SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

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RIN 3235–AL10

Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission (''Commission'') is proposing for comment new rules under the Securities Exchange Act of 1934 (''Exchange Act'') that are intended to implement provisions of Title VII (''Title VII'') of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (''Dodd-Frank Act'') relating to external business conduct standards for security-based swap dealers (''SBS Dealers'') and major security-based swap participants (''Major SBS Participants'').

DATES: Comments should be received on or before August 29, 2011.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/proposed.shtml*); or
- Send an e-mail to *rule-comments@sec.gov*. Please include File Number S7–25–11 on the subject line; or
- Use the Federal eRulemaking Portal (*http://www.regulations.gov*). Follow the instructions for submitting comments.

Paper Comments

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–1090.

All submissions should refer to File Number S7–25–11. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/proposed.shtml*). Comments are also available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549 on official business days between the hours of 10 a.m. and 3 p.m. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Lourdes Gonzalez, Acting Co-Chief Counsel, Joanne Rutkowski, Branch Chief, Cindy Oh, Special Counsel, Office of Chief Counsel, Division of Trading and Markets, at (202) 551–5550, at the Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549.

SUPPLEMENTARY INFORMATION: The Commission is proposing Rules 15Fh–1 to 15Fh–6 and 15Fk–1 under the Exchange Act governing certain business conduct requirements for SBS Dealers and Major SBS Participants. The Commission is soliciting comments on all aspects of the proposed rules and will carefully consider any comments received.

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I. Introduction

A. Statutory Framework

On July 21, 2010, the President signed the Dodd-Frank Act into law.[1] Title VII of the Dodd-Frank Act generally provides the Commission with authority to regulate ''security-based swaps,'' the Commodity Futures Trading Commission (''CFTC'') with authority to regulate ''swaps,'' and both the CFTC and the Commission with authority to regulate ''mixed swaps.'' [2]

Section 764 of the Dodd-Frank Act amends the Exchange Act by adding new Section 15F.[3] Paragraph (h) of the new section authorizes and requires the Commission to adopt rules specifying business conduct standards for SBS Dealers [4] and Major SBS Participants [5] in their dealings with counterparties, including counterparties that are ''special entities.'' ''Special entities'' are generally defined to include federal agencies, states and their political subdivisions, employee benefit plans as defined under the Employee Retirement Income Security Act of 1974 (''ERISA''), governmental plans as defined under ERISA, and endowments.[6] Congress granted the Commission broad authority to promulgate business conduct requirements, as appropriate in the public interest, for the protection of investors or otherwise in furtherance of the purposes of the Exchange Act.[7]

Section 15F(h)(6) of the Exchange Act directs the Commission to prescribe rules governing business conduct standards for SBS Dealers and Major SBS Participants (collectively, ''SBS Entities''). These standards, as described in Exchange Act Section 15F(h)(3), must require an SBS Entity to: verify that a counterparty meets the eligibility standards for an ''eligible contract participant'' (''ECP''); disclose to the counterparty material information about the security-based swap, including material risks and characteristics of the security-based swap, and material incentives and conflicts of interest of the SBS Entity in connection with the security-based swap; and provide the counterparty with information concerning the daily mark for the security-based swap. Section 15F(h)(3) also directs the Commission to establish a duty for SBS Entities to communicate in a fair and balanced manner based on principles of fair dealing and good faith. Section 15F(h)(1) of the Exchange Act grants the Commission authority to promulgate rules applicable to SBS Entities that relate to, among other things, fraud, manipulation and abusive practices involving security-based swaps (including security-based swaps that are offered but not entered into),

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010).

[2] Section 712(d) of the Dodd-Frank Act provides that the Commission and the CFTC, in consultation with the Board of Governors of the Federal Reserve System (''Federal Reserve''), shall jointly further define the terms ''swap,'' ''security-based swap,'' ''swap dealer,'' ''security-based swap dealer,'' ''major swap participant,'' ''major security-based swap participant,'' ''eligible contract participant,'' and ''security-based swap agreement.'' Public Law 111–203, 124 Stat. 1376, 1644–1646 (2010). These terms are defined in Sections 721 and 761 of the Dodd-Frank Act and, with respect to the term ''eligible contract participant,'' in Section 1a(18) of the Commodity Exchange Act, 7 U.S.C. 1a(18), as re-designated and amended by Section 721 of the Dodd-Frank Act. Section 721(c) of the Dodd-Frank Act also requires the CFTC to adopt a rule to further define the terms ''swap,'' ''swap dealer,'' ''major swap participant,'' and ''eligible contract participant,'' and Section 761(b) of the Dodd-Frank Act permits the Commission to adopt a rule to further define the terms ''security-based swap,'' ''security-based swap dealer,'' ''major security-based swap participant,'' and ''eligible contract participant,'' with regard to security-based swaps, for the purpose of including transactions and entities that have been structured to evade Title VII. Public Law 111–203, 124 Stat. 1376, 1658–1672, 1754, 1759 (2010). Finally, Section 712(a) of the Dodd-Frank Act provides that the Commission and CFTC, after consultation with the Federal Reserve, shall jointly prescribe regulations regarding ''mixed swaps,'' as may be necessary to carry out the purposes of Title VII. Public Law 111–203, 124 Stat. 1376, 1642 (2010).

[3] *See* Public Law 111–203, 124 Stat. 1376, 1789–1792, § 764(a) (adding Exchange Act Section 15F). All references to the Exchange Act are to the Exchange Act, as amended by the Dodd-Frank Act.

[4] Section 761 of the Dodd-Frank Act amends Section 3(a) of the Exchange Act to add new Exchange Act Section 3(a)(71)(A), which generally defines ''security-based swap dealer'' as ''any person who: (i) holds themself [sic] out as a dealer in security-based swaps; (ii) makes a market in security-based swaps; (iii) regularly enters into security-based swaps with counterparties as an ordinary course of business for its own account; or (iv) engages in any activity causing it to be commonly known in the trade as a dealer or market maker in security-based swaps.'' Public Law 111–203, 124 Stat. 1376, 1758, § 761.

The Commission and the CFTC are jointly proposing rules and interpretive guidance under the Exchange Act and the Commodity Exchange Act to further define the terms ''swap dealer,'' ''security-based swap dealer,'' ''major swap participant,'' ''major security-based swap participant,'' and ''eligible contract participant.'' *See* Further Definition of ''Swap Dealer,'' ''Security-Based Swap Dealer,'' ''Major Swap Participant,'' ''Major Security-Based Swap Participant'' and ''Eligible Contract Participant,'' Exchange Act Release No. 63452 (Dec. 7, 2010), 75 FR 80174 (Dec. 21, 2010) (''Definitions Release'').

[5] Section 761 of the Dodd-Frank Act amends Section 3(a) of the Exchange Act to add new Exchange Act Section 3(a)(67)(A), which defines ''major security-based swap participant'' as ''any person: (i) Who is not a security-based swap dealer; and (ii)(I) who maintains a substantial position in security-based swaps for any of the major security-based swap categories, as such categories are determined by the Commission, excluding both positions held for hedging or mitigating commercial risk and positions maintained by any employee benefit plan (or any contract held by such a plan) as defined in paragraphs (3) and (32) of Section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002) for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan; (II) whose outstanding security-based swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or (III) that is a financial entity that (aa) is highly leveraged relative to the amount of capital such entity holds and that is not subject to capital requirements established by an appropriate Federal banking regulator; and (bb) maintains a substantial position in outstanding security-based swaps in any major security-based swap category, as such categories are determined by the Commission.'' Public Law 111–203, 124 Stat. 1376, 1755–1756, § 761(a) (to be codified at 15 U.S.C. 78c(a)(67)(A)).

See also Definitions Release, *supra* note 4.

[6] Public Law 111–203, 124 Stat. 1376, 1789–1790, § 764(a) (to be codified at 15 U.S.C. 78o–10(h)(2)(C)).

[7] *See* Public Law 111–203, 124 Stat. 1376, 1790 (to be codified at 15 U.S.C. 78o–10(h)(3)(D)) (''[b]usiness conduct requirements adopted by the Commission shall establish such other standards and requirements as the Commission may determine are appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this Act''). *See also* Public Law 111–203, 124 Stat. 1376, 1789 (to be codified at 15 U.S.C. 78o–10(h)(1)(D)) (requiring that SBS Entities comply as well with ''such business conduct standards * * * as may be prescribed by the Commission by rule or regulation that relate to such other matters as the Commission determines to be appropriate'').

diligent supervision of SBS Entities and adherence to all applicable position limits.[8]

Section 15F(h)(4) of the Exchange Act requires that an SBS Dealer that ''acts as an advisor to a special entity'' must act in the ''best interests'' of the special entity and undertake ''reasonable efforts to obtain such information as is necessary to make a reasonable determination'' that a recommended security-based swap is in the best interests of the special entity. Section 15F(h)(5) requires that SBS Entities that offer to or enter into a security-based swap with a special entity comply with any duty established by the Commission that requires an SBS Entity to have a ''reasonable basis'' for believing that the special entity has an ''independent representative'' that meets certain criteria and undertakes a duty to act in the ''best interests'' of the special entity.[9] This provision also requires that an SBS Entity disclose in writing the capacity in which it is acting (*e.g.*, as principal) before initiating a transaction with a special entity.[10]

Section 15F(k) of the Exchange Act requires each SBS Entity to designate a chief compliance officer and imposes certain duties on that person.

B. Consultations

In developing the rules proposed herein, the Commission staff has, in compliance with Sections 712(a)(2)[11] and 752(a)[12] of the Dodd-Frank Act, consulted and coordinated with the CFTC and the prudential regulators.[13] Commission staff also met with persons representing a broad spectrum of views on the proposed rules.[14] These meetings were conducted jointly with CFTC staff. Among the persons who participated in the meetings were other regulators, broker-dealers, consumer and investor advocates, endowments, end-users, financial institutions, futures commission merchants, industry trade groups, investment fund managers, labor unions, pension fund managers, self-regulatory organizations (''SROs''), state and local governments, and swap dealers. We have considered standards or guidance issued by prudential regulators and international organizations, requirements applicable under foreign regulatory regimes, and recommendations for industry ''best practices.''[15] We have also taken into account the more than 70 comments received by the CFTC on its proposed business conduct rules for swap dealers and major swap entities.[16]

The staffs of the Commission and the CFTC have been consulting with the staff of the Department of Labor, and will continue to do so, concerning the potential interface between ERISA and the business conduct requirements of the Dodd-Frank Act. We recognize the importance of the ability of SBS Dealers to offer security-based swaps to special entities that are subject to ERISA, both for dealers and for the pension plans that may rely on security-based swaps to manage risk and reduce volatility.

C. Approach to Drafting the Proposed Rules

1. General Objectives

Section 15F(h) of the Exchange Act provides the Commission with both mandatory and discretionary rulemaking authority. Our intent, in exercising this authority, is to establish a regulatory framework that both protects investors and promotes efficiency, competition, and capital formation.[17] The Commission staff has worked closely with CFTC staff in consulting with the public and in developing the proposed rules, with a view to establishing consistent and comparable requirements for our respective registrants, to the extent possible.[18]

The Commission understands that the proposed rules discussed herein, as well as other proposals that the Commission is considering to implement the Dodd-Frank Act, if adopted, could significantly affect—and be significantly affected by—the development of the security-based swaps market in a number of ways. If the Commission adopts rules that are too permissive, for example, they may not adequately protect investor interests or promote the purposes of the Dodd-Frank Act. If, however, the Commission adopts measures that are too onerous, they could unduly limit hedging and other legitimate activities by discouraging participation in security-based swap markets. We are aware that the further development of the security-based swaps market, including in response to rules adopted by the Commission under the Dodd-Frank Act, may alter the calculus for regulation of business conduct of SBS Entities. We urge commenters, as they review the proposed rules, to consider generally the role that regulation may play in the development of the market for security-

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[8] The Commission has proposed for comment a new Rule 9j–1 under the Exchange Act, which is intended to prevent fraud, manipulation, and deception in connection with the offer, purchase or sale of any security-based swap, the exercise of any right or performance of any obligation under a security-based swap, or the avoidance of such exercise or performance. Prohibition against Fraud, Manipulation, and Deception in Connection with Security-Based Swaps, Exchange Act Release No. 63236 (Nov. 3, 2010), 75 FR 68560 (Nov. 8, 2010). The Commission is separately considering the matter of position limits, and would propose any position limits in a separate rulemaking, as necessary.

[9] Pub. L. 111–203, 124 Stat. 1376, 1791 (to be codified at 15 U.S.C. 78o–10(h)(5)).

[10] *Id.*

[11] Section 712(a)(2) of the Dodd-Frank Act states in part, ''the Securities and Exchange Commission shall consult and coordinate to the extent possible with the Commodity Futures Trading Commission and the prudential regulators for the purposes of assuring regulatory consistency and comparability, to the extent possible.'' Public Law 111–203, 124 Stat. 1376, 1641–1642 (to be codified at 15 U.S.C. 8302(a)(2)).

[12] Section 752(a) of the Dodd-Frank Act states in part that, ''[i]n order to promote effective and consistent global regulation of swaps and security-based swaps, the Commodity Futures Trading Commission, the Securities and Exchange Commission, and the prudential regulators (as that term is defined in Section 1a(39) of the Commodity Exchange Act), as appropriate, shall consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards with respect to the regulation (including fees) of swaps.'' Public Law 111–203, 124 Stat. 1376, 1749–1750 (to be codified at 15 U.S.C. 8325(a)).

[13] ''Prudential regulator,'' as explained in Section 711 of the Dodd-Frank Act, has the meaning given to it in section 1a of the Commodity Exchange Act (7 U.S.C. 1a), including any modification thereof under section 721(b) of the Dodd-Frank Act. Public Law 111–203, 124 Stat. 1376, 1641 (to be codified at 15 U.S.C. 8301).

