FINAL CFTC RULES ON BUSINESS CONDUCT STANDARDS FOR SWAP DEALERS AND MAJOR SWAP PARTICIPANTS

February 21, 2012

To Our Clients and Friends:

On January 11, 2012, the U.S. Commodity Futures Trading Commission (the "CFTC") adopted final rules on external business conduct standards (the "Final Rules") for swap dealers ("SDs") and major swap participants ("MSPs") in dealing with counterparties, as subpart H of part 23 of the CFTC Regulations to implement Section 4s(h) of the Commodity Exchange Act (the "CEA"), which was added by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act").

The Final Rules were published in the Federal Register on February 17, 2012. The Final Rules will become effective on April 17, 2012 (the "Effective Date").

SDs and MSPs must comply with the rules in subpart H of part 23 on the later of 180 days after the Effective Date or the date on which SDs or MSPs are required to apply for registration under section 3.10 of the CFTC Regulations. The text of the Final Rules can be found at http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-1244a.pdf.

JURISDICTIONAL INTERPLAY

In the release for the Business Conduct Rules (the "Release"), the CFTC addressed a number of policy issues, including those arising from different regulatory systems.

Securities and Exchange Commission's Business Conduct Standards

The Dodd-Frank Act also required the Securities and Exchange Commission (the "SEC") to adopt business conduct standards rules for security-based SDs and MSPs. As the SEC's business conduct standards rules remain at the proposal stage, the CFTC's Final Rules may differ from the SEC's final rules for security-based swap dealers ("SBS Dealers") and major security-based swap participants ("Major SBS Participants" and, together with SBS Dealers, "SBS Entities"); however, in the Release, the CFTC notes that its objective is to establish consistent requirements for CFTC and SEC registrants to the extent practicable given the differences in existing regulatory regimes and approaches.

Department of Labor

The Final Rules provide greater counterparty protection to certain entities called "Special Entities," which include any employee benefit plan (an "ERISA Plan") subject to Title I of the

Employee Retirement Income Security Act of 1974 ("ERISA") administered by the Department of Labor (the "DOL"). Many comments on the proposed rules raised the issue of whether a SD or MSP could be considered a "fiduciary" when dealing with an ERISA Plan if the business conduct rules were complied with. The DOL has publicly stated that it reviewed the Final Rules and concluded that the Final Rules would not require SDs and MSPs to engage in activities that would render them ERISA fiduciaries under the DOL's current fiduciary rule, which the DOL previously proposed to amend. The DOL also stated that it will ensure that any change to such rule will be harmonized with the Final Rules such that compliance with the Final Rules will not result in any unintended consequences for SDs and MSPs.

SEC's Municipal Advisor Registration

The Dodd-Frank Act amended the Securities Exchange Act of 1934 to provide for new regulatory oversight of "municipal advisors" that provide advice to a "municipal entity" with respect to, *inter alia*, municipal derivatives and other financial products. There are some unresolved issues involving whether a municipal advisor shall register with the CFTC as a commodity trading advisor (a "CTA") while CTAs who provide advice relating to swaps to municipal entities are exempt from registration as municipal advisors, and whether a SD or MSP dealing with a municipal entity in compliance with the Final Rules may be deemed to be a municipal advisor. In the Release, the CFTC is considering a number of alternatives with respect to such dual registration issues in consultation with the SEC and believes that it has tried to harmonize these rules. The CFTC states that it will continue to cooperate with the SEC toward regulatory harmonization.

CTA Status for SDs

In the proposed rules, the CFTC has noted that a SD will likely be acting as a CTA when it makes a recommendation to a counterparty, especially when the recommendation is tailored to the needs of a counterparty. The Final Rules added new section 4.6(a)(3) to the CFTC Regulations to provide an exclusion for SDs whose swap-related advice is "solely incidental" to their business as SDs (*e.g.*, SDs make swap-related recommendations to counterparties with respect to otherwise arm's-length principal-to-principal swap transactions). In the Release, the CFTC provides examples of advisory activities that will likely be considered beyond the scope of this exclusion such that a SD providing such a recommendation could be treated as a CTA. For example, a SD that has general discretion to trade the account of, or otherwise act for or on behalf of, a counterparty would be engaging in an activity that is not solely incidental to the business of a SD. However, limited discretion related to the execution of a particular counterparty order would not rise to the level of a CTA activity. Where a SD receives separate compensation for, or otherwise profits from, a swap-related recommendation, the exclusion will

not apply. Similarly, the exclusion will not apply where a SD enters into an agreement with a counterparty to provide advisory services or otherwise holds itself out to the public as a CTA.

SCOPE OF APPLICATION OF THE FINAL RULES

The Final Rules impose a number of business conduct requirements on SDs and MSPs in their dealings with counterparties. In addition, special conduct requirements apply to a special subset of counterparties called "Special Entities."

The Final Rules will apply to activities of SDs and MSPs with respect to both swaps that are actually entered into and swaps that are "offered" but not entered into. For instance, the suitability rule will be triggered by a SD's or MSP's "recommendation" of any swap, and the fair dealing rule will apply to all communications made in connection with a swap, including pre-offering and during the offering process, even if the swap is not ultimately entered into. In the Release, the CFTC clarifies that the term "offer," as used in the Final Rules, has the general meaning used in contract law, which the CFTC interprets to mean that an offer is a "manifestation of willingness to enter into a bargain," which, if the other party accepted, would result in a transaction.

Some rules will apply before any swap is offered to a counterparty, such as rules on the verification of a counterparty's eligibility and on the "know your counterparty" requirement and the rules with respect to whether a Special Entity has an independent representative.

