Client Update

Final SEC Rules on Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants

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On April 13, 2016, the Securities and Exchange Commission (the "SEC") adopted final rules (the "Final Rules") to implement business conduct standards and chief compliance officer ("CCO") requirements for security-based swap dealers ("SBSDs") and major security-based swap participants ("MSBSPs" and, together with SBSDs, "SBS Entities").[1]

The Final Rules became effective on July 12, 2016, but the compliance date will only commence after the SEC finalizes other SBS Entities regulations, such as registration, capital and margin rules.[2] Therefore, the Final Rules will have no impact in the near future.[3]

JURISDICTIONAL INTERPLAY

In the Release, the SEC addressed a number of issues arising from the interaction of different regulatory systems that could apply to SBS Entities.

[1] The SEC also approved amendments to rules 3a67-10 and 3a71-3 and adopted rule 3a71-6 under the Securities Exchange Act of 1934 (the "Exchange Act") to address the cross-border application of the Final Rules and the availability of substituted compliance.

[2] The text of the Final Rules and the accompanying release (the "Release") are *available at*: https://www.federalregister.gov/articles/2016/05/13/2016-10918/business-conduct-standards-for-security-based-swap-dealers-and-major-security-based-swap#h-4.

[3] See our client memorandum, "SEC Final Rules on Registration of Security-Based Swap Entities and Proposed Rules on Statutorily Disqualified Associated Persons" (September 21, 2015), *available at*: http://www.debevoise.com/insights/publications/2015/09/sec-final-rules-on-registration.

Commodity Futures Trading Commission's Business Conduct Standards

The Commodity Futures Trading Commission (the "CFTC") adopted final external and internal business conduct standards for swap dealers ("SDs") and major swap participants ("MSPs" and, together with SDs, "Swap Entities"). As the SEC expects that a number of SBS Entities may also be Swap Entities, the Release notes that the Final Rules generally intend to harmonize with corresponding rules of the CFTC with respect to both business conduct rules and CCO requirements.

Department of Labor Regulations

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"). The Release states that the DOL revised the definition of "fiduciary" in its amended rule in April 2016 with the intent to allow SBS Entities to avoid becoming ERISA fiduciaries when acting as counterparties to a security-based swap ("SBS") transaction.[4]

Broker-Dealer, Investment Adviser and Municipal Advisor Regulations

The Release notes that a SBS Entity must separately determine whether it is subject to regulation as a broker-dealer, an investment adviser, a municipal advisor or other regulated entity, since the duties imposed by the Final Rules are in addition to any duties that may be imposed under other laws. Depending on its activities, a SBSD that acts as an advisor to a Special Entity or to a municipal entity may also need to register as an investment adviser or municipal advisor.

A SBSD that is also registered as a broker-dealer will need to determine the interplay between the existing broker-dealer regulations and the Final Rules. For instance, the Release recognizes that many SBS Entities may be subject to the requirements of self-regulatory organizations ("SROs") when they are also registered as a broker-dealer. The Release states that the Final Rules are generally designed to be consistent with various SRO requirements.

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[4] The DOL's amended rule explicitly establishes a "swap and security-based swap transactions" exclusion for SDs and SBSDs from the definition of "fiduciary" such that SDs and SBSDs engaged in regulated conduct as part of a swap or SBS transaction with an employee benefit plan would not give rise to additional obligations or restrictions under Title I of ERISA. See Conflict of Interest Rule—Retirement Investment Advice, 81 FR 20946, at 20984-86 (Final Rule, Apr. 8, 2016).

SCOPE OF APPLICATION OF THE FINAL RULES

Application of the Final Rules to Pre-Compliance Date SBS

The SEC clarifies that the Final Rules generally will not apply to any SBS entered into prior to the compliance date (including with respect to either a partial or full termination of a pre-compliance date SBS, unless the partial termination involves a material amendment).

Application of the Final Rules to Inter-affiliate Transactions

SBS transactions that SBS Entities enter into with their "majority-owned affiliates" do not have to comply with the requirements of the Final Rules relating to verification of counterparty status, disclosures regarding the product and potential conflicts of interest, daily mark and clearing rights, "know your counterparty" and suitability obligations, and obligations pertaining to Special Entities.

Exceptions for Anonymous SEF or Exchange-Traded SBS

There are two general sets of exceptions from the business conduct requirements:

- the business conduct rules relating to pre-transaction disclosure of material risks and characteristics of a SBS, of material incentives or conflicts in connection with a SBS, and of clearing rights will not apply where the SBS Entity does not know the identity of the counterparty prior to execution of the transaction;
- certain business conduct requirements do not apply to transactions with Special Entities that are anonymous and executed on a registered national securities exchange or SBS execution facility (a "SEF"), where the identity of the counterparty is not known to the SBS Entity prior to execution of the transaction.

