transaction will take place on a Designated Contract Market (DCM) or Swap Execution Facility (SEF) (each as defined in the CEA) if the Swap Entity does not know the identity of its counterparty prior to execution.

Although the relevant drafting is far from clear, full implementation of the Final Rules will most likely be required on the later to occur of a) 180 days after the effective date of the Final Rules (which is 60 days after it is published in the *Federal Register*), or b) the date on which Swap Entities are required to be registered (which is the effective date of the last to be published of the swap product definitions and the swap entity definitions). The CFTC has not yet published the Final Rules, but assuming that they are published one day this month, compliance could be required as early as a corresponding date in October (240 days after publication). The Final Rules will not apply to any unexpired swaps entered into prior to the effective date unless they are amended in a material way after the effective date.

# III. ANALYSIS OF THE FINAL RULES

The Final Rules represent the first of seven separate rulemakings that together constitute new subpart H of Part 23 of the CFTC Rules, which set out the conduct of business compliance requirements applicable to Swap Entities.[4] Each of the key requirements in the Final Rules is discussed below (in the order in which they appear in the Executive Summary) along with practice points relating to that requirement.

## 1. Prohibition on Fraud, Manipulation and Other Abusive Practices

A. Comments

(i) The prohibitions imposed on Swap Entities by Section 240.410(a) of the Final Rules generally comport with the standards one would expect to apply in any commercial relationship, but the fact they are imposed only on Swap Entities and not on End Users in the context of the over-the-counter swap market represents a paradigm shift, since that market historically has operated on the premise that parties do not need to be protected from each other in a bilateral negotiation.

(ii) The three operative clauses of Section 23.410(a) (which are taken word for word from the statute) all express prohibitions on fraudulent conduct, but use different formulations of similar words to do so. It is consequently unclear how different conduct might be interpreted under each of the three different clauses. What is clear, however, is that clauses (a)(1) and (a)(2) apply to Special Entities only, while clause (a)(3) applies to any activity with any party, including another Swap Entity.

(iii) Section 23.410(b) provides an affirmative defense to alleged fraudulent conduct for a Swap Entity that does not act recklessly or intentionally and that complies in good faith with reasonably designed, written antifraud policies and procedures. Curiously, the affirmative defense applies only to violations of clauses (a)(2) and (a)(3).

B. Practice Notes

The affirmative defense provided depends on the Swap Entity having written policies and procedures that have been "reasonably designed to meet the particular requirement that is the basis of the alleged violation." This emphasis on particularity suggests that the affirmative defense may not be available if the written policies and procedures adopted by the Swap Entity simply repeat the general words of the statute and do not go further to prohibit specific types of fraudulent conduct.

## 2. Confidential Treatment of Counterparty Information

A. Comments

(i) The new confidentiality obligation imposed on Swap Entities by Section 23.410(c) of the Final Rules takes a subject generally left to commercial negotiation and turns it into an affirmative duty for Swap Entities. This provision could be interpreted to apply to conduct of a Swap Entity with regard to another Swap Entity, and not just conduct with regard to an End User.

(ii) The obligation only applies to information that is confidential and material and that is provided on behalf of a counterparty.

[4] The other six proposed rulemakings address, in the CFTC's words, "internal" conduct of business requirements for Swap Entities. See "Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants," 76 Fed. Reg. 6715 (Feb. 8, 2011); "Orderly Liquidation Termination Provision in Swap Trading Relationship Documentation for Swap Dealers and Major Swap Participants," 76 Fed. Reg. 6708 (Feb. 8, 2011); "Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants," 75 Fed. Reg. 81519 (Dec. 28, 2010); "Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants," 75 Fed. Reg. 71397 (Nov. 23, 2010); "Implementation of Conflicts of Interest Policies and Procedures by Swap Dealers and Major Swap Participants," 75 Fed. Reg. 71391 (Nov. 23, 2010); and "Designation of a Chief Compliance Officer; Required Compliance Policies; and Annual Report of a Futures Commission Merchant, Swap Dealer, or Major Swap Participant," 75 Fed. Reg. 70881 (Nov. 19, 2010).

B. Practice Notes

Although the Final Rules do not explicitly create a safe harbor for Swap Entities with respect to treatment of confidential information, one can be created de facto by the inclusion of a broad grant of reasonable disclosure authority in each master agreement.