The CFTC confirms that the Final Rules apply only to swaps that are unexpired and executed on or after the Effective Date of the Release; therefore, they do not apply to unexpired swaps executed before the Effective Date. However, the CFTC will consider a material amendment to the terms of a pre-Effective Date unexpired swap to be a new swap that is subject to the Final Rules.

SDs and MSPs are not treated in the same manner under the Final Rules. MSPs are not required to comply with the suitability duty, pay-to-play, "know your counterparty" and scenario analysis provisions. Further, the CFTC noted in the Release that SDs are not required to provide MSPs with the same protections afforded other counterparties under the Final Rules, although SDs may contractually agree to do so. However, with respect to entities that are neither SDs nor MSPs, the Final Rules do not permit counterparties of SDs or MSPs to opt in or opt out of the protection provided by the Final Rules.

Last, the CFTC confirms in the Release that the Final Rules (other than the anti-evasion and anti-fraud provisions) do not apply to a swap entered into with an affiliate where the transaction is not a publicly reportable swap transaction. For instance, a swap to move risk between two

wholly-owned subsidiaries of a common parent, without credit exposure to each other, will not be subject to the Final Rules. Further, the CFTC decides not to apply certain of the Final Rules to swaps executed on a designated contract market (a "DCM") or swap execution facility (an "SEF"). Certain of the Final Rules (such as "know your counterparty," true name and owner, verification of eligibility, disclosures, suitability, and Special Entity rules) apply to such on-facility swaps only where the SD or MSP knows the identity of the counterparty prior to execution. For uncleared swaps executed on an SEF, SDs and MSPs have ongoing duties to counterparties, so that their duties (such as those to provide a daily mark, engage in fair dealing, and maintain confidentiality of counterparty information) will continue to apply. For swaps where the identity of the counterparty becomes known just prior to execution on an SEF, the Final Rules, including the disclosure duties, will apply, and SDs and MSPs will be required to develop mechanisms for providing disclosures, potentially working with the SEF to develop functionality to facilitate disclosures.

GENERAL PROVISIONS OF THE FINAL RULES

Policies and Procedures to Ensure Compliance

The Final Rules require that SDs and MSPs:

- have written policies and procedures reasonably designed to ensure compliance with the Final Rules and prevent evasion, or participating in or facilitating an evasion, of any provision of the CEA or its regulations, and
- implement and monitor compliance with such policies and procedures as part of their supervision and risk requirements specified under the CEA.

In the Release, the CFTC clarifies that a SD or MSP may take into consideration the nature of its particular business in developing its policies and procedures and tailor them accordingly, but the SD or MSP will remain responsible for complying with all applicable provisions of the CEA and the CFTC regulations. Further, the CFTC notes that, in exercising its prosecutorial discretion for violation of the Final Rules, it will consider as a mitigating factor the SD's and MSP's good faith compliance with such policies and procedures.

Know Your Counterparty

The know-your-counterparty rule only applies to SDs. SDs are required to implement policies and procedures reasonably designed to obtain and retain a record of "essential facts" concerning each counterparty whose identity is known to the SD prior to execution as are necessary for conducting business with such counterparty.

"Essential facts" are defined as (1) facts required to comply with applicable laws, regulations and rules, (2) facts required to implement the SD's credit and operational risk management policies in connection with transactions entered into with the counterparty and (3) information regarding the authority of any person acting for the counterparty. While counterparties are not permitted to opt out of the know-your-counterparty rule, SDs are permitted to comply with this rule by obtaining written representations from a counterparty at the outset of the relationship rather than on a transaction-by-transaction basis, where appropriate, so long as the SDs get appropriate representations from the counterparty, and the counterparty undertakes to provide SDs with timely updates of material changes.

True Name and Owner

The Final Rules require SDs and MSPs to obtain and retain records of the true name, address, and principal occupation or business of each counterparty whose identity is known by such SD or MSP prior to execution of a transaction, as well as the name and address of any other person guaranteeing the performance of a counterparty and any person exercising any control with respect to the positions of such counterparty.

Reasonable Reliance on Representations

The Final Rules on reliance on counterparty representations is an important provision, as the CFTC permits SDs and MSPs to rely on written representations of a counterparty to satisfy their due diligence obligations. Reliance on written representations is sufficient for compliance unless SDs and MSPs have information that would cause a reasonable person to question the accuracy of the representations received.

Further, the CFTC confirms that the representations may be contained in counterparty relationship documentation and may be deemed renewed with each subsequent offer or entry into a transaction so long as the counterparty agrees to timely update any material changes to the representations.

Last, the CFTC also states that it expects SDs and MSPs to review the representations in their documentation on a periodic basis, noting that it believes "best practice" would be at least an annual review in connection with the required annual compliance review by the chief compliance officer of the continuing adequacy of the representations.

Manner of Disclosure and Standard Format Disclosures

The Final Rules permit SDs and MSPs to comply with various disclosure requirements by any reliable means agreed in writing with the counterparty, including verbally, if the agreement to verbal disclosure is confirmed in writing. For swaps initiated on an SEF or DCM, no written agreement is required regarding the manner of disclosure as long as the manner is reliable. Daily

marks and certain other disclosures may be provided by password-protected Web pages, but the CFTC notes in the Release that SDs and MSPs must adopt policies and procedures to ensure communications, including daily marks, are reliable and timely. The Final Rules permit SDs and MSPs to arrange with third parties, including any derivatives clearing organization ("DCO") and SEF, to provide disclosures, but SDs and MSPs remain ultimately responsible for compliance with the disclosure duties.

