January 27, 2012

# CFTC Adopts Business Conduct Rule for Swap Dealers

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The CFTC recently finalized a Business Conduct Rule that establishes the standards that swap dealers ("**SDs**") and major swap participants ("**MSPs**") must follow in their dealings with counterparties. Interestingly, the CFTC has provided significant distinctions between the duties of SDs on one hand, and MSPs on the other, for the first time, reflecting the different roles these entities play in swap markets. At its broadest level, the Business Conduct Rule prohibits SDs/MSPs from engaging in fraud, deception or manipulation and requires SDs/MSPs to communicate with counterparties in a fair and balanced manner based on principles of good faith and fair dealing. In addition, the rule sets forth specific obligations for dealings with all counterparties, "Non-Swap Entities" (as defined below) and U.S. government entities, ERISA plans and other "Special Entities" (as defined below).

The earliest that SDs and MSPs will have to comply with the Business Conduct Rule is approximately eight months following the rule's publication in the Federal Register.

## Interactions with All Counterparties

The Business Conduct Rule imposes several types of obligations on SDs/MSPs with respect to their interactions with all counterparties, whether other dealers or end users.[1]

### General Antifraud Rule

The Business Conduct Rule contains a general provision against fraud, manipulation and deception by SDs/MSPs. The antifraud provision is based on a strict liability standard, but the rule makes available an affirmative defense against allegations of fraudulent, deceptive or manipulative activities if an SD/MSP can establish that it did not act intentionally or recklessly and complied in good faith with written policies and procedures reasonably designed to meet the particular requirements that are the bases for the alleged violation.

In addition, the CFTC did not adopt its proposed "trading ahead" and front-running prohibitions, nor did it adopt the standards it proposed for swap execution, which would have required SDs and other CFTC registrants

[1] The Business Conduct Rule does not apply to those swaps that are entered into with affiliates that would not be considered "publicly reportable swap transaction" under the CFTC's recently adopted real-time reporting rule.

executing swaps on a designated contract market ("DCM") or swap execution facility ("SEF") to execute a swap on terms that have a reasonable relationship to the best terms available.

## Verification of a Counterparty's Identity and Legal Status

SDs/MSPs must confirm the identity and legal status of potential counterparties. Specifically, SDs/MSPs must have a written record that documents the true name and address of each counterparty whose identity is known to the SD/MSP at any time prior to execution and the principal occupation or business of such counterparty, as well as the name and address of any other person guaranteeing the performance of such counterparty and any persons that control the counterparty's positions. In addition, before entering into or offering to enter into any swap agreement an SD/MSP must verify whether the counterparty is an eligible contract participant ("**ECP**") or is a Special Entity (as defined in the sidebar).[2] However, an SD/MSP may rely on representations from the counterparty specifically identifying itself as an ECP or Special Entity.

SDs, but not MSPs, are required to implement "know your counterparty" policies and procedures that are designed to obtain essential facts about a counterparty whose identity is known to the SD prior to execution, including, for example, facts required to implement the SD's credit and operational risk management policies and information regarding the authority of persons acting on behalf of the counterparty.

An SD/MSP may satisfy these and other diligence obligations through reasonable reliance upon a counterparty's representations, as discussed in the sidebar on the next page.

## Confidential Treatment of Counterparty Information

SDs/MSPs are prohibited from disclosing any material confidential information provided by a counterparty and from using such information for their own purposes in a way that would be materially adverse to that counterparty's interests. More particularly, in the absence of a counterparty's written authorization, SDs/MSPs may only disclose or use material confidential information to the extent that such disclosure or use is needed for the effective execution of a swap, to hedge exposure created by such a swap or to comply with legal requirements to disclose such information. SDs/MSPs must implement written policies and procedures to protect confidential information from disclosure and improper use, including information barriers and restrictions on access to confidential counterparty information.

### Categories of Special Entities

The CFTC defines Special Entity as:

- a federal agency;
- 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;
- any employee benefit plan subject to Title I of ERISA;
- any governmental plan, as defined in Section 3 of ERISA; or
- any endowment, including an organization described in Internal Revenue Code Section 501(c)(3) endowment, but only where the endowment itself is a counterparty.

In addition, any employee benefit plan "defined in" Section 3 of ERISA but not "subject to" ERISA or otherwise defined as a Special Entity, e.g., certain church plans, may *elect* to be a Special Entity by notifying an SD/MSP of its election prior to entering into a swap with the particular SD/MSP.

The "federal agency" category will be a narrow one, because the definition of "swap" under CEA Section 1a(47) already excludes any transaction where the counterparty is the federal government, a Federal Reserve bank or a federal agency backed by the full faith and credit of the United States.