[14] A list of Commission staff meetings in connection with this rulemaking is available on the Commission's website under ''Meetings with SEC Officials'' at *http://www.sec.gov/comments/df-title-vii/swap/swap.shtml.* In addition, the Commission received several letters from the public, available at *http://www.sec.gov/comments/df-title-vii/swap/swap.shtml.*

[15] *See, e.g.,* Int'l Org. of Securities Commissions, *Operational and Financial Risk Management Control Mechanisms for Over-the-Counter Derivatives Activities of Regulated Securities Firms,* (July 1994) (''IOSCO Report''); Bank for Int'l Settlements, Basel Committee on Banking Supervision, Risk Management Guidelines for Derivatives (July 1994) (''BIS Report''); Derivatives Policy Group, *Framework for Voluntary Oversight* (Mar. 1995), *http://www.riskinstitute.ch/137790.htm;* The Counterparty Risk Management Group, *Improving Counterparty Risk Management Practices* (June 1999) (''CRMPG I Report''); The Counterparty Risk Management Group, *Toward Greater Financial Stability: A Private Sector Perspective. The Report of the Counterparty Risk Management Policy Group II* (July 27, 2005) (''CRMPG II Report''); The Counterparty Risk Management Group, *Containing Systemic Risk: The Road to Reform, The Report of the CRMPG III* (Aug. 6, 2008) (''CRMPG III Report''). In considering industry voluntary best practices, the Commission acknowledges that such best practices were not necessarily intended to establish or guide regulatory standards for which market participants would have legal liability if violated.

[16] *See* Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 75 FR 80638 (Dec. 22, 2010) (''CFTC External Business Conduct Release''). Comments received by the CFTC are available at *http://comments.cftc.gov/PublicComments/CommentList.aspx?id=935.*

[17] *See* Section 3(f) of the Exchange Act, 15 U.S.C. 78c(f).

[18] *See* Section I.B, *supra.*

based swaps, as well as the role that market developments may play in changing the nature and implications of regulation, and to focus in particular on this issue with respect to the proposed business conduct standards for SBS Entities.

2. SRO Rules as a Potential Point of Reference

Under the framework established in the Dodd-Frank Act, SBS Entities are not required to be members of SROs, and no SRO has authority to regulate the activities of an SBS Entity, unless the SBS Entity is otherwise a member of that SRO. Nevertheless, we preliminarily believe that SRO business conduct rules provide a potential point of reference to inform our development of business conduct rules for SBS Entities, for several reasons.[19]

First, a number of the business conduct standards in Section 15F(h) of the Exchange Act, including those regarding fair and balanced communications,[20] supervision,[21] and designation of a chief compliance officer,[22] appear to be patterned on and are consistent with standards that have been established by SROs for their members, with Commission approval.[23]

Second, business conduct standards under SRO rules have been developed over the course of many decades with input from market participants. Many market participants are familiar with these standards and are experienced with implementing them through existing compliance and supervisory controls and procedures. Indeed, if the Commission were to promulgate completely new business conduct standards that deviate in approach from established SRO rules in the same areas, our actions could increase uncertainty and impose burdens on the many market participants already familiar with SRO business conduct standards by requiring them to adapt to and implement a new and different business conduct regime for security based swap transactions.

Third, to the extent that certain SBS Entities may also be registered as broker-dealers, they would be subject to the full panoply of SRO rules, including SRO business conduct rules, with respect to their activities related to security-based swaps.[24] If the Commission were to adopt business conduct standards that differ materially from those imposed by SRO rules, these firms could be required to comply with two different, and potentially inconsistent, business conduct regimes—the Commission's and the SRO's—for the same transaction. Conversely, consistency between the business conduct requirements could reduce potential competitive disparities between SBS Entities that are SRO members and those that are not. Consistent regulatory requirements could also potentially benefit counterparties to SBS Entities, by providing a more uniform level of protection and limiting the confusion or uncertainty that might otherwise arise if substantially different rules were to apply to the same type of transaction based solely on whether the SBS Entity is an SRO member.

At the same time, in considering the business conduct standards that have been developed by SROs, we are mindful that the security-based swap market historically has been primarily an institutional market in which transactions are typically negotiated on a principal-to-principal basis. While there is a wide range of counterparty sophistication within this market, the greater participation of institutional investors in the security-based swap market suggests a potentially different dynamic in the nature of the interactions between SBS Entities and their counterparties. Accordingly, it may be appropriate, for example, for the business conduct requirements applicable to SBS Entities to diverge to some extent from the requirements generally applicable to broker-dealers, whose activities may range from principal trading with institutional counterparties to retail brokerage on behalf of individual investors.

In light of these considerations, the Commission is seeking to strike a balance in its use of SRO business conduct standards as a point of reference for the proposed rules. As noted above, one potential benefit of this approach would be to provide greater legal certainty and promote consistent requirements across different types of SBS Entities. That potential benefit would not be achieved if the Commission were to implement, interpret and enforce its business conduct standards in a manner that differs substantially from that of the SROs without grounding such actions in functional differences between the security-based swap market and other securities markets. Thus, absent such functional differences, when a business conduct standard in these proposed rules is based on a similar SRO standard, we would expect—at least as an initial matter—to take into account the SRO's interpretation and enforcement of its standard when we interpret and enforce our rule. At the same time, as noted above, we are not bound by an SRO's interpretation and enforcement of an SRO rule, and our policy objectives and judgments may diverge from those of a particular SRO. Accordingly, we would also expect to take into account such differences in interpreting and enforcing our rules.

We request comment on all aspects of our approach to using business conduct requirements applicable to market professionals (such as broker-dealers and futures commission merchants) under existing SRO rules as a point of reference in developing the business conduct requirements applicable to SBS Entities.

3. Business Conduct Rules Not Expressly Addressed by the Dodd-Frank Act

In addition to business conduct requirements expressly addressed by Title VII of the Dodd-Frank Act, we are proposing for comment certain other business conduct requirements for SBS Dealers that we preliminarily believe would further the principles that underlie the Dodd-Frank Act. These rules would, among other things, impose certain ''know your counterparty'' and suitability obligations on SBS Dealers, and restrict SBS Dealers from engaging in certain ''pay to play'' activities.[25]

Know Your Counterparty—Broker-dealers are subject to ''know your customer'' standards that help to ensure investor protection and fair dealing in securities transactions, both for retail

[19] We have looked, in particular, to the requirements imposed by the Financial Industry Regulatory Authority, Inc., the Municipal Securities Rulemaking Board, and the National Futures Association.

[20] Section 15F(h)(3)C) of the Exchange Act, Public Law 111–203, 124 Stat. 1376, 1790 (to be codified at 15 U.S.C. 78o–10(h)(3)(C)). *Cf.* NASD Rule 2210(d)(1)(A).

[21] Section 15F(h)(1)(B) of the Exchange Act, Pub. L. 111–203, 124 Stat. 1376, 1789 (to be codified at 15 U.S.C. 78o–10(h)(1)(B)). *Cf.* NASD Rules 3010 and 3012.

[22] Section 15F(k) of the Exchange Act, Public Law 111–203, 124 Stat. 1376, 1793—1794 (to be codified at 15 U.S.C. 78o–10(k)). *Cf.* FINRA Rule 3130.

[23] The Commission exercises oversight over SROs with respect to their interpretive, rulemaking and enforcement activities. *See* Section 19 of the Exchange Act, 15 U.S.C. 78s.

[24] Because security-based swap transactions are ''securities'' within the meaning of Section 3(a)(10) of the Exchange Act, broker-dealers would be subject to SRO business conduct and other rules applicable to such transactions. Public Law 111–203, 124 Stat. 1376, 1755, § 761(a)(2) (to be codified at 15 U.S.C. 78c(a)(10)).

[25] The CFTC has recently proposed rules that would impose similar requirements for swap dealers and major swap participants. *See* CFTC External Business Conduct Release, *supra,* note 16.

and institutional investors.[26] We preliminarily believe that a ''know your counterparty'' standard would be consistent with the principles underlying the Dodd-Frank Act. Accordingly, we are proposing, in addition to the rules expressly addressed by Section 15F(h) of the Exchange Act, certain ''know your counterparty'' requirements for SBS Dealers.[27]

Suitability—Broker-dealers are subject to suitability standards that help to ensure investor protection and fair dealing in securities transactions, both for retail and institutional investors.[28] In addition, the Dodd-Frank Act effectively imposes a suitability requirement on SBS Dealers that, when acting as advisors, make recommendations to special entities.[29] We preliminarily believe that it would be appropriate to extend these protections to certain situations in which an SBS Dealer is entering into a security-based swap with a counterparty that is not a special entity. Accordingly, we are proposing certain suitability requirements for SBS Dealers when making recommendations to counterparties.[30]

Pay to Play—We are also proposing pay to play restrictions for SBS Dealers that are intended to complement the restrictions applicable to other market intermediaries seeking to engage in securities transactions with municipal entities. As explained more fully in Section II.D.5, pay to play practices, in which elected officials may allow political contributions to play a role in the selection of financial services providers, distort the process by which public contracts are awarded. Concerns about pay to play practices in the municipal securities and investment adviser contexts have prompted the promulgation of pay to play restrictions for those market professionals.[31] We are concerned that similar pay to play practices could distort the market for securities-based swap transactions.[32] These abuses encourage corrupt market practices, and can harm municipal entities that subsequently enter into inappropriate security-based swaps.[33] Because certain SBS Dealers may not be covered by other pay to play rules already in effect, we are proposing for comment here pay to play rules intended to create a comparable regulatory framework with respect to those SBS Dealers. Given the similarity of pay to play practices across various contexts, and to facilitate compliance, we are proposing pay to play rules that are intended to be consistent with existing pay to play rules, to the extent practicable.

We request comment on all aspects of our proposal to impose certain limited business conduct requirements not expressly addressed by the Dodd-Frank Act.

4. Differences Between SBS Dealers and Major SBS Participants

We have also considered how the differences between the definitions of SBS Dealer and Major SBS Participant may be relevant in formulating the business conduct standards applicable to these entities. The Dodd-Frank Act defines ''security-based swap dealer'' in a functional manner, by reference to the way a person holds itself out in the market and the nature of the conduct engaged in by that person, and how the market perceives the person's activities.[34] As described in our joint proposal with the CFTC regarding this definition:

> [S]wap dealers can often be identified by their relationships with counterparties. Swap dealers tend to enter into swaps with more counterparties than do non-dealers, and in some markets, non-dealers tend to constitute a large portion of swap dealers' counterparties. In contrast, non-dealers tend to enter into swaps with swap dealers more often than with other non-dealers. The Commissions can most efficiently achieve the purposes underlying Title VII of the Dodd-Frank Act—to reduce risk and to enhance operational standards and fair dealing in the swap markets—by focusing their attention on those persons whose function is to serve as the points of connection in those markets. The definition of swap dealer, construed functionally in the manner set forth above, will help to identify those persons.[35]

The definition of ''major security-based swap participant,'' in contrast, focuses on the market impacts and risks associated with an entity's security-based swap positions.[36] Despite the differences in focus, the Dodd-Frank Act applies substantially the same statutory standards to SBS Dealers and Major SBS Participants.[37] We have attempted to

[26] *See* Notice of Filing of Amendment No. 1 to a Proposed Rule Change and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment No. 1, to Adopt FINRA Rules 2090 (Know Your Customer) and 2111 (Suitability) in the Consolidated FINRA Rulebook, Exchange Act Release No. 63325 (Nov. 17, 2010), 75 FR 71479 (Nov 23, 2010) (effective July 9, 2012) (''Suitability Order'').

[27] Proposed Rule 15Fh–3(e), discussed in Section II.C.3, *infra.*

[28] *See* Suitability Order, *supra.*

[29] Section 15F(h)(4)(C) of the Exchange Act (''Any security-based swap dealer that acts as an advisor to a special entity shall make reasonable efforts to obtain such information as is necessary to make a reasonable determination that any security-based swap recommended by the security-based swap dealer is in the best interests of the special entity''). Pub. L. 111–203, 124 Stat. 1376, 1790–1791 (to be codified at 15 U.S.C. 78o–10(h)(4)(C)).

[30] Proposed Rule 15Fh–3(f), discussed in Section II.C.4, *infra.* The suitability obligation would not apply if the counterparty is an SBS Entity or a swap dealer or major swap participant. In addition, the proposed rule would include an alternative similar to the FINRA ''institutional suitability'' exemption, as described more fully below.

[31] *See* Rule 205(4)–5 under the Investment Advisers Act of 1940 (applying pay to play restrictions to investment advisers), and MSRB Rule G–37 (which seeks to eliminate pay to play practices in the municipal securities market through restrictions on political contributions and prohibitions on municipal securities business).

[32] For example, the Commission has brought a number of actions in connection with payments by J.P. Morgan Securities Inc. to local firms whose principals or employees were friends of Jefferson County, Alabama public officials in connection with $5 billion in County bond underwriting and interest rate swap agreement business awarded to the broker-dealer. The Commission has alleged that J.P. Morgan Securities engaged in pay to play practices in connection with obtaining municipal security underwriting and interest swap agreement business from municipalities. The Commission has alleged that J.P. Morgan Securities incorporated certain of the costs of these payments into higher swap interest rates it charged the County, directly increasing the swap transaction costs to the County and its taxpayers. *See SEC* v. *Larry P. Langford,* Litigation Release No. 20545 (Apr. 30, 2008) and *SEC* v. *Charles E. LeCroy,* Litigation Release No. 21280 (Nov. 4, 2009) (charging Alabama local government officials and J.P. Morgan employees with undisclosed payments made to obtain municipal bond offering and swap agreement business from Jefferson County, Alabama). *See also J.P. Morgan Securities Inc.*, File No. 3–13673 (Nov. 4, 2009) (instituting administrative and cease-and-desist proceedings against a broker-dealer that allegedly was awarded bond underwriting and interest rate swap agreement business by Jefferson County in connection with undisclosed payments by employees of the firm).