If agreed to by the counterparty, the disclosure of material information that is applicable to multiple swaps between a SD or MSP and a counterparty may be made in counterparty relationship documentation or other written master agreement. The CFTC also notes that because the types of swaps subject to the disclosure rules are not limited to standardized products, SDs and MSPs are expected to develop specific disclosures appropriate to the swaps they offer to and enter into with counterparties; therefore, where standardized disclosures are inadequate to meet the requirements of this rule, SDs and MSPs must timely make specific disclosures sufficient to allow the counterparty to assess the material risks and characteristics of complex swaps.

SDs and MSPs must also have policies and procedures to address when and how disclosure will be provided to counterparties based on, among other factors, the complexity of the transaction, the degree and nature of any leverage, the potential for periods of significant illiquidity and the lack of price transparency. In the Release, the CFTC reiterates that in the absence of fraud, it will consider "good faith compliance with policies and procedures reasonably designed to comply with the business conduct standards rules as a mitigating factor" in its exercise of prosecutorial discretion.

Finally, the CFTC provides guidance in the Release that non-reliance provisions routinely included in counterparty relationship documentation will not relieve SDs and MSPs of their duty to comply in good faith with the Final Rules, and the adjudicator in any particular case will have the discretion to determine the liability of the SD or MSP to its counterparty under the Final Rules, based on the facts and circumstances of that case.

Record Retention

SDs and MSPs are required to create a record of their compliance with the external business conduct rules of the Final Rules, maintain such records and make such records available to applicable prudential regulators upon request. SDs and MSPs are further required to implement policies and procedures to document disclosures and due diligence; such policies and procedures must be sufficiently detailed to permit compliance officers and the regulators to determine compliance with the Final Rules.

FINAL RULES FOR SDS AND MSPS DEALING WITH COUNTERPARTIES

Prohibition on Fraud, Manipulation and Other Abusive Practices

The Final Rules prohibit SDs and MSPs from (1) employing any device, scheme or artifice to defraud any Special Entity, (2) engaging in any transaction, practice or course of business that operates as a fraud or deceit on any Special Entity or (3) engaging in any act, practice or course of business that is fraudulent, deceptive or manipulative.

In the Release, the CFTC reiterates its view that these anti-fraud rules do not require proof of scienter. However, in response to comments to the proposed rules, the Final Rules provide an affirmative defense for SDs and MSPs in cases alleging violations of items (2) and (3) if the SD or MSP establishes that it (i) did not act intentionally or recklessly in connection with the alleged violation and (ii) complied in good faith with written policies and procedures reasonably designed to meet the particular requirement that is the basis for the alleged violation. However, the CFTC notes that outdated policies and procedures or policies and procedures that failed to address the scope of swap business conducted by such SD or MSP would not be deemed to be reasonable.

Confidential Treatment of Counterparty Information

The Final Rules prohibit SDs and MSPs from (1) disclosing to third parties material confidential information provided by or on behalf of a counterparty or (2) using any material confidential information provided by or on behalf of a counterparty for the SD's or MSP's own purposes in any way that would tend to be materially adverse to the interests of that counterparty.

In the Release, the CFTC confirms that while the confidentiality rule is not intended to restrict the necessary and appropriate use of the information by a SD or MSP, it is intended to address material conflicts of interest that must be identified and managed to avoid trading or other activities on the basis of confidential information that would tend to be materially adverse to the interest of the counterparty. In other words, even though the CFTC ultimately declines to adopt the rule that prohibits front-running, it intends that this confidentiality rule will be used to police fraudulent, deceptive and manipulative conduct depending on the facts and circumstances of an alleged violation instead of adopting a rule that specifically prohibits certain trading activities or behavior deemed to be trading ahead or front-running a counterparty's order. The CFTC further notes that the use of confidential counterparty information to trade ahead of or front-run a counterparty's order would tend to be materially adverse to the interests of the counterparty, and therefore, may violate the Final Rules. In connection with this, the CFTC declines to list the type of activities that would be deemed acceptable. The CFTC does not give much more guidance in the Release other than reiterating that this rule is not intended to

prohibit legitimate trading activities which may include (1) bona fide risk-mitigating or hedging activities in connection with the swap, (2) purchases or sales of the same or similar types of swaps consistent with commitments of a SD or MSP to provide liquidity for the swap and (3) bona fide market-making activities in the swap.

The CFTC states that SDs and MSPs are expected to implement written policies and procedures reasonably designed to protect material confidential information provided by or on behalf of a counterparty from improper disclosure or use by any person acting on behalf of such SD or MSP. The CFTC clarifies that such policies and procedures should be designed to identify and manage material conflicts of interest through, for example, information barriers (*e.g.*, restrictions on information sharing, limits on types of trading, separation between various functions of a firm) and restrictions on access to confidential counterparty information on a "need-to-know" basis. The CFTC also notes that information barriers may be used to restrict the dissemination of information within a complex organization and to prevent material conflicts by limiting knowledge and coordination of specific business activities among different units of the organization. In certain circumstances, good faith compliance with reasonably designed policies and procedures can constitute an affirmative defense to a non-scienter violation of improper disclosure or abuse of counterparty information.

Last, the CFTC clarifies that SDs and MSPs may disclose or use material confidential information if such disclosure or use is (1) required by law, (2) necessary for the effective execution of any swap for or with the counterparty, (3) used to hedge or mitigate any exposure created by such a swap, (4) to comply with a request of the CFTC, the Department of Justice, any self-regulatory organization ("SRO") designated by the CFTC or an applicable prudential regulator, or (5) authorized in writing by the counterparty.