Reliance on Representations

The SEC permits SBS Entities to rely on written representations of a counterparty to satisfy their due diligence obligations under the Final Rules, unless the SBS Entity has information that would cause a reasonable person to question the accuracy of the representations it received.

EXTERNAL BUSINESS CONDUCT REQUIREMENTS

Verification of Counterparty Eligibility

SBS Entities are required to verify, prior to entering into a SBS with any counterparty, that such counterparty meets the eligibility standards for an "eligible contract participant" (an "ECP").

In addition, a SBS Entity must (1) determine whether a counterparty is a Special Entity prior to entering into a SBS with that counterparty and (2) verify whether a counterparty is eligible to elect not to be a Special Entity (*i.e.*, any employee benefit plan defined in Section 3 of ERISA but not subject to Title I thereof (*e.g.*, church plans, workmen's compensation plans)), and, if so, to notify such counterparty of its right to make such an election.

Counterparties will be able to make representations about their status as ECP or Special Entity at the outset of a relationship with a SBS Entity, and can undertake to update or renew such representations for each relevant subsequent action.

Disclosure of Material Information

The Final Rules require SBS Entities, at a reasonably sufficient time prior to entering into a SBS, to disclose to any counterparty (other than a SBS Entity or Swap Entity) certain "material information." The Release notes that the disclosures should be reasonably clear and informative as to the relevant material risks or conflicts being disclosed, but the SEC does not require that the disclosures be tailored to a particular counterparty.

Material Information

The disclosures should include:

- the material risks of the SBS (including market, credit, liquidity, foreign currency, legal, operational, and other applicable risks);
- the material characteristics of the SBS (including economic terms, operational terms, and rights and obligations of the parties); and
- the material incentives or conflicts of interest that the SBS Entity may have in connection with such SBS (including compensation or other incentive that the SBS Entity may receive from any source other than the counterparty).

The "material information" definition in the Final Rules is generally consistent with the CFTC rules, except that the SEC does not require SBS Entities to provide scenario analysis. Additionally, the Final Rules do not mandate that counterparties agree to the manner of disclosure of material information, whereas the CFTC rules require counterparties to agree to the manner of disclosure, including whether pre-execution oral disclosures may be made. Another notable difference from the CFTC rules is that the SEC does not require the disclosure of pre-trade mid-market marks.

Material Incentives or Conflicts of Interest

The SEC states that SBS Entities are required to disclose material incentives or conflicts of interest in connection with the SBS. The Release highlighted two sources of incentives or conflicts of interest that may be "material" under the Final Rules: (1) differential compensation (*i.e.*, the difference in compensation a SBS Entity may receive for selling a SBS, particularly a customized SBS, versus selling another product with similar economic terms); and (2) affiliations or material business relationships a SBS Entity may have with any SBS valuation providers.

Disclosure of the Daily Mark

Cleared SBS

With respect to cleared SBS, a SBS Entity must disclose to its counterparty (other than a Swap Entity or SBS Entity) the daily mark that the SBS Entity receives from the appropriate clearing agency. To fulfill this obligation, a SBS Entity can also agree with the relevant clearing agency or clearing member (or an agent of such clearing agency or member) to provide the daily mark directly to the counterparty.

Uncleared SBS

With respect to uncleared SBS, the Final Rules require SBS Entities to provide to their counterparties a daily mark (which is the midpoint between the bid and offer, or equivalent[5]) on each business day. In addition, SBS Entities must disclose their data sources and a description of the methodology and

[5] For liquid SBS, the daily mark can be the midpoint between the bid and offer prices. For a illiquid SBS, a SBS Entity may calculate an equivalent to a midmarket value using mathematical models, quotes and prices of other comparable securities, SBS, or derivatives, or any combination.

assumptions used to prepare the daily mark and any material changes to such data sources, methodology, and assumptions.[6]

The SEC states that SBS Entities can clarify that the daily mark is not necessarily (i) the price at which either the counterparty or the SBS Entity would agree to replace or terminate the SBS, (ii) the sole basis for a margin call or (iii) the value of the SBS that is marked on the books of the SBS Entity.

Disclosure Regarding Clearing Rights

SBS Entities are required to disclose to their counterparties (other than SBS Entities or Swap Entities) certain information regarding the rights to clear SBS.

With respect to SBS subject to mandatory clearing, a SBS Entity must disclose to its counterparty:

- the clearing agencies that accept the SBS for clearing, and through which the SBS Entity is authorized to clear the SBS; and
- that the counterparty has the sole right to select the clearing agency that will be used to clear the SBS.