[33] *See also* Political Contributions by Certain Investment Advisers, Investment Advisers Act Release No. 3043 (July 1, 2010), 75 FR 41018 (July 14, 2010) (describing concerns that led to adoption of Advisers Act Rule 206(4)–5); Alexander W. Butler, Larry Fauver, and Sandra Mortal, *Corruption, Political Connections, and Municipal Finance,* 22 The Review of Financial Studies 2873 (2009) (describing effect of pay to play practices on greater credit risk, higher bond yields and underwriting premium fees in municipal bond sales and underwriting).

[34] *See* note 4, *supra* (definition of ''security-based swap dealer'').

[35] Definitions Release (using ''swap dealer'' to refer both to security-based swap dealer and to swap dealer).

[36] As explained in the Definitions Release, the ''major security-based swap participant'' definition uses terms—particularly ''systemically important,'' ''significantly impact the financial system,'' and ''create substantial counterparty exposure''—that denote a focus on entities that pose a high degree of risk through their security-based swap activities. In addition, the link between the ''major participant'' definition and risk was highlighted during the Congressional debate on the statute. *See* 156 Cong. Rec. S5907 (daily ed. July 15, 2010) (dialogue between Senators Hagen and Lincoln, discussing how the goal of the major participant definition was to ''focus on risk factors that contributed to the recent financial crisis, such as excessive leverage, under-collateralization of swap positions, and a lack of information about the aggregate size of positions'').

[37] In particular, under Section 15F of the Exchange Act, SBS Dealers and Major SBS Participants generally are subject to the same types of margin, capital, business conduct and certain other requirements, unless an exclusion applies. In this way, the statute applies comprehensive

take into account these differing definitions and regulatory concerns in considering whether the business conduct requirements that we are proposing for SBS Dealers that are not expressly addressed by the statute should or should not apply to Major SBS Participants as well.[38] In general, where the Dodd-Frank Act imposes a business conduct requirement on both SBS Dealers and Major SBS Participants, we have proposed rules that would apply equally to SBS Dealers and Major SBS Participants. Where, however, a business conduct requirement is not expressly addressed by the Dodd-Frank Act, the proposed rules generally would not apply to Major SBS Participants.[39]

We request comment on whether this approach is appropriate. Where the Dodd-Frank Act requires that a business conduct rule apply to all SBS Entities, should the rule impose the same requirements on Major SBS Participants as on SBS Dealers? Where we are proposing rules for SBS Dealers that are not expressly addressed by the Dodd-Frank Act, should any of these rules apply as well to Major SBS Participants? If so, which rules and why?

5. Treatment of Special Entities

Congress has provided certain additional protections in the Dodd-Frank Act for ''special entities''—including certain municipalities, pension plans, and endowments—in connection with security-based swaps. In particular, as described in Section II.D below, Sections 15F(h)(4) and (5) of the Exchange Act, as amended by the Dodd Frank Act, establish a set of additional provisions addressed solely to the interactions between SBS Entities and special entities in connection with security-based swaps.

Some commenters have noted that special entities, like other market participants, may use swaps and security-based swaps for a variety of beneficial purposes, including risk management and portfolio adjustment.[40] For example, we understand that pension plans can be authorized to use such instruments in order to meet the investment objectives of their members.[41] At the same time, some commenters have also noted that the financial sophistication of these entities can vary greatly.[42] Such variation in sophistication, among other factors, has raised concerns about potential abuses in connection with security-based swap transactions with special entities.[43]

In implementing the special entity provisions of the Dodd-Frank Act, we have sought to give full effect to the additional protections for these entities contemplated by the statute, while not imposing restrictions on SBS Entities that would unduly limit their willingness or ability to provide special entities with the access to security-based swaps that special entities may need for risk management and other beneficial purposes. We request comment on all aspects of the approach to special entities described in this release.

II. Discussion of Proposed Rules Governing Business Conduct

The proposed rules would implement the requirements of the Dodd-Frank Act relating to business conduct standards for SBS Entities.

A. Scope: Proposed Rule 15Fh–1

Proposed Rule 15Fh–1 provides that proposed Rules 15Fh–1 through 15Fh–6 and Rule 15Fk–1 are not intended to limit, or restrict, the applicability of other provisions of the federal securities laws, including but not limited to Section 17(a) of the Securities Act of 1933 (''Securities Act''), Sections 9 and 10(b) of the Exchange Act, and the rules and regulations thereunder.[44] It also provides that proposed Rules 15Fh–1 through 15Fh–6 and Rule 15Fk–1 would not only apply in connection with entering into security-based swaps but also would continue to apply, as relevant, over the term of executed security-based swaps. Specifically, as discussed more fully herein, an SBS Entity's obligations under proposed Rules 15Fh–3(c) (daily mark) and 15Fh–3(g) (fair and balanced communications) would continue to apply over the life of a security-based swap. In addition, SBS Entities would be subject to ongoing obligations under proposed Rules 15Fh–3(h) (supervision) and 15Fk–1 (chief compliance officer). The proposed rules would not, however, apply to security-based swaps executed prior to the compliance date of these rules.

Request for Comments

The Commission requests comments generally on all aspects of proposed Rule 15Fh–1 and the scope of the proposed business conduct rules. In addition, we request comment on the following specific issues:

- Should any rule proposed by this release specify in greater detail the manner in which its disclosure or other requirements apply to associated persons?[45] If so, for which rules would such clarification be helpful? How should the Commission apply the requirements of such rules to the associated person?
- Should the proposed rules apply to transactions between an SBS Entity and

regulation to entities (*i.e.,* Major SBS Participants) whose security-based swap activities do not cause them to be dealers, but nonetheless could pose a high degree of risk to the U.S. financial system generally. *See* Public Law 111–203, 124 Stat. 1376, 1785–1796 (to be codified at 15 U.S.C. 78o–10).

[38] *See* Section I.C.4, *infra*.

[39] There are exceptions to this principle. We are proposing that all SBS Entities be required to determine if a counterparty is a special entity. In addition, Section 3C(g)(5) of the Exchange Act creates certain rights with respect to clearing for counterparties entering into security-based swaps with SBS Entities but does not require disclosure. We are proposing a rule that would require an SBS Entity to disclose to a counterparty certain information relating to these rights. *See* Public Law 111–203, 124 Stat. 1376, 1766–1767 (to be codified at 15 U.S.C. 78c–3(g)(5)). The proposed rule is intended to further the purposes of the Dodd-Frank Act to ensure that, wherever possible and appropriate, derivatives contracts formerly traded exclusively in the OTC market are cleared through a regulated clearing agency.

[40] As explained by one commenter:

''Swaps permit [pension] plans to hedge against market fluctuations, interest rate changes, and other factors that create volatility and uncertainty with respect to plan funding. Swaps also help plans rebalance their investment portfolios, diversify their investments, and gain exposure to particular asset classes without direct investments. By helping to protect plan assets as part of a prudent long-term investment strategy, swaps benefit the millions of participants who rely on these plans for retirement income, health care, and other important benefits.''

Letter from Mark J. Ugoretz, President and CEO, The ERISA Industry Committee to David A. Stawick, Secretary, CFTC (Feb. 22, 2011).

[41] *See, e.g.,* Letter from Joseph A. Dear, Chief Investment Officer, California Public Employees' Retirement System *et al.* to David A. Stawick, Secretary, CFTC (Feb. 18, 2011) (the ''Public Pension Funds Letter''):

To fulfill obligations to our members, we invest in a wide variety of assets classes, including alternative investment management, global equity, global fixed income, inflation-linked assets, and real estate. As part of our investment and risk management policies, we have authorized the use of certain derivates. The authorized derivatives include futures, forward, swaps, structured notes and options.

[42] *See, e.g.,* Letter from Barbara Roper, Director of Investor Protection, Consumer Federation of America, Lisa Donner, Executive Director, Americans for Financial Reform, Michael Greenberger, J.D., Founder and Director of University of Maryland Center for Health and Homeland Security, and Damon Silvers, Director of Policy and Special Counsel, AFL–CIO to David A. Stawick, Secretary, CFTC (Feb. 22, 2011).

[43] *See, e.g.,* 156 Cong. Rec. S5903 (daily ed. Jul. 15, 2010) (statement of Sen. Lincoln) (discussing how ''pension plans, governmental investors, and charitable endowments were falling victim to swap dealers marketing swaps and security-based swaps that they knew or should have known to be inappropriate or unsuitable for their clients. Jefferson County, AL, is probably the most infamous example, but there are many others in Pennsylvania and across the country.'').

[44] Section 15F(h) of the Exchange Act does not, by its terms, create a new private right of action or right of rescission, nor do we anticipate that the proposed rules would create any new private right of action or right of rescission.

[45] As described below, proposed Rule 15Fh–2(d) would provide that the term ''security-based swap dealer or major security-based swap participant'' would include, ''where relevant,'' an associated person of the SBS Entity in question.

its affiliates? If so, which rules? Why or why not?

• Should any rules proposed by this release, such as those relating to the daily mark or fair and balanced communications, apply to security-based swaps that were entered into prior to the effective date of these rules? If so, which rules and why?

• Should any of the proposed rules apply to amendments, made after the effective date of these rules, to security-based swaps that were entered into prior to the effective date of the rules? If so, which rules and why?

• Are there any specific interactions or relationships between the proposed rules and existing federal securities laws that should be addressed? Are there any specific interactions or relationships between the proposed rules and other regulatory requirements, such as SRO rules, that should be addressed? Are there any specific interactions or relationships between the proposed rules and other existing non-securities statutes and regulations (*e.g.,* ERISA) that should be addressed? If so, how should those interactions or relationships be clarified?

• To the extent any of the rules proposed herein are intended to provide additional protections for a particular counterparty, should the counterparty be able to opt out of those protections? Should the ability to opt out be limited to certain types of counterparties? Why or why not? What criteria should determine or inform the decision to permit a counterparty to opt out? For example, should opt out be permitted when a counterparty is a regulated entity such as a registered broker-dealer? A registered futures commission merchant? A bank? Should opt out be permitted when a counterparty meets certain objective standards, such as being a ''qualified institutional buyer'' within the meaning of Rule 144A under the Securities Act?[46] Why or why not? What other standards, if any, should the Commission consider? What would be the advantages and disadvantages of permitting a counterparty to opt out? What are the reasons that a counterparty might want to opt out of protections provided by the proposed business conduct standards? For example, would permitting counterparties to opt out lower costs? Would these reasons vary among different types of counterparties? Would counterparties have a meaningful opportunity to elect whether or not to opt out of these protections, or would they face commercial or other pressure from SBS Entities that could curtail their choice? How would permitting counterparties to opt out affect the protections otherwise afforded by the proposed rules to the counterparties of SBS Entities? How would the overall effectiveness of a proposed rule be affected if a substantial population of counterparties opts out of that rule?

• As discussed below in Section II.E, proposed Rule 15Fk–1 would require an SBS Entity to have policies and procedures reasonably designed to achieve compliance with Section 15F and the rules and regulations thereunder. Should an SBS Entity be deemed to have complied with a requirement under the proposed rules if: (i) The SBS Entity has established and maintained written policies and procedures, and a documented system for applying those policies and procedures, that are reasonably designed to achieve compliance with the requirement; and (ii) the SBS Entity has reasonably discharged the duties and obligations required by the written policies and procedures and documented system and did not have a reasonable basis to believe that the written policies and procedures and documented system were not being followed? Why or why not? Please explain the advantages or disadvantages of this approach to the extent it results in rules that effectively require SBS Entities to maintain and enforce specified policies and procedures regarding certain conduct, rather than rules that directly require, or prohibit, that conduct. Would this approach be appropriate for certain specific requirements of the rules but not for others? Why or why not? Would such an approach encourage or discourage compliance with the requirements under the proposed rules? Would the behavior of SBS Entities or the way in which they design their compliance programs be different under this approach than it would be under the rules as proposed? How would the effectiveness of such an approach compare to the effectiveness of the rules as proposed in implementing the requirements of the Dodd-Frank Act regarding the business conduct of SBS Entities, especially with respect to special entities? Would such an approach affect the ability of the Commission to inspect for compliance with the rules or to bring enforcement actions regarding violations? If so, how?

• As discussed herein, we preliminarily believe that, absent special circumstances, it would be appropriate for SBS Entities to rely on counterparty representations in connection with certain specific requirements under the proposed rules. To solicit input on when it would no longer be appropriate for an SBS Entity to rely on such representations without further inquiry, the Commission is proposing for comment two alternative approaches. One approach would permit an SBS Entity to rely on a representation from a counterparty unless it knows that the representation is not accurate. The second would permit an SBS Entity to rely on a representation unless the SBS Entity has information that would cause a reasonable person to question the accuracy of the representation. Should the rules that the Commission ultimately adopts include a standard addressing the circumstances in which an SBS Entity may rely on representations to establish compliance with the proposed rules? Why or why not?

B. Definitions: Proposed Rule 15Fh–2

Proposed Rule 15Fh–2(a), as discussed in Section II.D.3 below, would define ''act as an advisor'' for purposes of Section 15F(h)(4) of the Exchange Act and proposed Rule 15Fh–4(b).

Proposed Rule 15Fh–2(b) would define ''eligible contract participant'' to mean any person defined in Section 3(a)(66) of the Exchange Act.