Verification of Counterparty Eligibility

Under the CEA, no person other than an "eligible contract participant" (an "ECP") is permitted to enter into a swap unless it is executed on or subject to the rules of a DCM. The Final Rules require SDs and MSPs to verify, prior to entering or offering to enter into a swap with any counterparty, that such counterparty meets the eligibility standards for an ECP. Also, in the course of ECP status verification, the Final Rules require SDs and MSPs to (1) determine whether the counterparty is a Special Entity and (2) verify whether a counterparty is eligible to elect to be a Special Entity and, if so, to notify such counterparty of its right to make such an election.

A safe harbor permits SDs and MSPs to reasonably rely on written representations of a potential counterparty to establish its eligibility as an ECP or Special Entity, in the absence of "red flags."

The Final Rules exempt SDs and MSPs from these verification requirements (1) where the relevant swap is initiated on a DCM (even when the counterparty is known to the SD or MSP) or (2) in a transaction initiated on a SEF, but only when the SD or MSP does not know the identity of the counterparty to the transaction prior to execution.

Disclosure of Material Information

The Final Rules require SDs and MSPs, at a reasonably sufficient time prior to entering into a swap – other than for swaps initiated on DCMs or SEFs where the SD or MSP does not know the identity of the counterparty prior to execution – to disclose to any swap counterparty (other than a SD, MSP or security-based SD or MSP) certain "material" information. The CFTC explains that "material information" means, for this purpose, information for which there is a substantial likelihood that a reasonable counterparty would consider important in making a swap-related decision. The CFTC generally expects that SDs and MSPs will rely on a combination of standardized and transaction specific disclosures to satisfy this requirement.

Material Information The CFTC deems the following items to be "material information" for a counterparty to be able to assess a particular swap, and a SD or MSP shall provide these in a manner reasonably designed for such assessment:

- the material risks of the swap, including market, credit, liquidity, foreign currency, legal, operational and other applicable risks;
- the material characteristics of the swap (including the economic terms thereof, the terms relating to the operation thereof, and the rights and obligations of the parties during the term of the swap); and
- the material incentives and conflicts of interest that the SD or MSP may have in connection with such swap, including (a) the price of the swap and the "mid-market mark" of the swap and (b) any compensation or other incentive that the SD or MSP may receive from any source other than the counterparty.

Material Risks In the Release, the CFTC clarifies that "material risks" disclosure ought to identify the material factors that influence day-to-day changes in valuation, any factors or events (*e.g.*, future economic conditions) that might result in significant losses, the sensitivities of the swap to such factors and conditions, the approximate magnitude of the gains or losses that the swap will likely experience and the unique risks associated with particular types of swaps, underlying asset classes and trading venues.

For instance, if a SD or MSP creates a swap on a broad-based index of unique assets, it will have to disclose the material risk of that index unless the counterparty can otherwise access

information on that index of unique assets. Under the same logic, a SD or MSP would not have to disclose information about crude oil prices for a swap on crude oil because such information is already available to market participants.

Material Characteristics The CFTC states in the Release that "material characteristics" include the material terms of a swap included in a typical confirmation sent by a SD or MSP to a counterparty upon execution. However, the CFTC declines to state categorically that the material characteristics disclosure requirement will be satisfied when a counterparty receives a copy of all documentation governing the terms of the swap, noting that the determination as to whether this requirement is met will depend on the facts and circumstances of a particular transaction, particularly where certain features (including caps, collars, floors, knock-ins, knock-outs, range accrual features, embedded optionality and embedded volatility) increase the complexity of the swap.

Material Incentives and Conflict of Interest SDs and MSPs will be required to have policies and procedures reasonably designed to identify material incentives and conflicts with respect to the price and mid-market mark of the swap and any compensation it may receive from any source other than the counterparty. Again, the CFTC notes that it will consider good faith compliance with such policies and procedures when exercising its prosecutorial discretion in connection with any violation of this rule. Further, the CFTC confirms that SDs and MSPs, which receive certain incentives (including fee rebates, discounts and revenue and profit sharing) from various market infrastructures (*e.g.*, DCOs, DCMs, SEFs and swap data repositories), will be required to disclose such incentives to their counterparties.

Scenario Analysis This provision of the Final Rules only applies to a SD and requires that, prior to entering into a swap "not made available for trading" on a DCM or SEF with a counterparty (other than a SD, MSP or security-based SD or MSP), a SD must:

- notify the counterparty that it can request and consult on the design of a scenario analysis to allow the counterparty to assess its potential exposure in connection with the swap;
- upon request of the counterparty, provide a scenario analysis which is designed in consultation with the counterparty and performed over a range of assumptions, including severe downside stress scenarios that would result in a significant loss;
- disclose all material assumptions and explain the calculation methodologies used to perform any requested scenario analysis (but the SD is not required to disclose

confidential, proprietary information about any model it uses to prepare the scenario analysis); and

- in designing the requested scenario analysis, consider any relevant analyses that the SD undertakes for its own risk management purposes, including analyses performed as part of its "New Product Policy" required by the applicable CFTC regulations.

In the Release, the CFTC explains that, unlike the proposed rules, the Final Rules do not require scenario analysis for all swaps but only when the counterparty requests such analysis after being made aware that it has the right to make such request. Further, the CFTC states that, while a SD may use appropriately qualified, independent third party providers to perform the scenario analysis, the SD will remain responsible for ensuring compliance with the rule. The CFTC also notes that, while this rule does not require the disclosure of confidential, proprietary information about any model a SD may use to prepare the scenario analysis, it does require the disclosure of all material assumptions and an explanation of the calculation methodologies, which the CFTC does not consider to be confidential, proprietary information. Last, the Final Rules do not permit SDs to satisfy their duty to provide the scenario analysis on a portfolio basis as the CEA specifically requires that such scenario analysis be in connection with a particular swap.