## 3. Know-Your-Counterparty and Counterparty Verification Requirements

A. Comments

(i) Section 23.430 of the Final Rules represents an improvement over the Proposed Rules in that it includes an express safe harbor permitting Swap Entities to rely on a written representation to verify that a counterparty is an ECP or Special Entity, provided that the representation specifies the particular provision in the relevant definition that applies to the counterparty, and provided further that the Swap Entity does not possess information that would cause a reasonable person to question the accuracy of the representation.

(ii) There is an exemption from the know-your-counterparty (KYC) due diligence and verification requirements for swaps entered into anonymously on a DCM or SEF, but the exemption does not apply to transactions on such facilities when the Swap Entity knows the identity of its counterparty prior to execution.

B. Practice Notes

(i) Because these KYC and status verification requirements apply to non-anonymous trades executed on a DCM or SEF, Swap Entities will have to give considerable thought as to how such requirements can be met in the context of such trades. The need for a way to address this issue will become acute once certain swaps become subject to mandatory execution on SEFs and DCMs.

(ii) The Final Rules allow an employee benefit plan defined in Section 3 of the Employee Retirement Security Act of 1974 (ERISA) that is not otherwise a Special Entity to elect to become a Special Entity. This election would seem to cover certain entities that are neither ERISA plans nor governmental plans. (Examples of such entities are church plans, foreign plans and arrangements to comply with state workers compensation, unemployment or disability insurance laws.) The Final Rules also impose a new obligation on Swap Entities to a) determine whether a counterparty is such an entity, and b) notify such counterparty of its right elect to become a Special Entity. Swap Entities may therefore wish to obtain a representation from any plan counterparty that is not an entity entitled to elect to become Special Entity. If the representation is given, no further action is required; if the counterparty says the representation is incorrect, the Swap Entity can then give notice to the counterparty of its election right.

## 4. Disclosure of Material Transaction Information (Including the Price of a Swap)

A. Comments

(i) In the preamble to the Final Rules (Preamble), the CFTC expressed its expectation that the required disclosures must a) enable a counterparty to assess its potential exposure; b) identify "material factors" that identify the day-to-day changes in valuation or that might lead to significant losses; c) consider the effect of future economic factors and other material events; and d) identify the sensitivities of the swap to the above factors/conditions as well as the approximate gains/losses the swap may experience.

(ii) The Final Rules have been modified slightly to clarify that a Swap Entity's disclosure of material information applicable to multiple swaps may be made in "counterparty relationship documentation," which would include an ISDA Master Agreement. However, although standardized disclosure may be appropriate for certain swaps, the CFTC stated in the Preamble that, where appropriate, tailored disclosure must be provided to counterparties in a timely manner.

(iii) These broad disclosure requirements appear to be modeled on the levels of disclosure required in connection with public offerings of securities, which is not a useful reference point for the swaps market filled with sophisticated counterparties that are ECPs.

(iv) The CFTC relied on the plain language of the CEA to state that there is no exemption from conflicts of interest disclosures even when counterparties may be aware of or expect certain common business practices. In addition, the CFTC confirmed that *all* conflicts of interest must be disclosed, including the receipt by the Swap Entity of any incentive payments received from DCOs, DCMs or SEFs.

B. Practice Notes

(i) Compliance with the "price" disclosure requirement will be challenging, since many common forms of swap (such as a fixed-floating interest rate swap) do not have an explicit "price" that can be reported (as is the case with a futures contract or security). Consultation with the CFTC may be necessary to develop an acceptable compliance approach in this regard.

(ii) The required delivery "prior to execution of a swap" of a mid-market mark for the swap (as set forth in Section 23431(d)(2)) will be challenging because the terms of the unexecuted swap will, by definition, not yet be entered into the book and records of the Swap Entity. The mark will accordingly have to be generated through a process that is outside the ordinary course of business and will most likely require a Swap Entity to create pre-trade links between the Swap Entity front office and the internal valuation group that will provide such marks after the swap is executed.

(iii) Swap Entities should scrub their existing disclosure templates provided to counterparties and update as necessary to meet the requirements of the Final Rules.