Proposed Rule 15Fh–2(c), as discussed in Section II.D.4.b. below, would define ''independent representative of a special entity'' for purposes of Section 15F(h)(5) of the Exchange Act and proposed Rule 15Fh–5.

Proposed Rule 15Fh–2(d) would provide that ''security-based swap dealer or major security-based swap participant'' would include, where relevant, an associated person of the SBS Dealer or Major SBS Participant.[47] To the extent that an SBS Entity acts through, or by means of, an associated person of that SBS Entity, the associated person must comply as well with the

[46] *See* Rule 144A(a), 17 CFR 230.144A(a) (defining ''qualified institutional buyer''). *See* Letter from Kenneth E. Bensten, Jr., Executive Vice President, Public Policy and Advocacy, SIFMA, and Robert C. Pickel, Executive Vice Chairman, ISDA to David A. Stawick, Secretary, CFTC (Feb. 17, 2011) (on file with Commission) (''SIFMA/ISDA 2011 Letter'') (recommending that Commission permit opt out by ''sophisticated counterparties,'' including '' 'qualified institutional buyers' as defined in Rule 144A * * * and corporations having total assets of $100 million or more'').

[47] *See* Section 3(a)(70) of the Exchange Act, Pub. L. 111–203, 124 Stat. 1376, 1757–1758 (to be codified at 15 U.S.C. 78c(a)(70)) (defining ''Person Associated with a Security-Based Swap Dealer or Major Security-Based Swap Participant'').

applicable business conduct standards.[48]

Proposed Rule 15Fh–2(e), as discussed in Section II.D.1 below, would define ''special entity.''

Proposed Rule 15Fh–2(f), as discussed in Section II.D.4.e below, would define a person that is ''subject to a statutory disqualification'' to mean a person that would be subject to a statutory disqualification under the provisions of Section 3(a)(39) of the Exchange Act.

Request for Comments

The Commission requests comments generally on all aspects of proposed Rule 15Fh–2. In addition, we request comments on the following specific issues:

- Are there additional terms that should be defined by the Commission; if so, how should such terms be defined and why?[49]
- Should the proposed rules expressly identify the requirements that apply to associated persons of an SBS Entity? If so, which rules and why?
- Is it possible that an associated person that is an entity (*i.e.,* not a natural person) that effects or is involved in effecting security-based swaps on behalf of an SBS Entity would be subject to a statutory disqualification? If so, should the Commission consider excepting any such persons from the prohibition in Section 15F(b)(6)? Under what circumstances and why? Should the Commission except such persons globally or on an individual basis?
- Are there certain statutorily disqualified persons who should not be permitted to remain associated with an SBS Entity based upon the nature of the disqualification?
- Should there be any differentiation in relief based upon the nature of the person, *e.g.,* a natural person or an entity? If so, when and why?

C. Business Conduct Requirements: Proposed Rule 15Fh–3

1. Counterparty Status

Proposed Rule 15Fh–3(a)(1) would require an SBS Entity, as provided by Section 15F(h)(3)(A) of the Exchange Act, to verify that a counterparty whose identity is known to an SBS Entity prior to the execution of the transaction meets the eligibility standards for an ECP before entering into a security-based swap with that counterparty other than on a registered national securities exchange.[50] Although the statute is silent concerning the timing of the verification, we believe it is important for an SBS Entity to verify ECP status before entering into a security-based swap because, among other things, Section 6(l) of the Exchange Act makes it unlawful to effect a transaction in a security-based swap with or for a person that is not an ECP, unless the transaction is effected on a registered national securities exchange.[51] In addition, proposed Rule 15Fh–3(a)(1) would not require an SBS Entity to verify the ECP status of a counterparty in a transaction executed on a registered national securities exchange or a registered security-based swap execution facility (''SEF''). Such verification would not be necessary because, under proposed Rule 809, SEFs may not provide access to entities that are not ECPs, and thus an SBS Entity could effectively rely on the verification of ECP status by a SEF or any broker or SBS Dealer indirectly providing access.[52]

Proposed Rule 15Fh–3(a)(2) would require an SBS Entity to verify whether a counterparty whose identity is known to an SBS Entity prior to the execution of the transaction is a special entity before entering into a security-based swap with that counterparty.[53] Although the Dodd-Frank Act does not specifically require an SBS Entity to verify whether a counterparty is a special entity, we preliminarily believe that such verification would facilitate the implementation of the special business conduct rules under the Dodd-Frank Act that apply to SBS Entities dealing with special entities.[54]

We believe that SBS Entities may satisfy these proposed verification requirements through any reasonable means.[55] For example, an SBS Entity could verify that a counterparty is an ECP by obtaining a written representation from the counterparty. We preliminarily believe that it would not be reasonable for an SBS Entity to rely on a representation that merely states that the counterparty is an ECP because the counterparty may not be familiar with the definitions of the term under the federal securities laws. However, it would be reasonable for an SBS Entity to rely on a written representation as to specific facts about the counterparty (e.g., that it has $10 million in assets) in order to conclude that the counterparty is an ECP.

Similarly, we preliminarily believe that it would not be reasonable for an SBS Entity to rely on a representation that merely states that the counterparty is not a ''special entity'' because the counterparty may not be familiar with the definition of the term under the federal securities laws. However, an

[48] *See* Section 20(b) of the Exchange Act, 15 U.S.C. 78t(b) (''It shall be unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do under the provisions of this title or any rule or regulation thereunder through or by means of any other person.'').

[49] The Commission is proposing to define certain additional terms solely for purposes of proposed Rules 15Fh–6 and 15Fk–1. *See* proposed Rules 15Fh–6(a) and 15Fk–1(e).

[50] *See* Section 15F(h)(3)(A) of the Exchange Act (requiring the Commission to establish a duty for an SBS Entity to verify that its counterparty meets the eligibility requirements of an ECP). Public Law 111–203, 124 Stat. 1376, 1790 (to be codified at 15 U.S.C. 78o–10(h)(3)(A). Under Exchange Act Section 3(a)(65), the term ''eligible contract participant'' has the same meaning as in Section 1a of the Commodity Exchange Act (7 U.S.C. 1a). Public Law 111–203, 124 Stat. 1376, 1755 (to be codified at 15 U.S.C. 78c(a)(65)). *See also* Definitions Release (proposing to further define ''eligible contract participant'' to include, among others, swap dealers, major swap participants, security-based swap dealers and major security-based swap participants).

[51] Public Law 111–203, 124 Stat. 1376, 1777, § 764(e) (to be codified at 15 U.S.C. 78f(l)) (''[i]t shall be unlawful for any person to effect a transaction in a security-based swap with or for a person that is not an eligible contract participant, unless such transaction is effected on a [registered] national securities exchange''). *See also* Public Law 111–203, 124 Stat. 1376, 1801, § 768(b) (to be codified at 15 U.S.C. 77e(d)) (''unless a registration statement meeting the requirements of section 10(a) [of the Securities Act] is in effect as to a security-based swap, it shall be unlawful for any person * * * to offer to sell, offer to buy or purchase or sell a security-based swap to any person who is not an eligible contract participant'').

[52] Registration and Regulation of Security-Based Swap Execution Facilities, Exchange Act Release No. 63825 (Feb. 2, 2011), 76 FR 10948 (Feb. 28, 2011) (proposed Rule 809 would permit, but not require SEF participation ''only if such person is registered with the Commission as a security-based swap dealer, major security-based swap participant, or broker (as defined in section 3(a)(4) of the Act, 15 U.S.C. 78c(a)(4)), or if such person is an eligible contract participant (as defined in section 3(a)(65) of the Act, 15 U.S.C. 78c(a)(65)).'').

[53] *See generally* Section 15F(h)(1)(D) of the Exchange Act, Public Law 111–203, 124 Stat. 1376, 1789 (to be codified at 15 U.S.C. 78o–10(h)(1)(D)) (authorizing the Commission to prescribe business conduct standards that relate to ''such other matters as the Commission determines to be appropriate'').

[54] *See* Section II.D, *infra.* Because proposed Rule 15Fh–3(a)(2) would only apply when an SBS Entity knows the identity of its counterparty prior to the execution of a transaction, it is consistent with Section 15F(h)(7) of the Exchange Act, which contemplates an exception to all of the various business conduct requirements of Section 15F(h) for any transaction that is initiated by a special entity on an exchange or SEF, where the SBS Entity does not know the identity of the counterparty to the transaction.

[55] The SBS Entity must keep records of its verification. *See* proposed Rule 15Fk–1, discussed *infra* at Section II.E, which would require an SBS Entity to have written policies and procedures and maintain records sufficient to enable its chief compliance office to verify compliance with the requirements of the proposed rules. In addition, the Commission is required to propose a rule regarding reporting and recordkeeping requirements for SBS Entities. *See* Section 15F(f)(2) of the Exchange Act, Public Law 111–203, 124 Stat. 1376, 1788 (to be codified at 15 U.S.C. 78o–10(f)(2)) (''The Commission shall adopt rules governing reporting and recordkeeping for security-based swap dealers and major security-based swap participants'').

SBS Entity could verify that a counterparty is not a special entity by obtaining a written representation from the counterparty that it does not fall within any of the enumerated categories of persons that are ''special entities'' for purposes of Section 15F of the Exchange Act (*e.g.,* that the counterparty is not a municipality, pension plan, etc.). In the context of either the ECP or the special entity verification, an SBS Entity would be entitled to rely on a counterparty's written representation for purposes of compliance with Rule 15Fh–3(a) without further inquiry, absent special circumstances described below.[56]

To solicit input on when it would no longer be appropriate for an SBS Entity to rely on such representations without further inquiry, the Commission is proposing for comment two alternative approaches. One approach would permit an SBS Entity to rely on a representation from a special entity for purposes of Rule 15Fh–3(a) unless it knows that the representation is not accurate. The second would permit an SBS Entity to rely on a representation unless the SBS Entity has information that would cause a reasonable person to question the accuracy of the representation.

Under either approach, an SBS Entity could not ignore information in its possession as a result of which the SBS Entity would know that a representation is inaccurate.[57] In addition, under the second approach, an SBS Entity also could not ignore information that would cause a reasonable person to question the accuracy of a representation and, if the SBS Entity had such information, it would need to make further reasonable inquiry to verify the accuracy of the representation.[58]

An SBS Entity that has complied with the requirements of proposed Rule 15Fh–3(a)(1) concerning a counterparty's eligibility for a particular security-based swap would fulfill its obligations under the proposed rule for that security-based swap, even if the counterparty subsequently ceases to meet the eligibility standards for an ECP during the term of that security-based swap. However, verification of a counterparty's status as an ECP (and, as applicable, as a special entity) for one security-based swap would not necessarily satisfy the SBS Entity's obligation with respect to other security-based swaps executed with that counterparty in the future. An SBS Entity would need to verify the counterparty's status for each subsequent security-based swap (which it could do by relying on written representations from the counterparty, as described above). An SBS Entity could satisfy this obligation by relying on a representation in a master or other agreement that is deemed to be repeated and incorporated into each security-based swap under that agreement as of the date on which each security-based swap is executed.[59]

Request for Comments

The Commission requests comments generally on all aspects of this provision. In addition, we request comments on the following specific issues:

• Although we are proposing to require that an SBS Entity verify that a counterparty is an ECP, we are not proposing at this time to require that the SBS Entity otherwise determine that a potential counterparty is ''qualified'' to engage in security-based swaps before entering into a security-based swap with that person.[60] Given that the Dodd-Frank Act permits any ECP to engage in security-based swaps, would it be appropriate for the Commission to limit which ECPs may engage in security-based swaps? Should the Commission impose an additional requirement that an SBS Entity determine that an ECP is otherwise ''qualified'' before the SBS Entity can enter into security-based swaps with such ECP? If so, what qualifications should be applied, and to which types of ECPs? For example, the definition of ECP includes persons with $5 million or more invested on a discretionary basis that enter into the security-based swap ''to manage risks.'' [61] In contrast, under FINRA rules, ''retail customers'' would include persons (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of up to $50 million.[62] To what extent do natural persons and institutions with assets of less than $50 million engage in security-based swap transactions? Would the ''know your counterparty'' and suitability obligations of an SBS Dealer under proposed Rule15Fh–3(e) and (f), as described more fully below, help to

[56] An SBS Entity would not be required to obtain a representation from the counterparty and so could elect to verify the counterparty's status through any other reasonable means.

[57] As described *infra,* proposed Rule 15Fh–3(e) would require an SBS Dealer to have policies and procedures reasonably designed to obtain and retain certain essential facts regarding a counterparty. As a result, information in the SBS Entity's possession would include information gathered by an SBS Dealer through compliance with the ''know your counterparty'' provisions of proposed Rule 15Fh–3(e), as well as any other information the SBS Entity has acquired through its interactions with the counterparty including other representations obtained from the counterparty by the SBS Entity.

[58] *Cf.* Rule 144A(d)(1)(iv) under the Securities Act, 17 CFR 230.144A(d)(1)(iv) (providing that in determining whether a prospective purchaser is a qualified institutional buyer, a seller of securities is entitled to rely on a certification by an executive officer of the purchaser with respect to the amount of securities owned and invested on a discretionary basis). The Commission, in its release adopting Rule 144A, explained that ''[u]nless circumstances exist giving a seller reason to question the veracity of the certification, the seller would not have a duty of inquiry to verify the certification.'' Private Resales of Securities to Institutions, Securities Act Release No. 6862 (April 27, 1990), 55 FR 17933 (Apr. 30, 1990). *Cf. also* Short Sales, Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (Aug. 6, 2004) at n. 58 (explaining that a broker-dealer can rely on a customer's assurance to establish the ''reasonable grounds'' required by Rule 203(b)(1)(ii) unless the broker-dealer ''knows or has reason to know'' that a customer's prior assurances resulted in failures to deliver).