Daily Mark With respect to cleared swaps, the Final Rules require SDs and MSPs to notify counterparties (other than SDs, MSPs and SBS Entities) of their right to receive, upon request, the daily mark from the appropriate DCO or futures commission merchant ("FCM"); however, the counterparty has the right to decide whether it will receive the daily mark through access to the DCO or FCM, or directly from the SD or MSP.

With respect to uncleared swaps, the Final Rules require SDs and MSPs to:

- provide counterparties, during the term of the swap as of the close of business or such other time as the parties agree in writing, with a daily mark, which shall be the mid-market mark of the swap and shall not include amounts for profit, credit reserve, hedging, funding, liquidity or any other costs or adjustments; and

- disclose to such counterparties (a) the methodology and assumptions used to prepare the daily mark, (b) any material changes during the term of the swap and (c) any additional information concerning the daily mark to ensure a fair and balanced communication.

When appropriate, the SD or MSP can clarify that the daily mark may not necessarily be (i) the price at which either the counterparty or the SD or MSP would agree to replace or terminate the

swap, (ii) the sole basis for a variation margin call or (iii) the value of the swap that is marked on the books of the SD or MSP.

In the Release, the CFTC provided guidance that the term "mid-market mark" can be determined through mark-to-model calculations when a liquid market does not exist. In addition, while SDs and MSPs may delegate daily mark duties to third-party vendors, the SD or MSP will ultimately remain responsible for compliance with this rule.

Clearing Disclosures

For swaps where clearing is mandatory, the Final Rules require SDs and MSPs to notify any counterparty (other than a SD, MSP, or security-based SDs and MSPs) that it has the sole right to select the DCO through which the swap will be cleared. For swaps that are not required to be cleared, the Final Rules require SDs and MSPs to notify any such counterparty that it may elect to require that the swap be cleared and that it has the sole right to select the DCO at which the swap will be cleared.

Communications—Fair Dealing

The Final Rules require that any communication between a SD or MSP and a counterparty must be delivered in a fair and balanced manner based on principles of fair dealing and good faith. The CFTC indicates that it will make determination of "fair dealing" by considering factors such as whether the communication (1) provides a sound basis for evaluating the facts with respect to any swap, (2) avoids making exaggerated or unwarranted claims, opinions or forecasts, and (3) balances any statement that refers to the potential opportunities or advantages presented by a swap with statements of corresponding risks. The CFTC also notes that fair dealing requires the SD or MSP to avoid unfairly advantaging one counterparty or group of counterparties over another.

Recommendations to Counterparties – Institutional Suitability

Duties in Recommendation The Final Rules require that when a SD recommends a swap or a trading strategy involving a swap to a counterparty (other than a SD, MSP or SBS Entity), it must: (1) undertake reasonable diligence to understand the potential risks and rewards associated with such swap or trading strategy and (2) have a reasonable basis to believe that the recommended swap or trading strategy is suitable for the counterparty.

Whether a communication between a SD and a counterparty constitutes a "recommendation" will be determined on the facts and circumstances of the particular situation. The CFTC indicates that it will base its determination on an "analysis of the content, context and presentation of the particular communication or set of communications." More precisely, the

CFTC deems such determination to be an objective inquiry that depends, in part, on whether, given its content, context and manner of presentation, a particular communication would reasonably be viewed as a "call to action" or a suggestion that a counterparty enter into a swap, which in turn will require an examination of the underlying substantive information transmitted to the counterparty and consideration of any other facts and circumstances (*e.g.*, any accompanying explanatory message from the SD). The CFTC notes that the likelihood that a communication will be deemed a recommendation increases in direct proportion to the degree to which the communication is "individually tailored" to a specific counterparty or targeted group of counterparties regarding a swap, group of swaps or trading strategy involving a swap.

In recommending a swap, a SD must satisfy two criteria of suitability:

- General suitability of the swap: it must use reasonable diligence to understand the potential risks and rewards of that swap or of the trading strategy that involves a swap.
- Specific suitability to counterparty: it must have a reasonable basis to believe that the swap or trading strategy involving a swap is suitable to that specific counterparty.

To satisfy the general suitability criterion, reasonable diligence required of the SD will vary depending on, *inter alia*, the complexity of, and risks associated with, the swap or trading strategy and the SD's familiarity with the swap or trading strategy.

To satisfy the specific suitability criterion, the SD must establish a reasonable basis for the recommendation by obtaining information about the counterparty, including the counterparty's investment profile, trading objectives and ability to absorb potential losses associated with the recommended swap or trading strategy.

Safe Harbor The Final Rules include a safe harbor, which contains a three-pronged test, for SDs to satisfy the specific suitability requirement with respect to counterparties that are not Special Entities:

- a SD has reasonably determined that the counterparty, or an agent to which the counterparty has delegated decision-making authority, is capable of independently evaluating investment risks with regard to the relevant swap or swap trading strategy;
- the counterparty or its agent represents in writing that it is exercising independent judgment in evaluating the SD's recommendations with respect to such swap or trading strategy; and

- the SD discloses in writing that it is acting in its capacity as a counterparty and is not undertaking to assess the suitability of such swap or trading strategy for the counterparty.

Additionally, in the case of a counterparty that is a Special Entity and where the recommendation would cause the SD to act as an "advisor" to the Special Entity, in order to satisfy its suitability obligation in reliance on this safe harbor, the SD must comply with both the three-prong test and with its obligations under the provisions of the Final Rules imposed on SDs that act as advisors to Special Entities to make a reasonable determination.