(iv) Swap Entities will be required to establish and implement robust policies and procedures in order to determine when and how standardized and/or particularized disclosures are made to counterparties, as well as the extent of the detail of such disclosure. Such policies and procedures should be drafted to ensure that all disclosure materials provided to a counterparty are consistent, as any disagreements between information provided across multiple disclosure documents could serve as a predicate to litigation by a counterparty for material inaccuracies in disclosure.

## 5. Scenario Analysis Requirement for Swap Dealers

A. Comments

(i) The Final Rules have significantly narrowed the scope of the proposed scenario analysis requirement by 1) exempting MSPs, and 2) making the requirement applicable only upon a request from an End User. In addition, scenario analysis disclosure now applies only to swaps that are not "made available for trading" within the meaning of Section 2(h)(7) of the CEA.

(ii) The inclusion of the scenario analysis disclosure requirement in the Final Rules has taken an industry best practice (epitomized by recommendations from the Counterparty Risk Management Policy Group[5]) and transformed it into a federal law subject to CFTC oversight and potential private litigation risk.

(iii) The obligations imposed on Swap Dealers to consult with an End User on the design of a requested scenario analysis and to disclose all material assumptions as well as explaining the relevant calculation methodologies will likely complicate the execution of time-sensitive trades.

B. Practice Notes

(i) Swap Dealers will have to determine how much consultation with an End User is sufficient to satisfy their scenario analysis design consultation obligation. Defensive drafting may be necessary to disclaim liability if a counterparty a) requests a scenario analysis but declines to participate in any consultation, or b) participates in the design consultation but subsequently takes issue with the resulting scenario analysis.

(ii) As with the KYC and counterparty verification requirements discussed above, Swap Dealers will need to work with DCMs and SEFs to meet the challenge of incorporating the scenario analysis notification and delivery requirements into non-anonymous trading systems.

(iii) The CFTC confirmed in the Preamble that a Swap Dealer may outsource the provision of scenario analyses to appropriately qualified third parties, though the Swap Dealer remains responsible for compliance with the Final Rules.

(iv) The development of standard templates for scenario analyses through industry working groups composed of Dealers and End Users should contribute considerably to the reduction of the burden of meeting this requirement.

[5] The Counterparty Risk Management Policy Group is composed of OTC derivatives dealers including Bank of America, BNP Paribas, Citigroup, Goldman Sachs, HSBC, JP Morgan and Morgan Stanley.

## 6. Delivery of Daily Marks

A. Comments

(i) The requirement that a Swap Entity must notify an End User of its right to obtain a daily mark from a relevant DCO does not explain how that right may be exercised by the End User.

(ii) Swap Entities must provide an individual daily mid-market mark for each uncleared swap entered into with an End User. An End User may agree to receive additional disclosures (e.g., a mid-market mark on a portfolio basis). However, all such disclosures are in addition to, and not a replacement for, the required disclosure of individual mid-market marks.

(iii) The Final Rules permit disclosure of the mid-market mark of an uncleared swap on a password-protected website or through an appropriately qualified third party service provider.

B. Practice Notes

(i) Swap Entities may be able to limit their potential liability under Rule 23.431(d) on the basis of good faith compliance with reasonably designed policies and procedures. Accordingly, Swap Entities should verify that their policies and operational arrangements are sufficient to ensure that daily marks can be sent in a secure, timely and auditable manner.

(ii) Any Swap Entity that does not already have an internal valuation group that prepares and distributes marks to counterparties will have to form one.

## 7. Clearing Notifications to End Users

A. Comments

(i) The Final Rules provide no guidance for when an End User elects to clear a swap at a DCO of which the Swap Entity is not a member.

(ii) An End User's "right" to elect to clear an uncleared swap is not subject to an explicit time limit as to when the election can be made. This raises the possibility that an End User could attempt to make such an election at any time during the life of such a swap, which could have consequences for netting arrangements and could lead to "cherry-picking" by End Users in times of market stress.

B. Practice Notes

Counterparty documentation with End Users should be appropriately drafted to anticipate circumstances where an End User wishes to clear a swap at a DCO for which the Swap Entity has no clearing relationships. The drafting should also clarify that the End User's right to elect clearing for an uncleared swap applies only prior to entry into the swap.