Under Regulation R, a bank or a broker-dealer satisfies its customer eligibility requirements if the bank or broker-dealer ''has a reasonable basis to believe that the customer'' is an institutional customer or high net worth customer before the time specified in the rule. When adopting Regulation R, the Commission stated that a bank or broker-dealer would have a ''reasonable basis to believe'' if it obtains a signed acknowledgment that the customer met the applicable standards, unless it had information that would cause it to believe that the information provided by the customer was or was likely to be false. Definitions of Terms and Exemptions Relating to the ''Broker'' Exceptions for Banks, Exchange Act Release No. 56501 (Sep. 28, 2007), 72 FR 56514 (Oct. 3, 2007).

Commenters have suggested a similar approach. *See* SIFMA/ISDA 2011 Letter (suggesting that an SBS Entity should be able to rely on written representations by the counterparty ''absent actual notice of countervailing facts (or facts that reasonably should have put the [SBS Entity] on notice)'').

We note that Congress used similar language in the statutory provisions governing registration of SBS Entities. *See* Section 15F(b)(6) of the Exchange Act, Public Law 111–203, 124 Stat. 1376, 1785 (to be codified at 15 U.S.C. 78o–10(b)(6)) (generally making it unlawful for an SBS Entity to permit an associated person that is subject to a statutory disqualification to effect or participate in effecting security-based swaps on behalf of the SBS Entity if the SBS Entity ''knew, or in the exercise of reasonable care should have known,'' of the statutory disqualification).

[59] *See, e.g.,* SIFMA/ISDA 2011 Letter (suggesting that an SBS Entity should be able to rely on a master agreement that contains (1) a counterparty eligibility representation that is deemed to be made at the inception of each transaction and (2) a covenant that the counterparty will notify the SBS Entity if it ceases to be an ECP).

[60] *Cf.* FINRA Rule 2360(16)(A) (providing that no member or person associated with a member shall accept an order from a customer to purchase or write an option contract unless, among other things, the customer's account has been approved for options trading).

[61] A natural person with $5 million or more invested on a discretionary basis would qualify as an ECP if he or she entered into a security-based swap ''to manage risks.'' *See* Section 1a(18)(A)(xi) of the Commodity Exchange Act.

[62] Under FINRA rules, unless a person had total assets of at least $50 million, a broker-dealer engaging in transactions with that person would be subject to retail suitability obligations. *See* FINRA Rule 2111(b) (referring to NASD Rule 3110(c)(4)).

mitigate concerns regarding these persons?

• Are there alternative approaches that would be feasible in terms of market practice for determining ECP and special entity status? If so, what would be the advantages and disadvantages of these approaches for SBS Entities and counterparties? Should the Commission, for example, establish specific documentation requirements or procedures that could be used to verify ECP or special entity status? Should specific types of documentation be required? If so, what types of documentation (*e.g.,* bank or brokerage statements, legal entity filings)?

• Should the Commission otherwise specify the means by which SBS Entities should verify the status of a counterparty? If so, what means should it require?

• What are the advantages and disadvantages of the two alternative proposed approaches for determining when an SBS Entity may no longer rely on counterparty representations? Which alternative would strike the better balance among the regulatory interest in the verification of ECP and special entity status, the sound functioning of the security-based swap market, and the potential compliance costs for market participants? What, if any, other alternatives should the Commission consider (*e.g.,* a recklessness standard) and why?

• In light of the additional protections that are afforded special entities under the Dodd-Frank Act described in Section I.C.5 above, should an SBS Entity be required to undertake diligence or further inquiry in ascertaining the special entity status of a potential counterparty before it can rely on any representation as to such status from the counterparty? Why or why not? If such diligence or inquiry is not required, should an SBS Entity be permitted to rely on representations as to special entity status from a counterparty only where the SBS Entity does not have information that would cause a reasonable person to question the accuracy of the representation? Why or why not? Would requiring such diligence or further inquiry—or allowing reliance on representations only in such a manner—unduly limit the willingness or ability of SBS Entities to provide special entities with the access to security-based swaps for the purposes described in Section I.C.5 above? Why or why not? What, if any, other measures should be required in connection with an SBS Entity's verification of a counterparty's special entity status?

• Are there particular classes of ECPs or special entities for which an SBS Entity should be required to undertake further review or inquiry, rather than rely on written representations to verify status? Should further review or inquiry be required when, for example, a potential counterparty is a natural person or a special entity? If so, what review or inquiry should be required and, in what circumstances?

• Are there other potentially reasonable means or procedures that an SBS Entity might use to verify ECP or special entity status, other than through written representations, as to which the Commission should consider providing guidance? If so, what means or procedures should such guidance address, and how?

2. Disclosure

Section 15F(h)(3)(B) of the Exchange Act broadly requires the Commission to adopt rules requiring disclosures by SBS Entities to counterparties of information related to ''material risks and characteristics'' of the security-based swap, ''material incentives or conflicts of interest'' that an SBS Entity may have in connection with the security-based swap, and the ''daily mark'' of a security-based swap.

a. Disclosure Not Required When the Counterparty Is an SBS Entity or a Swap Dealer or a Major Swap Participant

Section 15F(h)(3)(B) further provides that disclosures under that section are not required when the counterparty is ''a security-based swap dealer, major security-based swap participant, security-based swap dealer, or major security-based swap participant.'' [63] We believe that the repetition of the terms ''security-based swap dealer and major security-based swap participant'' in this Exchange Act provision is a drafting error, and that Congress instead intended an exclusion identical to that found in the Commodity Exchange Act, which provides that these general disclosures are not required when the counterparty is ''a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant.'' [64] Accordingly, we are proposing that the disclosure requirements under Rule 15Fh–3(b) (information about material risks and characteristics, and material incentives or conflicts of interests), Rule 15Fh–3(c) (the daily mark), and Rule 15Fh–3(d) (clearing rights) not apply whenever the counterparty is an SBS Dealer, a Major SBS Participant, a swap dealer or a major swap participant.[65]

Request for Comments

The Commission requests comments generally on all aspects of this exception. In addition, we request comments on the following specific issues:

• Should some or all of the disclosure requirements under proposed Rule 15Fh–3(b) (information about material risks and characteristics, material incentives or conflicts of interests), Rule 15Fh–3(c) (the daily mark), and Rule 15Fh–3(d) (clearing rights) apply when the counterparty is an SBS Entity, swap dealer or major swap participant? Why or why not? For example, we are not proposing to require that an SBS Entity provide a daily mark to a counterparty that is an SBS Entity, swap dealer or major swap participant, because we preliminarily believe that a counterparty that falls into one of these categories would be able to perform the function on its own. Nevertheless, would there be some advantage in requiring such counterparties to exchange their respective marks, on a daily basis, so that any discrepancies are more transparent and can be identified and addressed promptly? Why or why not? Would there be disadvantages to this approach? Why or why not? Similarly, would there be any advantage in requiring any of the other disclosures to be made to a counterparty that is an SBS Entity, swap dealer or major swap participant? Why or why not? Would there be disadvantages? Why or why not?

• Should the Commission instead require that disclosures be made upon request by a counterparty that is an SBS Entity, swap dealer or major swap participant? Why or why not?

• Should the Commission require a different type or amount of disclosure for categories of counterparties that are market professionals such as broker-dealers, futures commission merchants and banks? What criteria should determine or inform the type or amount of disclosure? For example, should an SBS Entity be permitted to provide different or less detailed disclosure to a counterparty that is a registered broker-dealer? A registered futures commission merchant? A bank?

[63] Public Law 111–203, 124 Stat. 1376, 1790 (to be codified at 15 U.S.C. 78o–10(h)(3)(B)).

[64] Public Law 111–203, 124 Stat. 1376, 1708 (to be codified at 7 U.S.C. 6s(h)(3)(B)).

[65] *But see* proposed Rule 15Fh–1 (the proposed rules ''are not intended to limit, or restrict, the applicability of other provisions of the federal securities laws, including but not limited to, Section 17(a) of the Securities Act of 1933 and Sections 9 and 10(b) of the Securities Exchange Act of 1934.'').

b. Timing and Manner of Certain Disclosures

Proposed Rule 15Fh–3(b) would require that disclosures regarding material risks and characteristics and material incentives or conflicts of interest be made to potential counterparties before entering into a security-based swap, but would not mandate the manner in which those disclosures are made.[66] Proposed Rule 15Fh–3(d) similarly would require that disclosures regarding certain clearing rights be made before entering into a security-based swap, but also would not mandate the manner of disclosure. To the extent such disclosures were not otherwise provided to the counterparty in writing prior to entering into a security-based swap, proposed Rules 15Fh–3(b)(3) and 15Fh–3(d)(3) would require an SBS Entity to make a contemporaneous record of the non-written disclosures made pursuant to proposed Rules15Fh–3(b) and 15Fh–3(d), respectively, and provide a written version of these disclosures to the counterparty in a timely manner, but in any case no later than the delivery of the trade acknowledgement[67] of the particular transaction.[68]

Because disclosures of material risks and characteristics, material incentives or conflicts of interests, and clearing rights include information that the counterparty should consider in deciding whether to enter into the security-based swap, we are proposing to require that these disclosures be provided before entry into a security-based swap.

Concerning the manner of disclosure, however, we preliminarily believe that parties should have flexibility to make disclosures by various means, provided that the SBS Entity (1) makes an appropriate record of such disclosures and (2) supplies its counterparty with a written version of any disclosure required under these rules that was not made in writing prior to the transaction. Means of disclosure may include master agreements and related documentation, telephone calls, emails, instant messages, and electronic platforms.[69] Proposed Rule 15Fh–3(b) would require that the required disclosures regarding material risks and characteristics and material incentives or conflicts of interest be made ''in a manner reasonably designed to allow the counterparty to assess'' the information being provided. This provision is intended to require that disclosures be reasonably clear and informative as to the relevant material risks or conflicts that are the subject of the disclosure. This provision is not intended to impose a requirement that disclosures be tailored to a particular counterparty or to the financial, commercial or other status of that counterparty.[70]

We understand that security-based swaps generally are executed under master agreements, with much of the transaction-specific disclosure provided over the telephone, in instant messages or in confirmations. We anticipate that SBS Entities may elect to make certain required disclosures of material information to their counterparties in a master agreement or other written document accompanying such agreement.[71]

Commenters have asked that we clarify the applicability of these disclosure requirements to SEF- and exchange-traded security-based swaps in which the SBS Entity may not know the identity of the counterparty until immediately prior to (or after) execution of a transaction. The Dodd-Frank Act only addresses this issue in the context of special entities. Specifically, Section 15F(h)(7) provides an exception to the requirements of Section 15F(h) for a transaction that is ''initiated'' by a special entity on a SEF or an exchange and for which the SBS Entity does not know the identity of the counterparty to the transaction.[72]

We are seeking comment, therefore, on whether and how the proposed disclosure requirements should be satisfied for security-based swap transactions that are executed on a SEF or exchange and for which the SBS Entity does not know the identity of the counterparty until immediately prior to (or after) the execution of the transaction. In particular, we seek comment on how the disclosure obligations discussed below under proposed Rule 15Fh–3(b) (concerning material risks and characteristics, and material incentives or conflicts of interest) and proposed Rule 15Fh–3(d) (regarding clearing rights) could be met.

The statute requires rules adopted by the Commission to require the SBS Entity to make these disclosures. We believe that SBS Entities generally should be able to rely on means reasonably designed to achieve timely delivery of the required disclosures. In particular, an SBS Entity could cause

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[66] Section 15F(h)(3)(B) of the Exchange Act is silent regarding both form and timing of disclosure. *See* Public Law 111–203, 124 Stat. 1376, 1790 (to be codified at 15 U.S.C. 78o–10(h)(3)(B)).

[67] *See* Trade Acknowledgement and Verification of Security-Based Swap Transactions, Exchange Act Release No. 63727 (Jan. 14, 2011), 76 FR 3859 (Jan. 21, 2011) (proposing Rule 15Fi–1(c)(1), which would require a trade acknowledgement to be provided within 15 minutes of execution for a transaction that has been executed and processed electronically; within 30 minutes of execution for a transaction that is not electronically executed, but that will be processed electronically; and within 24 hours of execution for a transaction that the SBS Entity cannot process electronically).

[68] *See also* Section 15F(g) of the Exchange Act (requiring the Commission to adopt rules governing daily trading records, including recordings of telephone calls):

(g) DAILY TRADING RECORDS.—

(1) IN GENERAL.—Each registered security-based swap dealer and major security-based swap participant shall maintain daily trading records of the security-based swaps of the registered security-based swap dealer and major security-based swap participant and all related records (including related cash or forward transactions) and recorded communications, including electronic mail, instant messages, and recordings of telephone calls, for such period as may be required by the Commission by rule or regulation.

(2) INFORMATION REQUIREMENTS.—The daily trading records shall include such information as the Commission shall require by rule or regulation.

(3) COUNTERPARTY RECORDS.—Each registered security-based swap dealer and major security-based swap participant shall maintain daily trading records for each counterparty in a manner and form that is identifiable with each security-based swap transaction.

Public Law 111–203, 124 Stat. 1376, 1788–1789 (to be codified at 15 U.S.C. 78o–10(g)).

[69] For SBS Entities to rely on electronic media, however, their counterparties must have the capability to effectively access all of the information required by Rule 15Fh–3(b)(3) in a format that is understandable but not unduly burdensome for the counterparty. *See* Use of Electronic Media by Broker-Dealers, Transfer Agents and Investment Advisers for Delivery of Electronic Information, Securities Act Release No. 7288 (May 9, 1996), 61 FR 24644 (May 15, 1996). *See also* Use of Electronic Media, Exchange Act Release No. 42728 (Apr. 28, 2000), 65 FR 25843 (May 4, 2000).