SDs may satisfy the first prong of this test in reliance on written representations from such counterparty that (1) in the case of a counterparty that is not a Special Entity, the counterparty has complied in good faith with written policies and procedures that are reasonably designed to ensure that the persons responsible for evaluating the recommendation and making trading decisions on its behalf are capable of doing so and (2) in the case of a counterparty that is a Special Entity, satisfy the terms of the safe harbor specific to recommendation for Special Entities.

FINAL RULES FOR SDS AND MSPS DEALING WITH SPECIAL ENTITIES

Greater Protection for "Special Entities"

An enhanced level of protection under the Final Rules is mandated by the CFTC for a subset of counterparties that are referred to as "Special Entities" defined as:

- any Federal agency;
- any state or political subdivision thereof or any instrumentality, department or corporation established by a state;
- any employee benefit plan subject to Title I of ERISA;
- any governmental plan (as defined in Section 3 of ERISA);
- any endowment (including organizations described in Section 501(c)(3) of the Internal Revenue Code of 1986); or
- any employee benefit plan defined in Section 3 of ERISA but not subject to Title I thereof (*e.g.*, church plans, foreign pension plans) that elects to be a Special Entity by notifying a SD or MSP of its election prior to entering into a swap with such SD or MSP.

In the Release, the CFTC provides some clarifications with respect to this definition. The CFTC states that in dealing with a master trust that holds the assets of more than one ERISA Plan, a SD or MSP can treat the master trust as one entity in complying with the Final Rules and does not need to separately comply with the Final Rules with respect to each of the ERISA Plans.

With respect to an endowment, the CFTC clarifies that it only applies with respect to endowments (foreign and domestic) that are counterparties to swaps with respect to their investment funds and would not apply to counterparties that are charitable organizations generally.

Last, the CFTC determines that the definition of "Special Entity" does not include collective investment vehicles that have investors that are themselves Special Entities; therefore, collective investment vehicles are not "looked through" by the CFTC for the application of the Final Rules with respect to protection of the Special Entities.

Requirements for SDs Acting as Advisors to Special Entities

Definition of "Advisor to a Special Entity" An SD "acts as an advisor to a Special Entity" when it recommends a swap or swap trading strategy that is tailored to the particular needs or characteristics of the Special Entity. The CFTC clarifies that the same analysis used to determine whether a SD is generally recommending a swap or a strategy involving a swap to any counterparty is also used to determine whether the communication between a SD and a Special Entity will be deemed to be a recommendation of a swap or a strategy involving a swap and consequently whether the SD will become an "advisor to a Special Entity." In addition to that "recommendation" analysis, to be deemed to be an "advisor to a Special Entity," the SD must also be deemed to have made recommendation of a swap or strategy involving a swap that is tailored to the particular needs or characteristics of the Special Entity. The CFTC will look at the terms of the swap to determine whether it is tailored to the needs or characteristics of a Special Entity; further, swaps that are designed for a targeted group of Special Entities (*e.g.*, school districts) are likely to be viewed as being designed for a Special Entity. However, the CFTC notes that it does not generally view swaps that are made available for trading on a DCM or a SEF as being tailored to a Special Entity.

The Final Rules also include two safe harbors from the definition of "acts as an advisor to a Special Entity" for two types of communications: (1) communications between a SD and any employee benefit plan subject to Title I of ERISA ("ERISA Plan") that has an ERISA fiduciary and (2) communications to any Special Entity or its representative that do not express an opinion as to whether the Special Entity should enter into the recommended tailored swap or swap trading strategy.

Duties of SDs as Advisors to Special Entities The Final Rules require SDs acting as "advisors to Special Entities" to make a reasonable determination that any swap or trading strategy involving a swap recommended by the SD is in the "best interests" of such Special Entity. As part of the SD's duty to determine that the swap or trading strategy is in the "best interests" of the Special Entity, the SD must undertake "reasonable efforts" to obtain all necessary information to make such a determination, including information relating to (1) the Special Entity's financial status and future funding needs, (2) the Special Entity's tax status, (3) the Special Entity's hedging, investment, financing or other objectives, (4) the Special Entity's experience with respect to entering into swaps generally and swaps of the type and complexity being recommended, (5) the Special Entity's financial capability to withstand changes in market conditions, and (6) other information relevant to the particular facts and circumstances of the Special Entity, market conditions and the type of swap or trading strategy being recommended.

The Final Rules permit SDs to reasonably rely on written representations of a Special Entity (including representations contained in the relationship documentation, where appropriate) to satisfy the duty to make reasonable efforts to obtain necessary information.

In the Release, the CFTC further clarifies that if a Special Entity does not provide complete information regarding its investment portfolio or other information relevant to the appropriateness of a particular recommendation, in order for the SD to comply with its "best interests" duty, the SD must make it clear to the Special Entity that the SD's recommendation is based on the limited information available to it and that the recommendation may have differed if the SD had been provided with more complete information. The CFTC notes that the best practice in this situation would be for the SD to ensure that such disclosures are communicated to the Special Entity's governing board or to a person occupying a similar status or performing a similar function. Ultimately, the CFTC places on the SD the burden of evaluating whether it is able to make any recommendation on swaps or trading strategies to a Special Entity when the SD cannot obtain the necessary information. If the SD determines that it does not have sufficient information to make the recommendation in the best interests of the Special Entity, the SD should refrain from doing so.

Safe Harbor The CFTC provides two safe harbors under the Final Rules for SDs that act as advisors to Special Entities.