With respect to SBS not subject to mandatory clearing, a SBS Entity must:

- determine whether the SBS is accepted for clearing by a clearing agency;
- disclose to the counterparty the clearing agencies that accept the SBS for clearing, and through which the SBS Entity is authorized to clear the SBS; and
- notify the counterparty that it may elect to clear the SBS and has the sole right to select the clearing agency that will be used to clear the SBS.

Know Your Counterparty

The Final Rules require a SBSD to have written policies and procedures reasonably designed to obtain and retain a record of the following essential facts with respect to each counterparty:

- facts required to comply with applicable laws, regulations and rules;

[6] This requirement differs from the CFTC rules, which do not require a SD to disclose its data sources. The CFTC rules only require a SD to disclose the methodology and assumptions used to prepare the daily mark.

- facts required to implement the SBSD's credit and operational risk management policies in connection with transactions entered into with such counterparty; and
- information regarding the authority of any person acting for such counterparty.

If the identity of the counterparty is revealed to the SBSD only immediately prior to or subsequent to execution, such SBSD is permitted to collect essential facts about its counterparty within a reasonable time after learning of the counterparty's identity.

Fair and Balanced Communications

The Final Rules require that any communication between a SBSD or MSBSP and a counterparty must be delivered in a fair and balanced manner based on principles of fair dealing and good faith, taking into account factors such as whether the communication: (1) provides a sound basis for evaluating the facts with regard to any SBS or SBS trading strategy, (2) avoids implying that past performance will recur or making any exaggerated or unwarranted claims, opinions, or forecasts, and (3) balances any statement referring to the potential opportunities or advantages presented by a SBS with an equally detailed statement of the corresponding risks.

Recommendations by SBSDs to Counterparties

Duties in Recommendation

In recommending a SBS or a trading strategy to a counterparty (other than a SBS Entity or Swap Entity), a SBSD must: (1) undertake reasonable diligence to understand the potential risks and rewards associated with such SBS or trading strategy and (2) have a reasonable basis to believe that the recommended SBS or trading strategy is suitable for the counterparty.

Whether a communication between a SBSD and its counterparty constitutes a "recommendation" will be determined based on the facts and circumstances of the particular situation. The SEC would look at whether the particular communication by the SBSD would reasonably be viewed as a "call to action" regarding buying, selling, materially amending, or early termination of a SBS, or would reasonably influence a counterparty to trade a particular SBS or group of SBS. A SBSD would generally not be deemed to be making a recommendation solely by reason of providing general financial or market information, or transaction terms in response to a request for competitive bids.

Safe Harbor for Institutional Counterparties

The SEC provides a safe harbor on suitability of recommendation made by SBSDs, but it is only restricted to recommendations made to "institutional counterparties." For a counterparty that is not an institutional counterparty, a SBSD will need to obtain information regarding the counterparty to establish a reasonable basis to believe that a recommended SBS or SBS trading strategy is suitable for the counterparty. This safe harbor is different from the parallel safe harbor under the CFTC rules, which is not similarly restricted.

To qualify for this safe harbor regarding suitability of recommendations, the SBSD must:

- have reasonably determined that the institutional counterparty (or its agent) is capable of independently evaluating investment risks with regard to the relevant SBS or SBS trading strategy;
- have obtained the institutional counterparty's (or its agent's) written representation that it is exercising independent judgment in evaluating the SBSD's recommendations with respect to such SBS or SBS trading strategy; and
- disclose in writing that the SBSD is acting in its capacity as a counterparty and is not undertaking to assess the suitability of such SBS or SBS trading strategy for the institutional counterparty.

An "institutional counterparty" is:

- any person (whether a natural person, corporation, partnership, trust or otherwise) that has total assets of at least $50 million; or
- any counterparty that is in one of the following categories of an ECP as defined under Section 1a(18) of the Commodity Exchange Act ("CEA"):
  - under clause 1a(18)(A): (i) financial institutions, (ii) eligible insurance companies, (iii) eligible investment companies, (iv) eligible commodity pools, (viii) U.S. or foreign broker dealers, eligible associated persons ("APs"), or investment bank holding companies, (ix) U.S. or foreign futures commission merchants, or (x) eligible floor brokers or floor traders; or
  - under clause 1a(18)(B): eligible investment advisers, commodity trading advisors, investment managers or fiduciaries.[7]

[7] The term "institutional counterparty" does not include an entity that qualifies as an ECP only under Section 1a(18)(A)(v) of the CEA by having total assets in excess of $10 million,

FINAL RULES FOR SBS ENTITIES DEALING WITH SPECIAL ENTITIES

Greater Protection for "Special Entities"

An enhanced level of protection is mandated by the SEC for a subset of counterparties that are referred to as "Special Entities."