[70] SBS Entities would, of course, have an on-going obligation to communicate with counterparties in a fair and balanced manner based on principles of fair dealing and good faith. *See* proposed Rule 15Fh–3(g) (discussed *infra* at Section II.C.5).

[71] While certain forms of disclosure may be highly standardized, the Commission anticipates that even such forms of disclosures will require certain provisions to be tailored to the particular transaction, most notably pricing and other transaction-specific commercial terms. We believe the proposed approach is generally consistent with the use of standardized disclosures suggested by industry groups and commenters. *See* CRMPG III Report (suggesting that standardized risk disclosures should be viewed as a supplement to, rather than a substitute for, more detailed disclosures); and Letter from Kenneth E. Bentsen, Jr., Executive Vice President, Public Policy and Advocacy, SIFMA and Robert G. Pickel, Executive Vice Chairman, ISDA to Elizabeth M. Murphy, Secretary, Commission and David A. Stawick, Secretary, Commodity Futures Trading Commission (Oct. 22, 2010) (on file with Commission) (''SIFMA/ISDA 2010 Letter'') (recommending the use of standard disclosure templates that could be adopted on an industry-wide basis, and noting that ''the process of developing standardized disclosure materials would * * * provide a means for identifying circumstances in which more tailored disclosure might be appropriate'').

[72] Public Law. 111–203, 124 Stat. 1376, 1792 (to be codified at 15 U.S.C. 78o–10(h)(7). *See* Section II.D, *infra.*

the required disclosures to be delivered through a third party or other indirect means (such as by contracting with a SEF to deliver the disclosure electronically) in circumstances in which it may not be practicable for an SBS Entity to directly provide the disclosures in a timely manner.

Commenters have suggested that SBS Entities should be able to rely on trade acknowledgements to satisfy certain disclosure requirements.[73] Because proposed Rule 15Fh–3(b) would require that disclosures be made before ''entering into'' a security-based swap, SBS Entities generally would not be able to rely on trade acknowledgements and other documents that are provided after the transaction is executed to satisfy the rule's disclosure obligations. SBS Entities could, however, rely on trade acknowledgements to memorialize disclosures they made, whether orally or by other means, prior to entering into the proposed transaction.[74]

Finally, although we are proposing to permit disclosure by a range of means, both oral and written, we may revisit whether Congress's objectives under Section 15F(h) and the focus here on supervision and compliance require some further specific obligations concerning the manner in which disclosures are made.

Request for Comments

The Commission requests comments generally on all aspects of this approach to the timing and manner of disclosure. In addition, we request comments on the following specific issues:

- Should the Commission impose more specific requirements concerning the timing and manner of disclosures? If so, what additional requirements should the Commission impose, and why?
- Commenters have urged the Commission to encourage the use of standardized disclosure templates.[75] Who would develop those templates? What would the content be? What disclosures do or do not lend themselves to a standardized template? How would the templates be updated or supplemented to respond to market developments or account for the characteristics of a specific transaction?
- Should the Commission require that all material disclosures be provided in writing prior to the execution of the transaction? If not, does the option to memorialize the disclosure and provide a written version of the disclosure to the counterparty provide adequate safeguards to ensure that parties are complying with the disclosure, supervision and compliance requirements discussed more fully below, as well as the provisions intended to increase the protection of special entities? Are there any other safeguards the Commission should consider? How do such safeguards provide the same or better protection or information for counterparties than written disclosures in advance of a transaction?
- Should the Commission require disclosures to be made a certain period of time before execution of a transaction? If so, what would be the advantages and disadvantages of various periods?
- Should the Commission impose specific requirements concerning the timing and manner in which disclosures are made to certain counterparties, such as special entities or categories of special entities? If so, which counterparties, and why? What requirements would be appropriate for which counterparties?
- Should the Commission require that disclosures be made in writing prior to the execution of the transaction when the counterparty is a special entity? Why or why not? If so, should this requirement apply with respect to all special entities? If not, how should the Commission distinguish among special entities?
- Should the Commission permit SBS Entities to rely on information in trade acknowledgements to satisfy certain disclosure requirements? Why or why not? Are there other approaches that would be more effective or efficient than the Commission's proposed approach to disclosure?
- In which situations (or under what circumstances) would the SBS Entity not know the identity of the counterparty prior to execution of the transaction on a SEF or exchange? If the SBS Entity subsequently learns the identity of the counterparty, when would such identity typically be ascertained (*e.g.,* before, at the time of, or after the execution of the transaction)? In such situations, how should material information be disclosed?
- The Dodd-Frank Act and the Commission's proposal with respect to SEFs contemplate that SEFs and exchanges will promulgate detailed standards for the listing and trading of security-based swaps that may be transacted on their markets. Should SEFs and exchanges also be required to provide a means to deliver the disclosures to counterparties required under proposed Rules 15Fh–3(b) and (d)? Would SEF and exchange listing and trading rules provide an adequate alternative means for providing the required disclosures? Why or why not? How would differences in rules across markets for similar products be addressed? What other issues may arise in connection with this approach and how could they be addressed?
- Should disclosures by means of a SEF or exchange require a standardized format? Are there specific transactions, classes of transactions, or types of counterparties for which this approach would or would not be appropriate? Are there other means by which SBS entities could satisfy their disclosure obligations in this context?
- Should an SBS Entity be permitted to reference publicly available information to comply with its disclosure requirements to its counterparty without having the information deemed to be adopted or affirmed by the SBS Entity? For example, should an SBS Entity be permitted to direct its counterparty to reports filed under the Exchange Act and publicly available on EDGAR without being considered to affirm or adopt the disclosure? Should an SBS Entity be permitted to satisfy the disclosure requirements by directing its counterparty to the Web site of a company underlying a credit default swap regarding disclosures of material risks without being considered to affirm or adopt the disclosure?

c. Material Risks and Characteristics of the Security-Based Swap

Section 15F(h)(3)(B) of the Exchange Act provides that business conduct requirements adopted by the Commission shall require disclosure by the SBS Entity of information about the material risks and characteristics of the security-based swap.[76] A fact is material if there is a substantial likelihood that a reasonable investor would consider the information to be important in making an investment decision.[77] Disclosures should include a clear explanation of the material economic

[73] *See* SIFMA/ISDA 2010 Letter (''We recommend that the Commissions clarify that, to the extent that a counterparty is in possession of the master documentation and confirmation specifying the economic and other material terms of a specific transaction, registrant counterparties will have satisfied this requirement.'').

[74] Proposed Rule 15Fk–1, discussed *infra* at Section II. E, would require an SBS Entity to have reasonable written policies and procedures concerning the timing and form of disclosure, and maintain records sufficient to enable its chief compliance officer to verify compliance with the disclosure requirements under the proposed rules.

[75] *See, e.g.,* SIFMA/ISDA 2010 Letter at 3.

[76] We read this provision to require disclosure about the material risks and characteristics of the security-based swap itself and not of the underlying reference security or index.

[77] *Basic Inc.* v. *Levinson,* 485 U.S. 224, 231–32 (1988).

characteristics of the security-based swap, including a discussion of the key assumptions that give rise to the expected pay-offs.[78] The SBS Entity should consider, among other things, the complexity of each of the characteristics of the security-based swap in determining the materiality of the characteristic, as well as the related material risks to be disclosed.[79]

We understand that there are certain general types of risks, including credit risk,[80] settlement risk,[81] market risk,[82] liquidity risk,[83] operational risk,[84] and legal risk [85] that are commonly associated with securities-based swaps.[86] Proposed Rule 15Fh–3(b)(1) would require an SBS Entity to disclose the material factors that influence the day-to-day changes in valuation, the factors or events that might lead to significant losses, the sensitivities of the security-based swap to those factors and conditions, and the approximate magnitude of the gains or losses the security-based swap would experience under specified circumstances.[87] SBS Entities should also consider the unique risks and characteristics associated with a particular security-based swap, class of security-based swap or trading venue, and tailor their disclosures accordingly.[88]

An SBS Entity also should consider risks that may be associated specifically with uncleared security-based swaps. Among other things, the absence of a credit support agreement in an uncleared security-based swap could create risks associated with the absence of a bilateral obligation to post initial and variation margin.[89] An SBS Entity should consider whether the absence of provisions that would typically be associated with a cleared security-based swap, for example, could create a material risk that would need to be disclosed in connection with a transaction involving a security-based swap that is not submitted for clearing.[90]

Request for Comments

The Commission requests comments generally on all aspects of this provision. In addition, we request comments on the following specific issues:

- The documentation governing a security-based swap transaction should include all of the terms agreed by the parties that could affect the economic and other risks of the transaction. Should the requirements for disclosure of material characteristics of a security-based swap be deemed satisfied if the SBS Entity has entered into a master agreement with and provided a trade acknowledgement (or draft trade acknowledgement) or other documentation governing the particular security-based swap to the counterparty? Why or why not? How would such an approach provide meaningful disclosure to counterparties regarding the risks of the transactions they are entering into? What types of risks might not be readily apparent to a counterparty from a review of the governing documentation for a transaction? Would the timeliness of such disclosure be a problem if information on a trade acknowledgement, for example, is not provided to a counterparty until after the parties have entered into a security-based swap?
- Are there particular material risks or characteristics that the Commission should specifically require an SBS Entity to disclose to a counterparty? If so, which ones and why?
- Are there specific material risks or characteristics that should be disclosed with respect to swaps that are not cleared, or are not SEF- or exchange-traded? If so, which ones and why?
- Are there particular material risks or characteristics that the Commission should specifically require an SBS Entity to disclose when the counterparty is a special entity or a particular category of special entity? If so, which ones and why? Should any such special disclosure requirements apply to any categories of counterparties other than special entities?
- Should the Commission require an SBS Entity to disclose its anticipated profit for the security-based swap? If so, how should an SBS Entity be required to compute profitability for purposes of the rule? [91] If the Commission were to adopt such a requirement, should it be limited to transactions in which the counterparty is a special entity, a particular category of special entity, or another type of counterparty?
- Should the SBS Entity disclose or identify for the counterparty information regarding the issuer of the underlying security that is publicly available, such as whether the issuer of an underlying security is subject to the

[78] *See* CRMPG III Report at 61. *See also* SIFMA/ISDA 2010 Letter (stating that ''[t]here is no better description of the characteristics of a transaction than the contract provisions expressly defining its economic terms.'').

[79] The adequacy of such disclosures will be determined by reference to the ''reasonable investor'' standard above.

[80] By ''credit risk,'' we mean the risk that a party to a security-based swap will fail to perform on an obligation under the security-based swap. IOSCO Report at 3; BIS Report at 11.

[81] By ''settlement risk,'' we mean the risk that a party will not receive funds or instruments from its counterparty at the expected time, either as a result of a failure of the counterparty to perform or a failure of the clearing agency to perform. *See* IOSCO Report at 3.

[82] By ''market risk,'' we mean the risk to the value of a security-based swap resulting from adverse movements in the level or volatility of market prices. *See* BIS Report at 12.

[83] By ''liquidity risk,'' we mean the risk that a counterparty may not be able to, or cannot easily, unwind or offset a particular position at or near the previous market price because of inadequate market depth or because of disruptions in the marketplace. *See* BIS Report at 13.

[84] By ''operational risk,'' we mean the risk that deficiencies in information systems or internal controls, including human error, will result in unexpected loss. *See* IOSCO Report at p. 3; BIS Report at 14.

[85] By ''legal risk,'' we mean the risk that agreements are unenforceable or incorrectly or inadequately documented. *See* IOSCO Report at p. 4; BIS Report at 16.

[86] *See generally* IOSCO Report; BIS Report.

[87] *See* CRMPG III Report at 60. These disclosures are intended to be disclosures concerning the material risks and characteristics of the security-based swap itself, not the material risks and characteristics of the security-based swap with respect to a particular counterparty. In other words, the proposed rule would not require an SBS Entity to disclose different material risks and characteristics to different counterparties solely because of the identity or nature of the counterparty. As noted previously, proposed Rule 15Fh–3(b) would require disclosures to be made in a manner reasonably designed to allow the counterparty to assess the material risks and characteristics. In addition, SBS Entities would have an on-going obligation to communicate with counterparties in a fair and balanced manner based on principles of fair dealing and good faith. *See* proposed Rule 15Fh–3(g) (discussed *infra* at Section II.C.5).

[88] We anticipate that SBS Entities may provide these disclosures through various means, including scenario analysis. *See, e.g.,* CRMPG III Report at 60 (recommending that disclosure include ''rigorous scenario analyses and stress tests that prominently illustrate how the instrument will perform in extreme scenarios, in addition to more probable scenarios'').

[89] We note that currently market participants often choose to use a credit support agreement or annex specifying the applicable valuation methodologies for the calculation of margin or collateral and the mechanics for the exchange of margin or collateral in connection with a security-based swap.

[90] With respect to uncleared security-based swaps, the Commission expects to propose rules regarding a counterparty's right to have any of its property received by an SBS Entity to margin, guarantee, or secure the obligations of the counterparty in an uncleared security-based swap segregated from the funds of the SBS Entity. *See* Section 3E(f)(1)(A) of the Exchange Act, Public Law 111–203, 124 Stat. 1376, 1775–1776 (to be codified at 15 U.S.C. 78c–5(f)(1)(A)) (requiring an SBS Entity to notify a counterparty at the beginning of a security-based transaction that the counterparty has the right to require segregation of the funds or other property supplied to margin, guarantee, or secure the obligations of the counterparty).