## 8. Fair and Balanced Communications Requirement

A. Comments

(i) In construing the extent of the obligations imposed on Swap Entities under Rule 23.433, the CFTC notes in the Preamble that all of a Swap Entity's communications must a) provide a sound basis for evaluating the facts with respect to any swap; b) avoid making exaggerated or unwarranted claims, opinions or forecasts; and c) balance any statement that refers to the potential opportunities or advantages presented by a swap with statements of corresponding risks.

(ii) The imposition of this "fair dealing" provision on some but not all swap market participants is inconsistent with the traditional view that the swaps markets are comprised of sophisticated persons and institutions that enter into bilateral agreements on the basis of arm's-length negotiations.

(iii) The standard that a given communication must be made in a fair and balanced manner based on principles of fair dealing and good faith is highly subjective and not easily translated into concrete guidance for purposes of creating a rigorous compliance program.

B. Practice Notes

Training of front-office staff in the dos and don'ts of proper communications will be critical to ensuring that these standards are met.

## 9. Requirement to Scrutinize Representatives for Special Entities

A. Comments

(i) Both the rule and the related safe harbor in Section 23.450 of the Final Rules for Swap Entities dealing with an ERISA plan as a swap counterparty are straightforward and easy to implement.

(ii) On the other hand, neither the rule nor the related safe harbor for dealing with a Special Entity other than an ERISA plan as a swap counterparty is easy to implement. A Swap Entity would need to engage in such extensive and invasive information-gathering to form a reasonable basis for believing that the Special Entity's representative has all the qualifications required by the Final Rules that doing business other than in reliance on the safe harbor would be commercially burdensome for the Swap Entity, but the availability of the safe harbor depends on the Special Entity and its representative taking novel burdens on themselves. In particular, in order for a Swap Entity to meet the safe harbor in Rule 23.450(d)(1), both the Special Entity and its representative must represent, among other things, that each has implemented and complies with certain written policies and procedures designed to ensure that the representative meets the appropriate criteria. With respect to the independence test, the representative must further represent that it has adopted and complies with policies and procedures relating to managing and mitigating conflicts of interest.

(iii) The application of the rule and the safe harbor for non-ERISA Special Entities becomes even more complicated if the representative is an employee of the Special Entity rather than a business organization providing advisory services for a fee.

(iv) This is another requirement that is inapplicable for anonymous transactions on a DCM or SEF, but which does apply when the Swap Entity will know the identity of its counterparty prior to execution.

B. Practice Notes

(i) Resolving the issues raised by the requirement imposed on Swap Entities to scrutinize the representatives of Special Entity counterparties may require discussion among industry groups as well as between bilateral counterparties.

(ii) Absent the use of a safe harbor, the Swap Entity's CCO should make the final decision on the qualifications of a Special Entity's representative so the decision will be impartial and insulated from commercial pressures. Any determination regarding a Special Entity's representative should be memorialized in sufficient detail to survive any challenge by the Special Entity, its representative or the CFTC.

(iii) A Swap Entity will have an extremely awkward client relationship problem if it ever concludes that a Special Entity counterparty does not have an appropriately qualified representative.

## 10. Recommendations Made by Swap Dealers

A. Comments

(i) Under Section 23.434, any recommendation regarding a swap or trading strategy involving a swap that is made by a Swap Dealer to an End User triggers an obligation to determine the suitability of the recommendation for the End User. (The Final Rule does not provide an exact definition of the term "recommendation," but instead includes guidance in an appendix which states that a recommendation occurs whenever a communication could reasonably be viewed as a "call to action" to enter into a swap.) A Swap Dealer can discharge this obligation with respect to the End User by making certain written disclosures and by obtaining representations from the End User and/or its representative. This safe harbor is reasonably easy to use for an End User that is not a Special Entity, but is so complicated to use for a Special Entity that the availability of the safe harbor in that context might be considered more theoretical than real.[6]

(ii) A recommendation made by a Swap Dealer to a Special Entity "that is tailored to the specific needs or characteristics of the Special Entity" will cause the Swap Dealer to be "acting as an advisor" to the Special Entity for purposes of Section 23.440 and trigger a further obligation for the Swap Dealer to determine that the swap or swap strategy "is in the best interests of the Special Entity." There is also a stated safe harbor for satisfying this requirement, but it involves the same complexities as the other safe harbor and so it, too, is relatively unavailable as a practical matter.