A "Specified Entity" is:

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

Entities Not Defined as Special Entities

Foreign pension and employee benefit plans and other foreign entities are excluded from the definition of "Special Entity."

Further, the SEC determines that the definition of "Special Entity" does not include collective investment vehicles that have investors that are Special Entities; therefore, a SBS Entity does not need to look through collective investment vehicles for the application of the Final Rules with respect to protection of the Special Entities.

Requirements for SBSDs Acting as Advisors to Special Entities

Definition of "Advisor to a Special Entity"

A SBSD "acts as an advisor to a Special Entity" when it recommends a SBS or a SBS trading strategy to the Special Entity.

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by being guaranteed by an ECP, or by having a net worth in excess of $1 million and entering into SBS for hedging purposes.

The Release notes that the Final Rules take a more expansive definition of "acts as an advisor to a Special Entity" than the CFTC. The CFTC's parallel rules deem a SD to be an advisor when it "recommends a swap or trading strategy involving a swap that is tailored to the particular needs or characteristics of a Special Entity." On the other hand, the SEC does not require that a communication to a Special Entity about a SBS or a trading strategy be individually tailored to a specific counterparty to constitute a "recommendation" for the purposes of the Final Rules (*e.g.*, the SEC believes that a communication to a group of Special Entities or to investment managers with multiple Special Entities could constitute a recommendation).

Duties of SBSDs as Advisors to Special Entities

The Final Rules require SBSDs acting as "advisors to Special Entities" to undertake "reasonable efforts" to obtain all necessary information to make such a determination, including the following:

- the Special Entity's authority to enter in a SBS;
- the Special Entity's financial status and future funding needs;
- the Special Entity's tax status;
- the Special Entity's hedging, investment, financial, or other objectives;
- the Special Entity's experience with respect to entering into SBS generally, and SBS of the type and complexity being recommended;
- the Special Entity's financial capability to withstand changes in market conditions during the term of the SBS; and
- other information relevant to the particular facts and circumstances of the Special Entity, market conditions, and the type of SBS or trading strategy being recommended.

Definition of "Best Interests" of the Special Entity

The determination whether a recommendation for a SBS or SBS trading strategy is in the "best interests" of the Special Entity will be based on the facts and circumstances of the particular recommendation and Special Entity.

The SEC clarifies that the "best interests" duty does not preclude a SBSD that "acts as an advisor" to a Special Entity from also acting as a counterparty to a Special Entity, as long as a SBSD complies with the requirements of the Final Rules applicable to SBSDs acting as advisors and as counterparties to Special Entities. Further, the "best interests" duty also does not preclude a SBSD from

negotiating commercially reasonable SBS terms in its own interest or from making a reasonable profit or fee from a transaction with a Special Entity.

Lastly, the Release states that the "best interests" duty applies only to recommendations made by a SBSD and does not otherwise require a SBSD acting as an advisor to undertake a general obligation to act in the "best interests" of the Special Entity.

Safe Harbors from the Definition of "Advisor to a Special Entity"

The Final Rules include two safe harbors from the definition of "acts as an advisor to a Special Entity."

Under the first safe harbor, a SBSD does not "act as an advisor" to an ERISA Plan that has an ERISA fiduciary if:

- the ERISA Plan represents in writing that it has an ERISA fiduciary;
- the ERISA fiduciary represents in writing that it acknowledges that the SBSD is not acting as an advisor; and
- the ERISA Plan represents in writing that:
  - it will comply in good faith with written policies and procedures reasonably designed to ensure that any recommendation that the Special Entity receives from the SBSD involving a SBS transaction is evaluated by an ERISA fiduciary before the transaction is entered into; or
  - any recommendation that the Special Entity receives from the SBSD involving a SBS transaction will be evaluated by an ERISA fiduciary before that transaction is entered into.

Under the second safe harbor, a SBSD does not "act as an advisor" to any Special Entity (including a Special Entity that is an ERISA Plan) if:

- the Special Entity represents in writing that it acknowledges that the SBSD is not acting as an advisor, and that the Special Entity will rely on advice from a "qualified independent representative"; and
- the SBSD discloses that it is not undertaking to act in the "best interests" of the Special Entity.

Requirements for SBSDs and MSBSPs Acting as Counterparties to Special Entities

Duties of SBS Entities as Counterparties to Special Entities

Any SBS Entity that offers to enter or enters into a SBS with a Special Entity (other than an ERISA Plan[8]) must have a "reasonable basis" to believe the Special Entity has a "qualified independent representative."