The first safe harbor applies only to ERISA plans, and a SD will not "act as an advisor to a Special Entity" that is an ERISA Plan if:

- the ERISA Plan represents in writing (a) that it has an ERISA fiduciary that is responsible for representing it in connection with the swap and (b) either that (A) any

recommendation it receives from the SD materially affecting the swap will be evaluated by a fiduciary before the transaction occurs or (B) it will comply in good faith with written policies and procedures designed to ensure that any such recommendation is so evaluated by a fiduciary; and

- the ERISA fiduciary represents in writing that it will not rely on the SD's recommendations.

Under the second safe harbor, a SD will not "act as an advisor to a Special Entity" of any type (including an ERISA Plan) if:

- it does not express an opinion as to whether the Special Entity should enter into the recommended swap or trading strategy;
- the Special Entity reasonably represents in writing that it will not rely on the SD's recommendations and will rely on advice from a "qualified independent representative" as defined in the Final Rules; and
- the SD discloses that it is not undertaking to act in the "best interests" of the Special Entity.

The CFTC makes it clear that a SD that wants to rely on this safe harbor must manage its communications with the Special Entity accordingly, and the parties must exchange the appropriate representations. The CFTC expects the SD to specifically represent that it does not express an opinion on whether the Special Entity should enter into the swap or strategy involving a swap. However, while nothing in the Final Rules would preclude a SD from representing that it will not express an opinion as to a recommended swap or trading strategy or that the Special Entity should consult its own advisor, such representations would not act as a safe harbor if, contrary to the representations, the SD actually expressed such an opinion.

Further, the CFTC states in Appendix A to the Final Rules that if a SD complies with this general safe harbor for transactions with any Special Entity, the following types of communications will not be subject to the "best interests" duty: (1) providing general transactional, financial, educational or market information; (2) offering a swap or swap trading strategy (including tailored swaps); (3) providing a term sheet (including with respect to tailored swaps); (4) responding to a Special Entity's request for a quote; (5) providing trading ideas for swaps or swap trading strategies (including for tailored swaps); and (6) providing marketing materials, whether by request or on an unsolicited basis about swaps or swap trading strategies (including about tailored swaps). This list is not exhaustive, and the CFTC does not intend to

create the negative implication that other communications are subject to the "best interests" duty. However, the CFTC notes that depending on the facts and circumstances, certain communications on this list may be deemed "recommendations," which do trigger a suitability obligation under the Final Rules.

Requirements for SDs and MSPs Acting as Counterparties to Special Entities

Duties of SDs and MSPs Acting as Counterparties Any SD or MSP that offers to enter or enters into a swap with a Special Entity (other than an ERISA Plan) must have a "reasonable basis" to believe the Special Entity has a representative that (1) has sufficient knowledge to evaluate the transaction and risks, (2) is not subject to statutory disqualification, (3) is independent of the SD or MSP, (4) undertakes a duty to act in the best interests of the Special Entity, (5) makes appropriate and timely disclosures to the Special Entity and (6) evaluates, consistent with any guidelines provided by the Special Entity, fair pricing and the appropriateness of the swap.

Additionally, in the case of "Governmental Special Entities," which are government plans or states, state agency, city, county, municipality or other political subdivisions thereof, or instrumentalities, departments or corporations established by a state, the SD or MSP must have a reasonable basis to believe that the representative of the Governmental Special Entity is subject to restrictions on certain political contributions imposed by the CFTC, the SEC or a self-regulatory organization subject to the jurisdiction of the CFTC or the SEC. However, if the representative of the Governmental Special Entity is also an employee of such Governmental Special Entity, then the SD or MSP does not have to satisfy this duty.

With respect to an ERISA Plan, the Final Rules require SDs or MSPs offering or entering into a swap with the ERISA Plan to have a "reasonable basis" to believe that the ERISA Plan has a representative that is a "fiduciary," as defined in Section 3 of ERISA.

All of the duties imposed on the SD or MSP described above do not apply to transactions initiated on a DCM or SEF where the SD or MSP does not know the identity of the counterparty to the transaction prior to execution.

In the Release, the CFTC states that where a SD or MSP is required to undertake due diligence to assess whether it has a reasonable basis to believe that a representative has sufficient knowledge to evaluate the transaction and risks, the SD or MSP should consider: (1) the complexity of the swap; and (2) the representative's (a) capability to make hedging or trading decisions, and the resources available to the representative to make informed decisions, (b) use of a consultant, (c) experience in financial markets generally and with the relevant type of

instruments (including the specific asset class), (d) ability to understand the economic features of the swap and (e) ability to evaluate how market developments would affect the swap.

A representative of a Special Entity will be deemed "independent" of the SD or MSP for purposes of this rule if it satisfies all of the following "Independence Tests": (1) the SD or MSP is not a principal of the representative and the representative is not a principal of the SD or MSP; (2) the SD or MSP did not refer, recommend or introduce the representative to the Special Entity within one year of its representation of the Special Entity in connection with the swap; and (3) the representative (a) provides timely and effective disclosure of all material conflicts of interest that could reasonably affect its judgment with respect to its obligations to the Special Entity, (b) complies with policies and procedures reasonably designed to manage and mitigate such conflicts, (c) is not controlled by, in control of or under common control with the SD or MSP and (d) is not and, within one year of representing the Special Entity in connection with the swap, was not an "associated person" of the SD or MSP (as defined in the CEA).

Prior to initiating a swap, the Final Rules require that a SD or MSP disclose to the Special Entity in writing (1) the capacity in which it is acting in connection with the swap and (2) if the SD or MSP engages in business with the Special Entity in multiple capacities, the material differences between such capacities.