[91] *See* Swap Financial Group, Dodd-Frank Title VII: Business Conduct and Special Entities Briefing for SEC/CFTC Joint Working Group (Aug. 9, 2010) (on file with the Commission) (''Swap Financial Group Presentation'') at 55 (describing profit as the ''[m]ark-up or 'spread' between price charged to the client and cost of dealer's hedge'').

periodic reporting requirements of the Exchange Act?

• Is there a basis for distinguishing between the types of disclosures that should be required to be provided by an SBS Dealer and those that should be required to be provided by a Major SBS Participant? If so, how should the types of disclosures required to be provided by a Major SBS Participant differ from those that have been proposed?

• Should the Commission specifically require scenario analysis disclosure? Why or why not? If such analysis should be required, should the Commission require the disclosure for uncleared security-based swaps? Should the Commission limit the scenario analysis disclosure requirement to ''high-risk complex security-based swaps,'' as described in the CRMPG III Report? If so, how should the definitional hurdles outlined in the CRMPG III Report be addressed? [92] If not, why? Is there another standard the Commission should consider for requiring scenario analysis?

• Should an SBS Entity be required to provide a scenario analysis for any security-based swap, upon reasonable request by any counterparty? What are the advantages and disadvantages to SBS Entities and counterparties associated with such an analysis? If the cost varies by type of security-based swap, please provide an average cost by category of security-based swap.

• Should a scenario analysis provided by an SBS Entity to a counterparty be required to be consistent with similar analyses prepared by the SBS Entity for its own internal purposes (*e.g.,* risk management)? If not, how would they differ and why?

• We do not intend that the proposed rule require an SBS Entity to disclose any information considered proprietary in nature. Would disclosure of proprietary information be a concern under the current formulation of the rule? If so, what types of proprietary information might be subject to disclosure under the proposed rule? Is there other information that could adequately substitute for purposes of meaningful disclosure? What methods, if any, could be applied to transform specific types of proprietary information into comparable information suitable for a counterparty (*e.g.,* aggregation, averaging)? What other mechanisms, if any, could be used to protect proprietary information while providing adequate disclosure to counterparties?

• As noted above, we understand that security-based swaps are often entered into under a master agreement that governs the relationship between the SBS Entity and its counterparty.[93] In particular, master agreements generally contain terms that govern all succeeding security-based swaps and other derivatives between the counterparties, and include provisions such as events of default, cross-default provisions, additional termination events, payment netting and close-out netting, and information regarding rights and obligations as a result of particular events.[94] Should the Commission require the use of a master agreement for security-based swaps? If a master agreement is required when parties enter into a security-based swap, what particular issues should be addressed in the master agreement? For example, should the master agreement be required to address whether payment netting or close-out netting rights exist? If the Commission does not require the use of a master agreement, should it require that all security-based swaps include certain provisions typically included in master agreements? If so, which provisions?

• Should an SBS Entity be required to disclose the absence of certain material provisions typically contained in master agreements for security-based swap transactions? [95] Similarly, should an SBS Entity be required to disclose if the documentation includes material provisions that are unusual in light of typical master agreements? In either case, how should the ''normal'' or ''typical'' master agreement be defined? By reference to particular types of standardized master agreements? If so, which ones? To what extent would a requirement to provide a disclosure separate from a master agreement regarding the material terms of the master agreement have the effect of incentivizing counterparties to review their agreements less carefully (and instead rely on the disclosure)? To what extent might disclosures regarding the documentation between the parties potentially affect any interpretation of the terms agreed by the parties in the event of a subsequent dispute over such terms? How might that in turn affect the nature or usefulness of the disclosures that SBS Entities might provide regarding their documentation?

• Should the Commission establish certain minimum standards for the agreements governing security-based swaps? If so, what standards and why?

d. Material Incentives or Conflicts of Interest

Proposed Rule 15Fh–3(b)(2) would require that an SBS Entity disclose all material incentives or conflicts it may have in connection with a security-based swap.[96] We preliminarily believe that the term ''incentives''—which is used in Section 15F(h)(3)(b)(ii) of the Dodd-Frank Act—refers not to any profit or return that the SBS Entity would expect to earn from the security-based swap itself, or from any related hedging or trading activities of the SBS Entity, but rather to any other financial arrangements pursuant to which an SBS Entity may have an incentive to encourage the counterparty to enter into the transaction. This disclosure would include, among other things, information concerning any compensation (*e.g.,* under revenue-sharing arrangements) or other incentives the SBS Entity receives from any source other than the counterparty in connection with the security-based swap to be entered into with the counterparty, but would not include, for

[92] *See* CRMPG III Report at 54–56 (''The definition of a high-risk complex financial instrument is itself a complex subject. * * * [T]he definitional challenge is better framed by identifying the key characteristics of classes of high-risk complex financial instruments that warrant special treatment in terms of sales and marketing practices, disclosure practices, diligence standards, and, more broadly, the level of sophistication required for all market participants. * * * While issues surrounding leverage, market liquidity, and price transparency are the key characteristics in identifying high-risk complex financial instruments, other factors have contributed to the problems witnessed during the credit market crisis.'').

[93] *See, e.g., Thrifty Oil Co.* v. *Bank of America Nat'l Trust and Sav. Ass'n,* 322 F.3d 139, 143 (9th Cir. 2003) (describing use of master agreements). We note that market participants may already look to certain master agreements that are generally considered covered by the swap safe harbors in the U.S. Bankruptcy Code (''Bankruptcy Code''). Sections 362(b)(17) and 560 of the Bankruptcy Code provide an exception to the automatic stay and *ipso facto* prohibitions in the Bankruptcy Code to allow for the exercise of any contractual right of any swap participant or financial participant to cause the liquidation, termination, or acceleration of one or more swap agreements, including netting and set-off rights. *See* 11 U.S.C. 362(b)(27) and 560. The definition of ''swap agreement'' under Section 101(53B)(v) of the Bankruptcy Code specifically contemplates master agreements. *See* 11 U.S.C. 101(53B)(v).

[94] Parties may also choose to use a credit support agreement or annex specifying the applicable valuation methodologies for the calculation of margin or collateral and the mechanics for the exchange of margin or collateral in connection with a security-based swap.

[95] For example, absent provisions for payment netting or close-out netting, questions may arise as to whether all of the counterparty's trades with the particular SBS Entity would be taken into account in calculating (1) net periodic payments, (2) one net close-out amount in respect of a default by either party, and (3) net margin obligations.

[96] *See* Section 15F(h)(3)(B)(ii) of the Exchange Act, Public Law 111–203, 124 Stat. 1376, 1790 (to be codified at 15 U.S.C. 78o–10(h)(3)(B)(ii)) (providing that business conduct requirements adopted by the Commission shall require disclosure by an SBS Entity of ''any material incentives or conflicts of interest'' that the SBS Entity may have in connection with the security-based swap).

example, expected cash flows received from a transaction to hedge the security-based swap or that the security-based swap is intended to hedge.[97]

Request for Comments

The Commission requests comments generally on all aspects of this provision. In addition, we request comments on the following specific issues:

- Are there specific material incentives or conflicts that the Commission should require an SBS Entity to disclose to a counterparty? Are there specific material incentives or conflicts that should be disclosed with respect to security-based swaps that are not cleared, or are not SEF- or exchange-traded?
- Should we require an SBS Entity to disclose affiliations or material business relationships with a SEF or exchange? Why or why not?
- Should we require an SBS Entity to disclose affiliations or material business relationships with a clearing agency? Why or why not?
- Should the Commission impose other more specific requirements concerning the content of the required disclosures when the counterparty is a special entity? If so, which ones and why? Should such specific requirements apply only to certain categories of special entities?
- Should the Commission impose other more specific requirements concerning the content of the required disclosures when an SBS Dealer is acting as an advisor to a special entity? If so, which ones and why? Should such specific requirements apply only to certain categories of special entities?
- Is there a basis for distinguishing between the types of conflicts disclosures required to be provided by an SBS Dealer and those required to be provided by a Major SBS Participant? If so, how should the types of conflicts disclosures required to be provided by a Major SBS Participant differ from those that have been proposed?
- We do not intend to require the disclosure of information considered proprietary in nature in order for an SBS Entity to discharge its obligation under the proposed rule. Is such disclosure a concern under the current formulation of the rule? If so, what types of proprietary information might be subject to disclosure under the proposed rule? Is there other information that could adequately substitute for purposes of meaningful disclosure? What other mechanisms, if any, could be used to protect proprietary information while providing adequate disclosure to counterparties?

e. Daily Mark

Exchange Act Section 15F(h)(3)(B)(iii) directs the Commission to adopt rules that require an SBS Entity to disclose: (i) for cleared security-based swaps, upon request of the counterparty, the daily mark from the appropriate derivatives clearing organization; [98] and (ii) for uncleared security-based swaps, the daily mark of the transaction.[99] We preliminarily believe that the daily mark, as proposed for the purposes of this rule, would provide helpful transparency to counterparties during the lifecycle of a security-based swap. As explained below, the daily mark under the proposed rule is intended to provide a counterparty with a useful and meaningful reference point against which to assess, among other things, the calculation of variation margin for a security-based swap or portfolio of security-based swaps, and otherwise inform the counterparty's understanding of its financial relationship with the SBS Entity.[100]

The term ''daily mark'' is not defined in the statute and, as explained below, we are proposing that the term have analogous meanings for cleared and uncleared security-based swaps. For cleared security-based swaps, proposed Rule 15Fh–3(c)(1) would require an SBS Entity, upon the request of the counterparty, to disclose to the counterparty in writing the daily end-of-day settlement price received by the SBS Entity from the appropriate clearing agency. ''End-of-day settlement price'' in this context refers to the value for any given security-based swap used by the clearing agency that forms the basis of subsequent margin calculations for clearing participants.[101]

We are not proposing to require that clearing agencies use a particular calculation methodology for purposes of the proposed rule.[102] We understand

[97] If an SBS Entity is also registered as a broker-dealer, it would be subject to similar disclosure requirements under FINRA rules in certain circumstances. *See, e.g.,* FINRA Rule 2269, Disclosure of Participation or Interest in Primary or Secondary Distribution (''A member who is acting as a broker for a customer or for both such customer and some other person, or a member who is acting as a dealer and who receives or has promise of receiving a fee from a customer for advising such customer with respect to securities, shall, at or before the completion of any transaction for or with such customer in any security in the primary or secondary distribution of which such member is participating or is otherwise financially interested, give such customer written notification of the existence of such participation or interest.'').

[98] Although Section 15F(h)(3)(B)(iii) of the Exchange Act refers to a ''derivatives clearing organization,'' the Commission believes that this was a drafting error and that Congress intended to refer to a ''clearing agency'' because the Dodd-Frank Act elsewhere requires security-based swaps to be cleared at registered clearing agencies, not derivatives clearing organizations. *See* Section 17A(g) of the Exchange Act, Public Law 111–203, 124 Stat. 1376, 1768 (to be codified at 15 U.S.C. 78q–1(g)).

[99] We note that various market participants have expressed concerns that the statutory requirement to provide a daily mark to a pension plan would necessarily include an SBS Entity within the definition of ''fiduciary'' for ERISA purposes under a current Department of Labor proposal, which may then cause the security-based swap to be a prohibited transaction under ERISA, unless it qualifies for a Prohibited Transaction Exemption. *See* Definition of the Term ''Fiduciary,'' 75 FR 65263 (Oct. 22, 2010); SIFMA/ISDA Letter; Joint Letter from American Bankers Association, American Benefits Council, Committee on Investment of Employee Benefit Assets, The ERISA Industry Committee, Financial Executives International's Committee on Corporate Treasury, Financial Services Roundtable, Insured Retirement Institute, National Association of Insurance and Financial Advisors, National Association of Manufacturers, Securities Industry and Financial Markets Association to David A. Stawick, Secretary, CFTC (Feb. 22, 2011); Letter from Sandra Haas, Managing Director, Head of Pensions, Endowment and Foundation Coverage, Morgan Stanley & Co., Incorporated, and Jim McCarthy, Managing Director, Head of Retirement Services and Client Advisory, Morgan Stanley Smith Barney LLC to Office of Regulations and Interpretations, Employee Benefits Security Admin., Dep't of Labor (Feb. 2, 2011); Letter from Don Thompson, Managing Director and Assistant General Counsel, JPMorgan Chase & Co. to Office of Regulations and Interpretations, Employee Benefits Security Admin., Dep't of Labor (Feb. 3, 2011). As noted in Section I.B., the staffs of the Commission, DoL and CFTC have been consulting and will continue to do so in order to address these concerns. See Letter from Phyllis C. Borzi, Assistant Secretary, Employee Benefits Security Administration, Department of Labor, to Gary Gensler, Chairman, CFTC (April 28, 2011) (''In DOL's view, a swap dealer or major swap participant that is acting as a plan's counterparty in an arm's length bilateral transaction with a plan represented by a knowledgeable independent fiduciary would not fail to meet the terms of the counterparty exception [to the proposed revised definition of ERISA fiduciary] solely because it complied with the business conduct standards set forth in the CFTC's proposed regulation.''). The Commission also solicits comments with respect to alternatives for addressing this issue.

In addition, as discussed infra in Section II.C.4, we do not believe that disclosure of the daily mark would in and of itself constitute a recommendation under proposed Rule 15Fh–3(f).

[100] As explained below, the daily mark under the proposed rule would not necessarily represent the last price at which a security-based swap traded, or a price that is executable.