A "qualified independent representative" (a "QIR") is a representative that:

- has sufficient knowledge to evaluate a SBS and its risks;
- is not subject to statutory disqualification;
- will undertake a duty to act in the best interests of the Special Entity;
- makes appropriate and timely disclosures to the Special Entity of material information concerning the SBS;
- will evaluate, consistent with any guidelines provided by the Special Entity, the fair pricing and the appropriateness of the SBS; and
- is independent of the SBS Entity (as discussed below).

Additionally, in the case of a "Governmental Special Entity[9]," a SBS Entity 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 SEC, the CFTC, or a SRO under the jurisdiction of the SEC or the CFTC, unless the representative of the Governmental Special Entity is also an employee of such Governmental Special Entity.

Definition of "Independent" Representative

The Release clarifies that a QIR should be independent of the SBS Entity, but need not be independent of the Special Entity itself.

[8] With respect to an ERISA Plan, a SBS Entity that offers to enter or enters into a SBS with an ERISA Plan must have a "reasonable basis" to believe the ERISA Plan has a representative that is a "fiduciary," as defined in Section 3 of ERISA.

[9] A "Governmental Special Entity" includes a government plan (as defined in Section 3 of ERISA) or a state or political subdivision thereof, or any instrumentality, department or corporation of or established by a state or political subdivision of a state.

A representative of a Special Entity is deemed to be independent of a SBS Entity if it satisfies all of the following "Independence Tests":

- the representative is not and, within one year of representing the Special Entity in connection with the SBS, was not an AP of the SBS Entity;
- the representative provides timely disclosures to the Special Entity of all material conflicts of interest that could reasonably affect the judgment or decision making of the representative with respect to its obligations to the Special Entity and complies with policies and procedures reasonably designed to manage and mitigate such material conflicts of interest;[10] and
- the SBS Entity did not refer, recommend, or introduce the representative to the Special Entity within one year of the representative's representation of the Special Entity in connection with the SBS.

Safe Harbors

To meet the requirement that a SBS Entity must have a "reasonable basis" to believe a Special Entity has a QIR, a SBS Entity may rely on representations from the Special Entity or its representative. There are two safe harbors available for the SBS Entity, one for SBS with non-ERISA Plans, and one for SBS with ERISA Plans.

With respect to transactions with Special Entities that are not ERISA Plans, a SBS Entity will be deemed to have a reasonable basis to believe that a representative of a Special Entity meets the conditions required by the Final Rules when the following conditions are satisfied:

- the Special Entity represents in writing to the SBS Entity 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 SBS Entity 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 SBS Entity that it (a) has policies and procedures reasonably designed to ensure that it satisfies the requirements of the Final Rules, (b) meets the

[10] For a disclosure to be "timely," a representative's disclosure must allow the Special Entity the opportunity to assess the likelihood of a conflict of interest prior to entering in to the SBS.

Independence Tests described above, has sufficient knowledge to evaluate the transaction and risks, is not subject to a statutory disqualification, undertakes a duty to act in the best interests of the Special Entity, and, if applicable, is subject to certain pay-to-play rules regarding political contributions (as discussed below) 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, a SBS Entity will be deemed to have a reasonable basis to believe that an ERISA Plan has a representative that meets the conditions required by the Final Rules, when the ERISA Plan provides in writing to the SBS Entity the representative's name and contact information in writing and represents in writing that the representative is a fiduciary as defined in Section 3 of ERISA.

Disclosure of Capacity by SBSDs

The Final Rules require that a SBSD, prior to initiating a SBS with a Special Entity, disclose to the Special Entity in writing (1) the capacity in which it is acting in connection with the SBS, and (2) if the SBSD engages in business with the Special Entity in multiple capacities, the material differences between such capacities and any other financial transaction or service involving the counterparty.

Antifraud Provisions for SBS Entities

The Final Rules prohibit a SBS Entity from:

- employing any device, scheme, or artifice to defraud any Special Entity or prospective customer who is a Special Entity;
- engaging in any transaction, practice, or course of business that operates as a fraud or deceit on any Special Entity or prospective customer who is a Special Entity; or
- engaging in any act, practice, or course of business that is fraudulent, deceptive, or manipulative.

The first two antifraud provisions are specific to a SBS Entity's interactions with Special Entities, while the third applies more generally.

These antifraud provisions differ in one respect from the antifraud provisions of the CFTC rules. The CFTC rules contain an affirmative "policies and procedures defense," which is available for SDs that complied in good faith with written policies and procedures reasonably designed to meet the requirement that is the

basis for an alleged antifraud violation and did not act intentionally or recklessly in connection with any antifraud violations.