A collective investment vehicle with Special Entity participants would not itself be a Special Entity.

[2] In the case of an employee benefit plan as defined in Section 3 of ERISA, but that does not otherwise fall within the definition of "Special Entity," an SD must verify whether the counterparty elects to be a Special Entity before offering to enter into a swap. Importantly, the requirement to verify counterparty eligibility does not apply to (a) a transaction initiated on a DCM or (b) a transaction initiated on a SEF where the SD/MSP does not know the identity of the counterparty prior to execution.

**Reliance on Counterparty Representations**

An SD/MSP may generally rely on a counterparty's written representations to satisfy the various diligence requirements of the rule. The representations may be in relationship documentation that covers multiple swaps with the same counterparty. If such documentation is to serve as the basis of an SD's/MSP's required diligence, a counterparty must update it in a timely manner to reflect any material changes to the information in the representations to ensure they remain appropriate for the requirement they are meant to fulfill. The CFTC believes a best practice would be to review representations at least annually as part of the separately proposed requirement that an SD/MSP chief compliance officer conduct an annual compliance review.

Reliance on representations must be reasonable. An SD/MSP cannot ignore red flags in a representation that would cause a reasonable person to question the representation's accuracy.

## Interactions with Non-Swap Entities

The Business Conduct Rule also imposes specific, heighted obligations on SDs/MSPs that apply in the context of their interactions with those counterparties that are not SDs, MSPs, security-based swap dealers ("**SBSDs**") or major security-based swap participants ("**MSBSPs**") ("**Non-Swap Entities**").

### Disclosures and Notifications

For many swaps,[3] SDs/MSPs must disclose to a counterparty that is a Non-Swap Entity:

- the material risks of the swap;
- the material characteristics of the swap; and
- the SD's/MSP's material incentives and conflicts of interest with respect to the swap.

In all cases, an SD/MSP must facilitate the Non-Swap Entity counterparty's access to a swap's daily mark. Specifically:

- for a cleared swap with a Non-Swap Entity, an SD/MSP must notify the counterparty of its right to receive the swap's daily mark from the derivatives clearing organization ("**DCO**"); and
- for an uncleared swap with a Non-Swap Entity, an SD/MSP must provide the counterparty with the swap's daily mark and the methodologies and assumptions used in calculating the mark, along with specified disclaimers.

An SD/MSP must also inform a Non-Swap Entity counterparty of its rights with respect to clearing decisions. In particular:

- for a swap with a Non-Swap Entity subject to mandatory clearing, an SD/MSP must:
  - notify the counterparty of its right to select the DCO; and
- for a swap with a Non-Swap Entity not subject to mandatory clearing, an SD/MSP must:
  - notify the counterparty of its right to require clearing and to select the DCO.

### Scenario Analyses

SDs must offer to provide Non-Swap Entity counterparties with a scenario analysis prior to entering into a swap not made available for trading by a

[3] These requirements do not apply to a transaction that is both (a) initiated on a SEF or DCM and (b) one in which the SD/MSP does not know the identity of the counterparty prior to the execution.

**How to Make Required Disclosures**

An SD/MSP may generally make any required disclosure by any reliable means agreed to in writing by a counterparty, including in the standard counterparty relationship documentation that applies to multiple swaps with a single counterparty.

However, the CFTC notes that standardized disclosure may not always be adequate, depending on the complexity of a transaction, the degree and nature of any leverage, the potential for periods of significant reduced liquidity, and the lack of price transparency. Furthermore, an SD's/MSP's disclosures regarding the material risks of a swap, the material characteristics of a swap and its own material incentives and conflicts of interest must be made in a manner reasonably designed to allow the counterparty to assess that information.

SEF or DCM.[4] If the counterparty accepts the offer, the SD must include in the scenario analysis any analyses it conducts for its own risk management purposes.

The rule does not expressly allow or prohibit charging a counterparty for a scenario analysis, but the CFTC notes its understanding that current industry practice is to provide such analysis, if requested, without an additional charge. The final rule is less burdensome on SDs than was the CFTC's proposed rule, because the proposed rule would have required SDs to provide scenario analyses to counterparties to *any* high-risk complex bilateral swap, and would also have allowed other counterparties to elect to receive such analyses even for swaps that are not high-risk. The SEC has not proposed scenario analysis requirements for SBSDs but noted that scenario analysis could be one way that SBSDs fulfill their obligation to disclose material information and has requested comment on whether it should require scenario analyses.