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[6] For instance, the safe harbor is not available if the Swap Dealer has expressed "an opinion as to whether the Special Entity should enter into a recommended swap," which seems likely to have been the case given that a recommendation is a "call to action" in the first place.

B. Practice Notes

(i) Given the burdens that flow from making recommendations and the difficulties involved in using the relevant safe harbors, a Swap Dealer should seek to avoid making recommendations of any sort to counterparties. This avoidance may not be too difficult to achieve given that it is standard practice in the OTC derivatives market for each counterparty to agree in its master documentation that it is "not relying on any communication (written or oral) from the other party as a... recommendation to enter into" a swap. This language is consistent with the best practices recorded in the Principles and Practices for Wholesale Financial Markets Transactions published in 1995, which put market participants on notice that they should ignore communications from counterparties even if they might seem to be recommendations unless there is a solid basis for believing that a truly disinterested recommendation is being made.[7]

(ii) Although Appendix 2 to the Final Rules includes statements to the effect that the existing "non-reliance" representation, without more, in an ISDA Master Agreement may not be sufficient in all cases to prevent a finding that a "recommendation" has been made, market participants may all benefit from finding ways to enhance the existing "non-reliance" language to establish a de facto safe harbor from all the conduct of business requirements deriving from the making of a "recommendation."

(iii) Since written representations may not be sufficient to protect a Swap Dealer if one of its employees intentionally makes an overt recommendation to an End User or Special Entity counterparty, Swap Dealers should complement the written representations in their counterparty relationship documentation with sufficient training to ensure that their sales and trading staff avoid such behavior.

## 11. Prohibitions on Political Contributions

A. Comments

(i) In addition to several other prohibitions on campaign contributions, Swap Entities and their covered associates are prohibited from pooling campaign contributions from political action committees and individuals (also known as "bundling").

(ii) This is another requirement that is inapplicable for anonymous transactions on a DCM or SEF, but which does apply when the Swap Entity will know the identity of its counterparty prior to execution.

B. Practice Notes

(i) Compliance with these provisions relies more heavily on education and training of a Swap Entity's "covered associates," as the rule restricts their private, rather than professional, conduct. Swap Entities must ensure that their covered associates report all political contributions subject to the rule.

(ii) Depending on the nature of its business with governmental Special Entities, a Swap Entity may wish to consider prohibiting its covered associates from making any political contributions.

## 12. Requirement for Written Policies and Procedures

A. Comments

(i) Swap Entities are explicitly required to implement written policies and procedures designed to protect the confidentiality of material confidential information provided by or on behalf of a counterparty.

(ii) The Final Rules provide no guidance as to the difference between "policies" and "procedures." Swap Entities may want to comply with the Final Rules using fewer policies, which are statements regarding mandatory or prohibited behavior formally adopted by the Swap Entity that must be observed under threat of dismissal or other disciplinary action, and more procedures, which are operating rules adopted by the Swap Entity to promote the efficient conduct of business.

[7] "A Participant may communicate to its counterparty economic or market information relating to Transactions and trade or hedging ideas or suggestions. All such communications (whether written or oral) should be accurate and not intentionally misleading. Absent a written agreement or an applicable law, rule or regulation that expressly imposes affirmative obligations to the contrary, a counterparty receiving such communications should assume that the Participant is acting at arm's length for its own account and that such communications are not recommendations or investment advice on which the counterparty may rely." Available at: http://www.sifma.org/services/stdforms/wholesaleFinMkt.html.

B. Practice Notes

(i) A Swap Entity may not be able to meet the standards set out in the Final Rules by using an off-the-shelf, generic set of policies and procedures, because such policies and procedures must be "reasonably designed" or adapted to fit the specific circumstances of the Swap Entity.

(ii) Written policies and procedures must be implemented with sufficient training for affected employees to promote compliance.

# IV. OTHER NOTEWORTHY POINTS

In addition to the key requirements discussed above, the Final Rules include certain other noteworthy points, which are highlighted below.