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

Prohibitions on Political Contributions by SBSDs

To prevent fraud, the Final Rules generally prohibit SBSDs from offering to enter into or entering into a SBS or SBS trading strategy with a "Municipal Entity[11]" within two years after any "contribution[12]" to an "official[13]" of such Municipal Entity was made by such SBSD or by any "covered associate[14]" of such SBSD (the "two-year rule").

Exceptions

The two-year rule does not apply:

- if the only contributions made by the SBSD to an official of such Municipal Entity were made by a covered associate who is a natural person 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;

[11] A "Municipal Entity" is defined as any agency, authority, or instrumentality of the state, political subdivision, or municipal corporate entity (using the same definition of "municipal entity" as the Exchange Act).

[12] A "contribution" is defined as any gift, subscription, loan, advance or deposit of money or anything of value made (1) for the purpose of influencing any 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.

[13] An "official" of a Municipal Entity is defined 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 Municipal Entity if the office (1) is responsible for, or can influence the outcome of, the selection of a SBSD by the Municipal Entity or (2) has authority to appoint any person who is responsible for, or can influence the outcome of, such selection.

[14] A "covered associate" is defined as (1) any general partner, managing member or executive officer (or person with similar status or function), (2) any employee who solicits a Municipal Entity for the SBSD and any person who supervises such employee and (3) any political action committee controlled by the SBSD or by any person listed in the foregoing clause (1) or (2).

- to any SBSD as a result of a contribution made by a natural person more than six months prior to becoming a covered associate of the SBSD (unless the natural person, after becoming a covered associate, solicits the Municipal Entity on behalf of the SBSD to offer to enter or to enter into a SBS or SBS trading strategy); or
- to a SBS that is executed on a registered national securities exchange or SEF where the SBSD does not know the identity of the counterparty to the transaction at a reasonably sufficient time prior to execution to permit the SBSD to comply with the obligations of the Final Rules.

INTERNAL BUSINESS CONDUCT REQUIREMENTS

Diligent Supervision

A SBS Entity is required to establish and maintain a system to supervise, and to diligently supervise, its business and the activities of its APs; at a minimum, the system must:

- designate at least one person with authority to carry out the supervisory responsibilities of the SBS Entity for each business for which registration as a SBS Entity is required;
- use reasonably efforts to determine that all supervisors are qualified, either by virtue of experience or training; and
- establish, maintain, and enforce written policies and procedures addressing the supervision of the types of SBS business in which the SBS Entity is engaged and the activities of its APs that are reasonably designed to prevent violations of federal securities laws and the rules and regulations thereunder.

The SBS Entity's written policies and procedures regarding supervision must include, at a minimum:

- procedures for the review by a supervisor of transactions for which registration as a SBS Entity is required;
- procedures for the review by a supervisor of incoming and outgoing written (including electronic) correspondence with counterparties or potential counterparties and internal written communications relating to the SBS Entity's SBS business;
- procedures for a periodic review, at least annually, of the SBS Entity's SBS business that is reasonably designed to assist in detecting and preventing violations of federal securities laws and the rules and regulations thereunder;

- procedures for conducting a reasonable investigation regarding the good character, business repute, qualifications, and experience of any person prior to association with the SBS Entity;
- procedures for considering whether to permit an AP to establish or maintain a securities or commodities account or a trading relationship at another SBSD, broker, dealer, investment adviser, or other financial institution for the AP to trade for the AP's benefit; and if permitted, procedures to supervise the AP's trading at the other firm;
- a description of the supervisory system, including the titles, qualifications, and locations of supervisors and the responsibilities of each supervisor with respect to the types of business in which the SBS Entity is engaged;
- procedures prohibiting an AP supervisor from supervising his or her own activities, or reporting to, or having his or her compensation determined by, someone he or she is supervising;[15]
- procedures reasonably designed to prevent the supervisory system from being compromised due to possible conflicts of interest with respect to the AP being supervised, including the position of such person, the revenue such person generates for the SBS Entity, or any compensation that the AP supervisor may derive from the AP being supervised; and
- procedures reasonably designed to comply with the duties set forth in section 15F(j) of the Exchange Act.[16] The Release specifically highlighted the requirement to establish robust and professional risk management systems, stating that any such system established by a SBS Entity should be effective to manage the risks of the SBS Entity within the risk tolerance limits to be determined for each type of risk.

[15] The Final Rules provide an exception to this prohibition: if the SBS Entity determines with respect to any of its supervisors that compliance with this prohibition is not possible due to the firm's size or a supervisor's position within the firm, the SBS Entity must document the factors used to reach such determination and how the supervisory arrangement with respect to the supervisor otherwise complies with the diligent supervision requirements of the Final Rules. The SBS Entity must also include a summary of such determination in the annual compliance report (as discussed below).