These requirements, when viewed together with the prohibition on fraudulent, deceptive or manipulative acts and the Business Conduct Rule's requirement that SDs communicate in a fair and balanced manner based on principles of fair dealing and good faith, effectively introduce into the over-the-counter swap market broad new disclosure requirements and potential liabilities. One potential limit on this liability, however, may be in the CFTC's suggestion that material disclosure will not generally require disclosure regarding a swap's underlying assets if sufficient information is publicly available.

## Suitability of Recommendations

Whenever an SD recommends a swap or trading strategy to a Non-Swap Entity, the SD must:

- undertake reasonable diligence to understand the potential risks and rewards of the swap; and
- have a reasonable basis to believe that the recommendation is suitable for the counterparty based on the counterparty's investment profile, trading objectives and ability to absorb potential losses.

The CFTC has not provided a bright-line test for what constitutes a recommendation. In general, the CFTC appears to adopt FINRA's approach that a recommendation is a communication that a counterparty would reasonably consider a "call to action" or a suggestion to enter into a swap. The CFTC notes, for example, that a flip book or pitch book that sets out a customized transaction tailored to the needs or characteristics of a specific counterparty would likely be a recommendation, whereas general marketing materials might not.

[4] The CFTC staff is holding a public roundtable on January 30, 2012 to discuss the proposed regulations to implement the "available to trade" provision of the CEA Section 2(h)(8) trade execution requirement.

While the rule does not specify what an SD must do to establish that it has undertaken reasonable diligence to understand a swap's risks and rewards, it does provide SDs with a safe harbor with respect to their obligations to establish that a recommendation is suitable for a specific counterparty.

To fit within the safe harbor:

- the SD must reasonably determine that the counterparty — or an agent to whom the counterparty has delegated decision making authority — is capable of independently evaluating investment risks with regard to the recommended swap or trading strategy (the SD may rely upon a specified representation from a Non-Swap Entity to satisfy this requirement);
- the counterparty or its agent must provide a written representation that it is exercising independent judgment; and
- the SD must give written notice that it is acting as a counterparty and is not undertaking to assess the suitability of the swap or trading strategy involving the swap for the counterparty.

In addition, to use the safe harbor in the context of dealing with a counterparty that is a Special Entity, the SD must comply with the Special Entity safe harbor described below and, if it is acting as an advisor to the Special Entity, the SD must comply with the aspects of the Business Conduct Rules governing Special Entity advisory activities. Similarly to the SEC's proposal, these suitability requirements apply only to SDs, and not to MSPs.

In response to concerns expressed by commenters about the implications under the CFTC's proposed rule of SDs being treated as commodity trading advisors ("**CTAs**") by virtue of providing incidental swap recommendations to counterparties, the CFTC has amended its rules to exclude from the CTA definition SDs whose advisory activities are solely incidental to their business as SDs.

## Interactions with Special Entities

The Business Conduct Rule imposes additional requirements on SDs/MSPs when they are dealing with Special Entities.

### SDs/MSPs Acting as Counterparties to Special Entities[5]

#### *Special Entity Representatives*

SDs/MSPs who enter or offer to enter into a swap with a Special Entity (other than a Special Entity that is an employee benefit plan subject to Title

[5] These requirements do not apply to a transaction that is both (a) initiated on a SEF or DCM and (b) one in which the SD/MSP does not know the identity of the counterparty prior to the execution.

**Determining Whether a Representative is Independent**

A representative will be deemed to be independent of the SD/MSP if:

- the representative was not an associated person of the SD/MSP within one year of representing the Special Entity in connection with the swap;
- there is no principal relationship between the representative and the SD/MSP;
- the representative discloses to the Special Entity all material conflicts of interest that could reasonably affect the judgment of the representative with respect to its duties to the Special Entity, and complies with policies and procedures designed to manage and mitigate such material conflicts of interest;
- there is no common control between the representative and the SD/MSP; and
- the SD/MSP has not referred or recommended the representative to the Special Entity within one year of the representation.

I of ERISA) must have a reasonable basis to believe that the Special Entity has a representative that:

- is sufficiently knowledgeable to evaluate the transaction and its risks;
- is not subject to statutory disqualification;
- is "independent" of the SD/MSP (as discussed in the sidebar);
- acts in the "best interests" of the Special Entity;
- makes appropriate and timely disclosures to the Special Entity;
- evaluates, consistent with any guidelines provided by the Special Entity, the fair pricing and appropriateness of the swap; and
- in the case of a governmental Special Entity, is subject to restrictions on certain political contributions to public officials of the governmental Special Entity, unless the representative is an employee of the counterparty.