## 1. Carveout for Certain Inter-Affiliate Transactions

Although the Final Rules themselves are silent on this point, the Preamble contains a statement by the CFTC that the counterparty conduct of business standards do not apply in respect of swaps entered into between Swap Entities and their affiliates that would not be "publicly-reportable swap transactions" as defined in the CFTC's new Part 43 Rules applicable to real-time reporting of swaps.[8] Following this cross-reference through to the Preamble to Part 43 (but not to anything in Part 43 itself) reveals that a Swap is not publicly reportable if it is not negotiated on an arm's-length basis. This oblique statement by the CFTC will give comfort with respect to many inter-affiliate Swaps, but banks in particular may still have issues because Section 23B of the Federal Reserve Act requires that any Swap between a bank and a non-bank affiliate must be on terms at least as favorable as those for transactions with third parties. It may be necessary to seek guidance as to whether a Swap that complies with Section 23B is negotiated at "arm's-length" for these purposes.

## 2. Swap Dealer and MSP Categories

Although the Dodd-Frank Act contemplates that an entity can be a Swap Entity with respect to a particular category of Swaps without being a Swap Entity with respect to all of its Swap business, the Final Rules do not explicitly operate in a way that is consistent with that concept. Absent clarification from the CFTC, a Swap Entity may have to follow the Final Rules for all of its Swaps even if it is registered only with respect to a particular category of Swaps.

## 3. Foreign Exchange Forwards and Swaps

Notwithstanding any determination by the Secretary of the Treasury to exempt foreign exchange swaps and forwards from the definition of "swap," Swap Entities must apply the provisions of the Final Rules to such transactions.[9]

## 4. ERISA Issues

The Proposed Rules attracted widespread criticism on the basis that complying with certain requirements—including provision of pricing and daily marks—could lead a Swap Entity to be deemed to be a fiduciary with respect to an ERISA Plan counterparty, in which case any Swap between the parties might be a non-exempt prohibited transaction. To address these concerns, the CFTC solicited a letter from the Department of Labor that is attached to the Final Rules as an Appendix and which expresses the conclusion that compliance with the Final Rules does not require Swap Dealers or MSPs to engage in activities that would make them fiduciaries under the Department of Labor's current five-part test defining fiduciary advice.[10] This is a helpful document, but it does not address a related troublesome point in the Final Rules, namely the position taken by the CFTC that a single targeted recommendation is sufficient to cause a Swap Dealer to be considered to be "acting as an advisor" to a Special Entity. If the Department of Labor were to agree with that view, such a recommendation could also turn a Swap with an ERISA Plan into a non-exempt prohibited transaction.

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[8] See "Real-Time Public Reporting of Swap Transaction Data," 77. Fed. Reg. 1182 (Jan. 9, 2012).

[9] See Section 1a(47)(E) of the CEA, as added by the Dodd-Frank Act.

[10] The letter is available at: http://www.cftc.gov/PressRoom/Events/ssLINK/ebsalettero11712.pdf.