[16] Section 15F(j) of the Exchange Act imposes the following duties on all registered SBS Entities: (1) monitor trading to prevent violations of position limits; (2) establish robust and professional risk management systems; (3) disclose to the SEC and prudential regulators information concerning its SBS trading activities; (4) establish and enforce internal systems and procedures to obtain any necessary information to perform any of the functions described in Section 15F(j) of the Exchange Act and provide such information to the SEC or prudential regulators on request; (5) implement conflict-of-interest systems and procedures; and (6) address antitrust considerations.

Safe Harbor

The Final Rules provide a safe harbor for SBS Entities and APs from the liability of the failure to supervise another person if the following conditions are satisfied:

- The SBS Entity must have established and maintained written policies and procedures, and a system for applying those policies and procedures, which would reasonably be expected to prevent and detect, to the extent practicable, any violation of the federal securities laws and the rules and regulations thereunder relating to SBS; and
- The SBS Entity or AP must have reasonably discharged the duties and obligations incumbent on it by reason of such procedures and system without a reasonable basis to believe that such procedures and system were not being followed.

Maintenance of Written Supervisory Procedures

A SBS Entity is required to promptly amend its written supervisory procedures when material changes occur in securities laws or rules or regulations, and when material changes occur in its business or supervisory system. Also, a SBS Entity must promptly communicate any material amendments to its supervisory procedures to all APs to whom such amendments are relevant.

Chief Compliance Officer

SBS Entities are required to designate an individual to serve as a CCO. The Final Rules also set forth the duties of the CCO and the requirements relating to an annual compliance report that must be prepared and signed by the CCO (the "Compliance Report"). The Release states that the requirements relating to the CCO are designed to be generally consistent with those relating to CCOs of other SEC-regulated entities and CCOs of CFTC-regulated Swap Entities.[17]

To promote the effectiveness and independence of the CCO, the Final Rules require that:

- the CCO must report directly to the board of directors or to the chief executive officer (or other equivalent officer) of the SBS Entity; and

[17] Although the requirements of the Final Rules pertaining to the CCO are generally consistent with the CFTC rules relating to CCOs of Swap Entities, significant differences remain. For example, under the Final Rules, the compensation and removal of the CCO require the approval of a majority of the board. However, the CFTC rules allow either the board or the senior officer to remove the CCO.

- the compensation and removal of the CCO require the approval of a majority of the board.

Duties of the CCO

The CCO is required to:

- review the compliance of the SBS Entity with respect to the SBS Entity requirements described in Section 15F of the Exchange Act, and the rules and regulations thereunder;
- take reasonable steps to ensure that the SBS Entity establishes, maintains, and reviews policies and procedures reasonably designed to remediate non-compliance issues identified by the CCO through: (a) compliance office review; (b) look-back; (c) internal or external audit finding; (d) self-reporting to the SEC and other authorities; or (e) any complaint that can be validated;
- take reasonable steps to ensure that the SBS Entity establishes and follows procedures reasonably designed for the handling, management response, remediation, retesting, and resolution of non-compliance issues;
- take reasonable steps to resolve any material conflicts of interest that may arise, in consultation with the board of directors or the chief executive officer (or other equivalent officer) of the SBS Entity; and
- administer each policy and procedure that is required to be established pursuant to Section 15F of the Exchange Act, and the rules and regulations thereunder.

CCO's Compliance Report

In addition to the duties above, a CCO must annually prepare and sign a Compliance Report that describes:

- The written policies and procedures of the SBS Entity (including the code of ethics and conflict of interest policies) reasonably designed to achieve compliance with the Exchange Act and the rules and regulations thereunder relating to its business as a SBS Entity (as discussed above).
- The SBS Entity's assessment of the effectiveness of its policies and procedures relating to its business as a SBS Entity.
- Any material changes to the SBS Entity's policies and procedures since the date of the preceding Compliance Report.

- Any areas for improvement, and recommended potential or prospective changes or improvements to its compliance program and resources devoted to compliance.
- Any material non-compliance matters identified.
- The resources set aside for compliance with the Exchange Act and the rules and regulations thereunder relating to its business as a SBS Entity.

The Compliance Report must:

- be submitted to the SEC within 30 days following the deadline for filing the SBS Entity's annual financial report with the SEC;
- be submitted to the board of directors and audit committee and the chief executive officer (or other equivalent officer) of the SBS Entity prior to submission to the SEC;
- be discussed in at least one meeting between the CCO and the chief executive officer (or other equivalent officer) in the preceding 12 months; and
- include a certification by the CCO or the chief executive officer (or other equivalent officer) that, to the best of his or her knowledge and reasonable belief and under penalty of law, the information contained in the Compliance Report is accurate and complete in all material respects.