Safe Harbors With respect to transactions with Special Entities that are not ERISA Plans, the Final Rules include a safe harbor for a SD or MSP to be deemed to have a reasonable basis to believe that a representative of a Special Entity meets the conditions required by the Final Rules described above. This safe harbor is satisfied where:

- the Special Entity represents in writing to the SD or MSP that (a) it has complied in good faith with written policies and procedures reasonably designed to ensure that it has selected a representative that satisfies the requirements of the Final Rules for the SD or MSP to transact with the Special Entity and (b) such policies and procedures provide for ongoing monitoring of the representative's performance in accordance with such requirements; and

- the representative represents in writing to the Special Entity and the SD or MSP that it (a) has policies and procedures reasonably designed to ensure that it satisfies the requirements of the Final Rules, (b) meets the Independence Tests described above and (c) is legally obligated to comply with the requirements of the Final Rules by agreement, condition of employment, law, rule, regulation or other enforceable duty.

With respect to transactions with ERISA Plans, the Final Rules include a safe harbor for a SD or MSP to be deemed to have a reasonable basis to believe that the ERISA Plan has a representative that meets the conditions required by the Final Rules described above if the ERISA Plan (1) provides the SD or MSP with the representative's name and contact information in writing and (2) represents in writing that the representative is an ERISA fiduciary.

The representations required to satisfy either of these safe harbors may be made, where appropriate, on a relationship basis in counterparty relationship documentation consistent with the requirements of the Final Rules in reliance on representation.

Chief Compliance Officer Review If a SD or MSP determines that it lacks a reasonable basis to believe that the representative of a Special Entity meets the applicable representative requirements, the Final Rules require that it create a written record of the basis for such determination and submit such record to its chief compliance officer for review to ensure that the SD or MSP has a substantial, unbiased basis for its determination.

Political Contributions by Certain Swap Dealers ("Pay-to-Play Rules")

Prohibitions on Political Contributions by SDs To prevent fraud, the Final Rules prohibit SDs from offering to enter into or entering into a swap or swap trading strategy with a Governmental Special Entity within two years after any "contribution" to an "official" of such Governmental Special Entity was made by such SD or by any "covered associate" of such SD, unless certain specific exceptions apply.

Further, the Final Rules also prohibit SDs and their covered associates from:

- providing or agreeing to provide payment to any person to solicit a Governmental Special Entity to offer to enter, or to enter into, a swap with such SD (unless such person is itself subject to restrictions on certain political contributions imposed by the CFTC, the SEC or a SRO subject to the jurisdiction of the CFTC or the SEC, or is a general partner, managing member or executive officer of such person or an employee of such person who solicits a Governmental Special Entity for the SD); or
- coordinating, or soliciting any person or political action committee to make, any contribution to an official of a Governmental Special Entity, or any payment to a political party of a state or locality, with which the SD is offering to enter or has entered into a swap or swap trading strategy.

Moreover, the Final Rules include a general anti-evasion rule prohibiting SDs from using any other person or means to do any act that would result in a violation of the prohibitions on political contributions or the two-year rule described above.

The Final Rules define:

- "contribution" as any gift, subscription, loan, advance or deposit of money or anything of value made (1) for the purpose of influencing an election for federal, state or local office, (2) for payment of debt incurred in connection with such election or (3) for transition or inaugural expenses incurred by the successful candidate for such office;
- "official" of a Governmental Special Entity as any person (including an election committee for such person) who was, at the time of the contribution, an incumbent, candidate or successful candidate for elective office of a Governmental Special Entity if the office (1) is responsible for, or can influence the outcome of, the selection of a SD by the Governmental Special Entity or (2) has authority to appoint any person who is responsible for, or can influence the outcome of, such selection; and
- "covered associate" as (1) any general partner, managing member or executive officer (or person with similar status or function), (2) any employee who solicits a Governmental Special Entity for the SD and any person who supervises such employee and (3) any political action committee controlled by the SD or by any person listed in the foregoing clause (1) or (2).

Exceptions to the Political Contribution Prohibition This prohibition does not apply:

- if the only contributions made by the SD to an official of such Governmental Special Entity were made by a covered associate to (1) officials for whom the covered associate was entitled to vote at the time of the contributions, but only when the aggregate contributions do not exceed $350 to any single official in any given election or (2) officials for whom the covered associate was not entitled to vote at the time of the contributions, but only when the aggregate contributions do not exceed $150 to any single official in any given election;
- to any SD as a result of a contribution made by a natural person more than six months prior to becoming a covered associate of the SD (unless the natural person, after

becoming a covered associate, solicits the Governmental Special Entity on behalf of the SD to offer to enter or to enter into a swap or swap trading strategy); or

- to a swap that is initiated on a DCM or SEF where the SD does not know the identity of the counterparty to the transaction prior to execution.

Requests for Exemption The CFTC may, upon application, conditionally or unconditionally exempt SDs from the prohibitions on political contributions and/or the two-year rule based upon the following factors (which list is not meant to be exclusive):

- whether the exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes of the CEA;
- whether the SD (a) before the contribution triggering the prohibition was made, implemented policies and procedures reasonably designed to prevent violations of such prohibitions; (b) prior to or at the time the contribution was made, lacked actual knowledge of the contribution; and (c) after learning of the contribution, took all available steps to cause the contributor to obtain a return of the contribution (and to take any other remedial or preventive measures, as appropriate);
- whether, at the time of the contribution, the contributor was a covered associate or otherwise an employee of the SD, or was seeking employment;
- the timing and amount of the contribution;
- the nature of the election (*i.e.*, federal, state or local); and
- the contributor's apparent intent or motive in making the contribution.

* * *

Please feel free to contact us with any questions.

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