When entering into, or offering to enter into, a swap with a Special Entity that is a Title I ERISA plan, an SD/MSP must have a reasonable basis to believe that the plan has a representative that is an ERISA fiduciary.

The CFTC also adopted a significant safe harbor, under which an SD/MSP will be deemed to have a reasonable basis to believe that a Special Entity has a qualified representative if:

- in the context of an ERISA plan counterparty, the ERISA plan represents in writing that its representative is an ERISA fiduciary, and provides the representative's name and contact information; and
- in the context of all other Special Entity counterparties,
  - the Special Entity represents in writing that, among other things, it complied in good faith with policies and procedures to select a qualified independent representative; and
  - the representative represents in writing that it (a) has policies and procedures designed to ensure that it satisfies the applicable criteria; (b) meets the independence test; and (c) is legally obligated to comply with the applicable duties to the Special Entity.

The final rule provides that when an SD/MSP does not believe it has a reasonable basis to believe the representative meets the criteria, it must make a written record of its initial determination for its chief compliance officer ("**CCO**") to review. The CCO must ensure that there is a substantial, unbiased basis for the determination. An SD/MSP must retain and make available to the CFTC these and all other compliance records.

### *Disclosures*

Prior to entering into a swap transaction with a Special Entity, an SD/MSP must disclose to the Special Entity in writing the capacity in which it is

acting in connection with the swap and, if it engages in business with the Special Entity in more than one capacity, the material differences between the capacities.

Similarly, while an SD could serve as both an advisor (as described below) and a counterparty to a Special Entity, it would have to comply with both sets of relevant regulatory requirements.

## SDs Acting as Advisors to Special Entities

An SD that acts as an advisor to a Special Entity must make a reasonable determination that any swap or trading strategy it recommends is in the Special Entity's best interests.

### *Acting as an Advisor to a Special Entity*

An SD acts as an advisor to a Special Entity when it makes a recommendation of a swap or trading strategy that is tailored to the particular needs or characteristics of the Special Entity. Whether a communication is a recommendation turns on the same factors as under the suitability requirements, but it will only result in advisory activity and thereby trigger the best interests duty if it is tailored to a Special Entity's particular needs or characteristics. The rule does not define what makes a swap or trading strategy tailored to a Special Entity's particular needs or characteristics, but the CFTC notes in an appendix to the rule that swaps with terms that are customized, tailored or designed for a specific Special Entity or a targeted group of Special Entities with common characteristics are likely to be considered as tailored to a Special Entity's particular needs or characteristics. In contrast, a swap that is made available for trading on a SEF or DCM will generally not be viewed as tailored to Special Entity's particular needs or characteristics.

### *Best Interest Determination*

As an advisor, an SD must make reasonable efforts to obtain specified information related to the Special Entity to determine whether a swap, or trading strategy involving a swap, is in the best interests of the Special Entity. This includes, but is not limited to, the Special Entity's:

- financial status and future funding needs;
- tax status;
- hedging, investment financing, and other objectives;
- prior swap experience; and
- ability to withstand changes in market conditions.

An SD may rely upon written representations of a Special Entity to satisfy its obligation to obtain necessary information.

### *Safe Harbors*

The CFTC also adopted two safe harbors that provide SDs with some certainty as to when they would not be deemed to be acting in an advisory role.

The first applies to all Special Entity counterparties and requires that:

**Safe Harbor Communications**

Assuming an SD complies with the safe harbor applicable to all Special Entities, the following is a non-exhaustive list of communications that will not trigger the "best interests" duty:

- providing general transaction, financial, educational, or market information;
- offering a swap or trading strategy, including swaps that are tailored to a Special Entity;
- providing a term sheet, including terms for swaps that are tailored to a Special Entity;
- providing trading ideas for swaps or trading strategies, including swaps that are tailored to a Special Entity; and
- providing marketing materials about swaps or swap trading strategies, either upon request or on an unsolicited basis, including swaps that are tailored to a Special Entity.

- the SD not express an "opinion" on 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 represent that it will not rely on the SD and will rely on advice of its independent representative; and
- the SD disclose that it is not undertaking to act in the Special Entity's best interests.

The release states that nothing in the rule precludes an SD from explicitly stating – either in its communication or in the counterparty relationship documentation – that it does not express an opinion as to whether the Special Entity should enter into a recommended swap. Accordingly, the release provides that so long as an SD complies with the safe harbor, it can communicate general information, offer a trading strategy or trading idea, and provide a term sheet or marketing materials without triggering the "best interests" duty.