CROSS-BORDER APPLICATION OF THE FINAL RULES

Entity-Level Requirements

The SEC determines that the following are "entity-level requirements":

- diligent supervision (including the requirement that SBS Entities establish procedures to comply with the duties set forth in Section 15F(j) of the Exchange Act, including conflict of interest systems and procedures); and
- CCO-related requirements.

The entity-level requirements apply to all SBS of a SBS Entity regardless of the U.S.-person status of the SBS Entity or that of its counterparty.

There is no specific relief for foreign SBS Entities from these entity-level requirements; however, under an SEC substituted compliance determination, a foreign SBS Entity may be able to satisfy the entity-level requirements by complying with corresponding requirements established by a foreign financial regulator.

Transaction-Level Requirements

Application of Transaction-Level Requirements to SBSDs

Requirements that are not entity-level requirements are deemed by the SEC to be transaction-level requirements. Under the Final Rules, only the "U.S. business" of a registered SBSD will be subject to the transaction-level requirements.[18]

"U.S. business" is defined as:

- With respect to a foreign SBSD[19]:
  - any SBS entered into, or offered to be entered into, by or on behalf of such foreign SBSD, with a U.S. person (other than a transaction conducted through a foreign branch of that U.S. person); or
  - any SBS arranged, negotiated, or executed by personnel of the foreign SBSD located in a U.S. branch or office, or by personnel of the foreign SBSD's agent located in a U.S. branch or office.
- With respect to a U.S. SBSD:
  - any transaction entered into or offered to be entered into by or on behalf of such U.S. SBSD (other than the SBS that constitutes "foreign business" of the U.S. SBSD).

"Foreign business" is defined as:

- With respect to a foreign SBSD: (1) any SBS entered into, or offered to be entered into, by or on behalf of a foreign SBSD with a non-U.S. person (except when the SBS is arranged, negotiated or executed by personnel of the foreign SBSD located in a U.S. branch or office or by personnel of an agent of the foreign SBSD located in a U.S. branch or office), or (2) any SBS with a U.S. person that is conducted through a foreign branch of such U.S. person; or
- With respect to a U.S. SBSD, any transaction conducted through the U.S. SBSD's foreign branch (1) with a non-U.S. person or (2) with a U.S.-person-counterparty that constitutes a transaction conducted through a foreign branch of that counterparty.

[18] With respect to MSBSPs, the Final Rules provide similar exceptions from transaction-level requirements for foreign and U.S. MSBSPs as for foreign and U.S. SBSDs.

[19] A foreign SBSD is a SBSD that is not a U.S. person.

A SBS is "conducted through a foreign branch" of a U.S. person where the foreign branch is the counterparty to the SBS and the personnel arranging, negotiating, and executing the transaction are all located outside the U.S.

While the general approach of the SEC and the CFTC on the cross-border application of the conduct rules may be similar, due to slight differences in the definitions of "U.S. Person" and foreign branches, and the terminology used on what constitutes business conducted with or conducted through a foreign branch, the actual application of the conduct rules to a SBS Entity may differ from that of a Swap Entity.

Substituted Compliance for SBS Entities

The SEC may make substituted compliance determinations to permit foreign SBS Entities to comply with comparable regulatory requirements in a foreign jurisdiction to substitute for compliance with certain business conduct requirements under the Final Rules. When a SBS Entity is relying on substituted compliance, its failure to comply with the relevant foreign requirement would actually constitute a violation of the Exchange Act.

Substituted compliance may be available for most requirements under the Final Rules; however, it is not available for:

- the antifraud requirements of the Final Rules and the Exchange Act prohibiting SBS Entities from engaging in fraudulent activities generally and in particular in connection with Special Entities; and
- requirements of the Exchange Act for SBS Entities to disclose to the SEC and any applicable prudential regulator information concerning the SBS Entities' trading in SBS and any information necessary for such regulators to perform certain statutory functions.

Generally, the SEC states that it will endeavor to take a "holistic approach" in making its determinations, focusing on regulatory outcomes as a whole with respect to requirements within the same category rather than making a requirement-by-requirement comparison. However, the SEC specifically cited requirements related to ECP verification, Special Entities, and political contributions as requirements that are unlikely to be available for substituted compliance.

There is no requirement that the SEC and the CFTC coordinate their substituted compliance determinations, this may present a special challenge for an entity that is both a Swap Entity and a SBS Entity.

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Please do not hesitate to contact us with any questions.