## 5. Clarification of Swap Entities Acting as Advisers

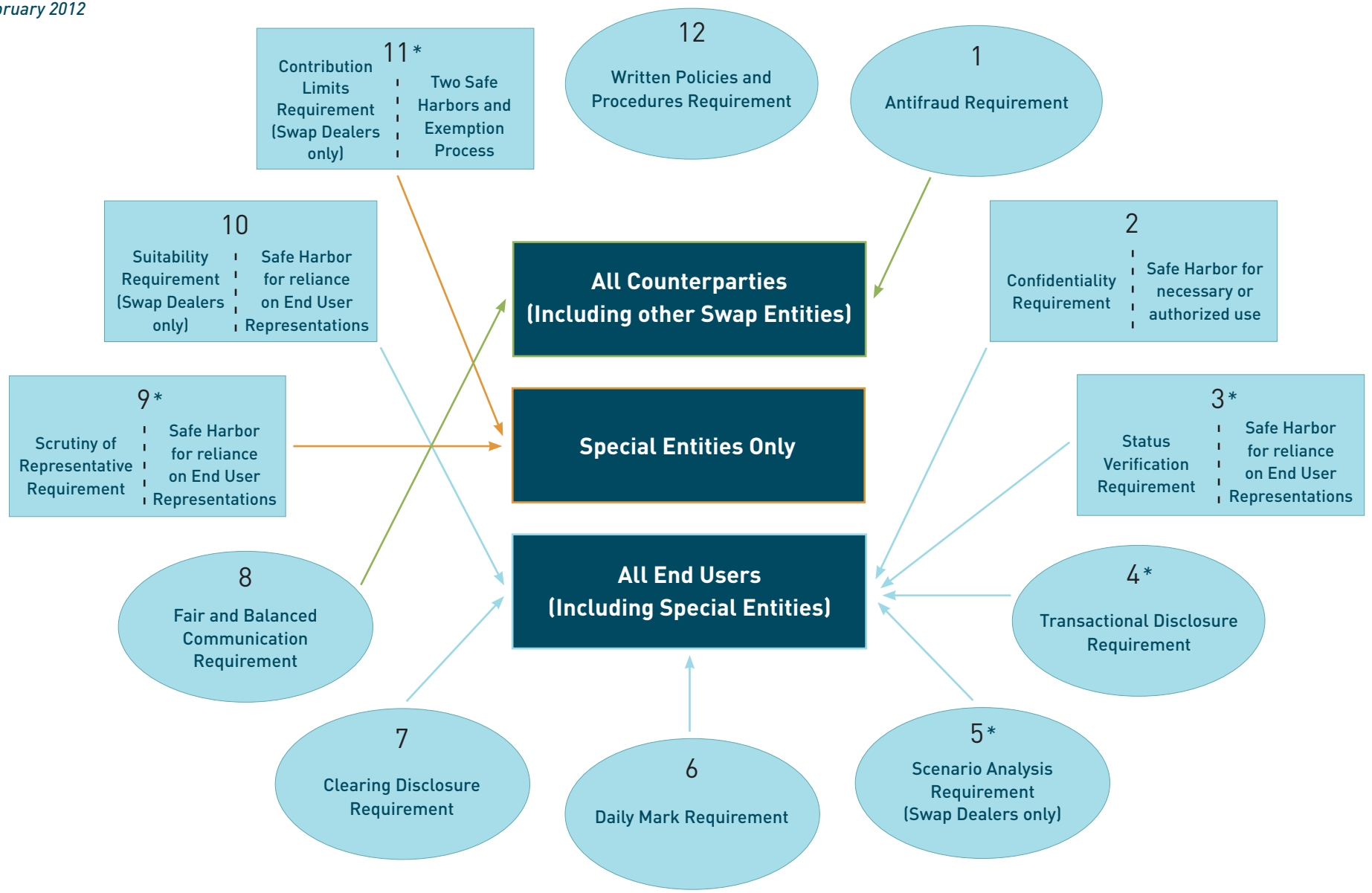
Even though the Final Rules describe a number of situations in which a Swap Dealer will be considered to be an advisor to its counterparty, they add an exclusion from the definition of CTA in CFTC Rule 4.6 for those Swap Dealers that are registered (or exempt from registration) under the CFTC rules and whose swap advisory activities are "solely incidental" to their business as a swap dealer.

## 6. Application of the Final Rules to Offers, Not Just Executed Swaps

Certain provisions of the Final Rules—such as the requirement to verify that the counterparty is an ECP and a Special Entity—must be met expressly by their terms prior to a Swap Entity "offering" to enter into a swap. The CFTC in the Preamble confirmed its interpretation that the term "offer" means an offer that, if accepted, would form a binding contract. Accordingly, a Swap Entity must ensure that all counterparty business conduct requirements required to be met prior to offering to enter into a swap are met prior to sending a term sheet to a potential End User counterparty, even if a trade is ultimately not entered into. Disclosure under the Final Rules must also be made "at a reasonable time prior to entry into a swap," which could, depending on the facts and circumstances, require that such disclosures be made contemporaneously with the provision of a term sheet or other indicia of an "offer" to enter into a swap. The antifraud, anti-manipulation and fair dealing requirements of the Final Rules apply in connection with all aspects of a Swap Entity's swaps business and hence would apply to any pre-offer communications between a Swap Entity and a potential End User counterparty.

# CFTC Dodd-Frank Business Conduct Requirements for Swap Dealers and Major Swap Participants

*February 2012*




** This requirement does not apply to transactions executed on a DCM or SEF where the Swap Entity does not know the identity of its counterparty prior to execution.*