An additional safe harbor applies to ERISA employee benefit plans and requires that:

- the plan represent in writing that it has an ERISA fiduciary;
- the fiduciary represent in writing that it does not rely on the SD's recommendations; and
- the plan represent that it will comply in good faith with policies and procedures ensuring any recommendation the Special Entity receives from the SD materially affecting a swap transaction is evaluated by a fiduciary before the transaction occurs, or that any recommendation the Special Entity has received from the SD materially affecting a swap transaction will be evaluated by a fiduciary before that transaction occurred.

### *Potential Characterization as ERISA Fiduciary*

One of the more controversial aspects of the CFTC's proposed Business Conduct Rule was the interaction of the business conduct standards and the Department of Labor ("**DOL**") regulations governing ERISA fiduciaries. Many commenters expressed concerns that the requirements that SDs provide scenario analyses, conduct suitability analyses and act in the best interests of a Special Entity would cause SDs that transact with ERISA plans to be deemed an ERISA "fiduciary." This would be problematic, among other reasons, because ERISA fiduciaries cannot enter into transactions with the plans to which they have a fiduciary duty. The CFTC attempted to address these concerns in the final release by noting its understanding from the DOL that compliance with the business conduct standards statutory provisions and CFTC rules will not, by itself, cause an SD/MSP to be an ERISA fiduciary to an ERISA plan. In addition, the CFTC attached to the final release a letter from the DOL that states, among other things, the DOL's conclusions that the business conduct standards do not require SDs/MSPs to engage in activities that would make them fiduciaries under DOL regulations.

**Governmental Special Entities, Covered Associates of SDs and Regulated Persons**

A "governmental Special Entity" is any:

- state, state agency, political subdivision of a state or any instrumentality, department or corporation of or established by a state or political subdivision of a state; or
- governmental plan, as defined in Section 3 or ERISA.

A "covered associate" of an SD is any:

- general partner, managing member, executive officer or other person with a similar status or function;
- employee who solicits a governmental Special Entity for the SD and any person who directly or indirectly supervises such an employee; and
- political action committee controlled by an SD or other covered associate.

A "regulated person" is:

- a person subject to the political contribution restrictions of the CFTC, SEC or a self-regulatory organization subject to the CFTC's or SEC's jurisdiction;
- a general partner, managing member, executive officer or other individual with a similar status or function at such a person; and
- an employee of such person who solicits a governmental Special Entity for the SD and any person who directly or indirectly supervises such an employee.

## Restrictions on Political Contributions by Certain SDs

The Business Conduct Rule also establishes pay-to-play restrictions on SDs. Subject to certain *de minimis* and other exceptions, the rule prohibits any SD from offering to enter or entering into a swap, or trading strategy involving a swap, with "governmental Special Entities" (as defined in the sidebar) where the SD or any "covered associate" (as defined in the sidebar) of the SD has made a contribution to an official of that entity within the prior two years. In addition, the rule generally restricts SDs and their covered associates from:

- providing or agreeing to provide payment to any person to solicit governmental Special Entities to enter into a swap, unless such solicitor is a "regulated person" (as defined in the sidebar);
- coordinating with or soliciting any person or political action committee to contribute to officials of governmental Special Entities with which the SD is offering to enter into or has entered into a swap; or
- coordinating with or soliciting any person to make any payment to a political party of the state or locality with which the SD is offering to enter into or has entered into a swap.

The CFTC has reserved the ability to grant exemptions from the political contribution requirements.

## Written Compliance Policies and Procedures

As noted throughout this client memorandum, some of the Business Conduct Rule's requirements expressly instruct SDs/MSPs to implement policies and procedures designed to satisfy a specific requirement. The rule also imposes a general requirement that SDs/MSPs have in place written policies and procedures that are reasonably designed to:

- ensure compliance with the business conduct standards; and
- prevent the SD/MSP from evading the CEA and CFTC regulations.

In addition, SDs/MSPs are required to create and retain records of their compliance with required business conduct standards.

## Effective Date and Compliance Schedule

The rule will not apply to unexpired swaps executed before the rule's designated effective date, which will be 60 days after the publication of the rule in the Federal Register. However, the CFTC will consider a material amendment to the terms of a swap made after the effective date to be a new swap subject to the rule.

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Absent any further CFTC action to delay the compliance date, SDs and MSPs must comply with the Business Conduct Rule by the later of:

- 180 days after the effective date of the Business Conduct Rule — i.e., 240 days after the publication of the Business Conduct Rule in the Federal Register; and
- the date on which SDs and MSPs must apply for registration with the CFTC.