[101] For example, ICE Trust, a clearing agency for credit default swaps, indicates that it ''establishes a daily settlement price for all cleared CDS instruments, using a pricing process developed specifically for the CDS market by ICE Trust. ICE Trust clearing participants are required to submit prices on a daily basis. ICE Trust conducts an auction process daily which results in periodic trade executions between its clearing participants. This process determines the daily settlement prices, which are validated by the ICE Trust Chief Risk Officer and used for the daily mark-to-market valuations.'' ICE Trust, *https://www.theice.com/ice_trust.jhtml* (March 14, 2011).

[102] The Commission understands that the particular methodologies used by clearing agencies to produce the end of day settlement price may vary. We understand that there are various means

that, for a given security-based swap, a clearing agency uses the same end-of-day settlement price for the daily valuation of positions held by all clearing members regardless of position direction or size, and independent of any member-specific attribute, such as credit quality, other portfolio holdings, or concentration of positions. Accordingly, the prices do not necessarily represent the last price at which the security-based swap traded, or a price that is executable.

Because the term ''daily mark'' is used both in the context of cleared and uncleared security-based swaps, the Commission preliminarily believes that the meaning of ''daily mark'' for uncleared swaps should be analogous to that for cleared swaps, and that the attributes of daily marks produced by clearing agencies for cleared security-based swaps under proposed Rule 15Fh–3(c)(1) should be equally applicable to, and provide guidance for the computation of, the daily mark required to be provided with respect to uncleared security-based swaps. To ensure a degree of uniformity in market practices among SBS Entities, proposed Rule 15Fh–3(c)(2) would require an SBS Entity to disclose the midpoint between the bid and offer prices for a particular uncleared security-based swap, or the calculated equivalent thereof, as of the close of business unless the parties agree in writing otherwise.[103] We preliminarily believe that the proposed rule would result in a daily mark that reflects daily changes in valuation that is: (a) The same for all counterparties of the SBS Entity that have a position in the uncleared security-based swap, (b) not adjusted to account for holding-specific attributes such as position direction, size, or liquidity, and (c) not adjusted to account for counterparty-specific attributes such as credit quality, other counterparty portfolio holdings, or concentration of positions.[104]

For actively traded security-based swaps that have sufficient liquidity, computing a daily mark as the midpoint between the bid and offer prices for a particular security-based swap, known as a ''midmarket value,'' would be consistent with the proposed Rule 15Fh–3(c)(2). For security-based swaps that are not actively traded, or do not have up-to-date bid and offer quotes, the SBS Entity may calculate an equivalent to a midmarket value using mathematical models, quotes and prices of other comparable securities, security-based swaps, or derivatives, or any combination thereof, provided that these calculations produce a daily mark that is consistent with the attributes described above.[105] Again, the daily mark is not intended to represent the value that either an SBS Entity or its counterparty would use for its own, internal valuation, or fair value for financial reporting purposes for the particular security-based swap. Nor would the daily mark necessarily represent a price at which the SBS Entity would be willing to execute a trade.[106]

Furthermore, though the daily mark may be used as an input to compute the variation margin between an SBS Entity and its counterparty, it is not necessarily the sole determinant of how such margin is computed. Differences between the daily mark and computations for variation margin result from adjustments for position size, position direction, credit reserve, hedging, funding, liquidity, counterparty credit quality, portfolio concentration, bid-ask spreads, or other costs, that may be included as part of the margin computations. Nonetheless, the Commission believes the daily mark, as proposed for the purposes of this rule, would provide a useful and meaningful reference point, similar to that for cleared security-based swaps, for counterparties holding positions in uncleared security-based swaps.[107]

Proposed Rule 15Fh–3(c)(2) would also require that, at or before delivery of the first disclosure of the daily mark, an SBS Entity disclose to the counterparty its data sources and a description of the methodology and assumptions to be used to prepare the daily mark for an uncleared security-based swap.[108] We preliminarily believe that such disclosure would provide the counterparty a useful context with which it can assess the quality of the mark received.[109] In addition, proposed Rule 15Fh–3(c) would also require that an SBS Entity promptly disclose any

by which security-based swap clearing agencies calculate end-of-day settlement prices for each product in which they hold a cleared interest each business day. In the credit default swap context, for example, end-of-day settlement prices may be determined each business day for each eligible product based upon pricing data from one or more of various sources, including prices of over-the-counter transactions submitted for clearing; indicative settlement prices contributed by clearing members; and pricing information licensed from other third-party sources. *See, e.g.,* Letter from Ann K. Shuman, Managing Director and Deputy General Counsel, Chicago Mercantile Exchange Inc., to Elizabeth Murphy, Secretary, Commission (Dec. 14, 2009) (File No. S7–06–09); Letter from Kevin McClear, General Counsel, ICE Trust, to Elizabeth Murphy, Secretary, Commission (Dec. 4, 2009) (File No. S7–05–09).

[103] Parties could agree that the daily mark would be computed as of a time other than the close of business but could not agree to waive the requirement that the daily mark be provided on a daily basis, as required by the statute.

[104] SIFMA and ISDA have suggested that ''[b]y market convention and often by contract, parties generally agree to utilize a mid-market level for margin purposes. Counterparties understand that this level does not represent a valuation at which a transaction may be entered into or terminated and accordingly may differ from actual market prices. We recommend that the Commissions endorse this use of mid-market levels for margin purposes as a uniform market practice.'' SIFMA/ISDA 2010 Letter at 17. For a discussion of midmarket value and adjustments, see ISDA Research Notes, The Value of a New Swap, Issue 3, 2010, available at *http://www.isda.org/researchnotes/pdf/NewSwapRN.pdf* (''ISDA Note'') (describing midmarket value as ''the net present value of the transaction assuming it is priced at mid-market'').

[105] *See* ISDA Note.

[106] As discussed in Section II.C.4, *infra,* we do not believe that compliance with the requirements of proposed Rule 15Fh–3(c), in and of itself, should cause an SBS Dealer to be deemed to have made a recommendation under proposed Rule 15Fh–3(f).

[107] *See* ISDA Note (''even though market participants do not actually transact at the midmarket rate, it is nonetheless useful because it is an objective, transparent rate that might be used as a basis for actual pricing'').

[108] *Cf.* Trading & Capital-Markets Manual § 2150 (Bd. of Gov. Fed. Reserve Sys. Jan. 2009), *available at http://www.federalreserve.gov/boarddocs/supmanual/trading/200901/0901trading.pdf:*

When observable market prices are available for a transaction, two pricing methodologies are primarily used—bid/offer or midmarket. Bid/offer pricing involves assigning the lower of bid or offer prices to a long position and the higher of bid or offer prices to short positions. Midmarket pricing involves assigning the price that is midway between bid and offer prices. Most institutions use midmarket pricing schemes, although some firms may still use bid/offer pricing for some products or types of trading. Midmarket pricing is the method recommended by the accounting and reporting subcommittee of the Group of Thirty's Global Derivatives Study Group, and it is the method market practitioners currently consider the most sound. * * *

For many illiquid or customized transactions, such as highly structured or leveraged instruments and more complex, nonstandard notes or securities, reliable independent market quotes are usually not available, even infrequently. In such instances, other valuation techniques must be used to determine a theoretical, end-of-day market value. These techniques may involve assuming a constant spread over a reference rate or comparing the transaction in question with similar transactions that have readily available prices (for example, comparable or similar transactions with different counterparties). More likely, though, pricing models will be used to price these types of customized transactions.

[109] The Commission recognizes that different SBS Entities may produce somewhat different marks for similar security-based swaps, depending on the respective data sources, methodologies and assumptions used to calculate the marks. Thus, the data sources, methodologies and assumptions would provide a context in which the quality of the mark could be evaluated. See Disclosure of Accounting Policies for Derivative Financial Instruments and Derivative Commodity Instruments and Disclosure of Quantitative and Qualitative Information about Market Risk Inherent in Derivative Financial Instruments, Other Financial Instruments and Derivative Commodity Instruments, Securities Act Release No. 7386 (Jan. 31, 1997), 62 FR 6044 (Feb. 10, 1997). We understand that currently, industry practice is often to include similar disclosures for margin calls in swap documentation, such as a credit support annex.

material changes to the data sources, methodology, or assumptions over the term of the security-based swap. An SBS Entity would not be required to disclose the data sources or a description of the methodology and assumptions more than once unless it materially changes the data sources, methodology or assumptions used to calculate the daily mark. For the purposes of this rule, a material change would include any change that has a material impact on the daily mark provided. We understand that the daily mark for illiquid security-based swaps may be generated using models that may or may not be proprietary. The required disclosure of the data sources or description of the methodology and assumptions used to prepare the daily mark is not intended to require so much detail as to result in disclosure of an SBS Entity's proprietary information.

We preliminarily believe that, for the disclosure to the counterparty to be meaningful, the daily mark for both cleared and uncleared security-based swaps should be provided without charge and with no restrictions on internal use by the recipient, although restrictions on dissemination to third parties are permissible. The rule would not, however, mandate the means by which an SBS Entity makes the required disclosures. Commenters have asked if SBS Entities may satisfy their obligations in this regard by making the relevant information available to counterparties through password-protected access to a website containing the relevant information.[110] The Commission preliminarily believes that such a method would be an appropriate way for SBS Entities to discharge their obligations with respect to daily marks, subject to compliance with the Commission's guidance on the use of electronic media.[111] In particular, the use of electronic media should not be so burdensome that intended recipients cannot effectively access the information provided. Further, persons to whom information is sent or provided electronically must have the opportunity to download directly the information, or otherwise have an opportunity to retain and analyze the information through the selected medium or have ongoing access equivalent to personal retention.[112] Information of this kind is directly relevant to a counterparty's understanding of its financial relationship under a security-based swap and so, we preliminarily believe that access to the information as described above is necessary to ensure a counterparty's ability to monitor that relationship over the life of the transaction.[113]

SBS Entities also should consider the need to provide appropriate clarifying statements or disclosures relating to the daily mark. Such statements or disclosures may include, as appropriate, that the daily mark may not be a price at which the SBS Entity would agree to replace or terminate the security-based swap, nor the value at which the security-based swap is recorded in the books of the SBS Entity.[114]

Request for Comments

The Commission requests comments generally on all aspects of this provision. In addition, we request comments on the following specific issues:

- Is the end-of-day settlement price an appropriate ''daily mark'' for cleared security-based swaps for purposes of this rule? If not, how should the Commission define ''daily mark'' in this context?
- Should the Commission prescribe a method for determining the end-of-day settlement price for cleared security-based swaps for purposes of this rule? If so, what method and why?
- Is the midpoint between the bid and offer prices for a particular uncleared security-based swap, or the calculated equivalent thereof, as of the close of business unless the parties agree in writing otherwise, an appropriate ''daily mark'' for uncleared security-based swaps? If not, how should the Commission define ''daily mark'' in this context, and why?
- Should the Commission prescribe a different method for calculating the daily mark for uncleared security-based swaps for purposes of this rule? If so, what method and why? Should valuations of equivalent positions used by the SBS Entity for other purposes, such as collateral valuation or the preparation of financial statements, be taken into consideration? Why or why not, and how?
- Are there requirements under proposed Rule 15Fh–3(c) that would cause an SBS Entity to be a fiduciary for ERISA purposes? If so, which requirements, and is there an alternate method for calculating the daily mark that would not cause an SBS Entity to be a fiduciary for ERISA purposes?
- In calculating the midmarket value, should the Commission require an SBS Entity to use third-party market quotations (*i.e.,* should the Commission allow an SBS Entity to use its own market quotations)? Why or why not? Should there be constraints or conditions on such use? Why or why not?
- Should the Commission require an SBS Entity to provide an executable quote or the price at which the SBS Entity would terminate the security-based swap, in addition to the daily mark, for purposes of comparison or other reasons? If so, should this additional information always be required or is there a stronger rationale for the additional information to be required for certain identifiable types of security-based swap positions, such as security-based swaps that are highly customized to a counterparty's requirements, or otherwise illiquid, and for which the daily mark may be significantly different from an executable quote?
- Should the Commission require an SBS Entity to provide a value that would be used for purposes of variation margin, in addition to the daily mark, for purposes of comparison or other reasons? If so, should this additional information always be required or is there a stronger rationale for the additional information to be required for certain identifiable types of security-based swap positions, such as security-based swaps that are highly customized to a counterparty's requirements, or otherwise illiquid, and for which the daily mark may be significantly different from a value used for variation margin?
- If the SBS Entity and a particular counterparty are parties to more than

[110] SIFMA/ISDA 2010 Letter at p. 17.

[111] *See* Use of Electronic Media by Broker-Dealers, Transfer Agents and Investment Advisers for Delivery of Electronic Information, Securities Act Release No. 7288 (May 9, 1996), 61 FR 24644 (May 15, 1996) (''Electronic Media Release''). *See also* Use of Electronic Media, Exchange Act Release No. 42728 (Apr. 28, 2000), 65 FR 25843 (May 4, 2000).

[112] *See* Electronic Media Release.

[113] A counterparty may also require continuing access to satisfy recordkeeping requirements to which it may be subject.

The Commission has proposed to require clearing agencies to make available to the public, on terms that are fair and reasonable and not unreasonably discriminatory, all end-of-day settlement prices and any other prices with respect to security-based swaps that the clearing agency may establish to calculate mark-to-market margin requirements for its participants and any other pricing or valuation information with respect to security-based swaps as is published or distributed by the clearing agency to is participants. *See* Clearing Agency Standards for Operation and Governance, Exchange Act Release No. 64017 (March 2, 2011), 76 FR 14472 (March 16, 2011) (proposed Rule 17Aj–1). As we explained in proposing Rule 17Aj–1, we preliminarily believe that public availability of this information would help to improve fairness, efficiency, and market competition by making available to all market participants data that may otherwise be available only to a limited subset of market participants. *See id.*

[114] *Cf.* CFTC External Business Conduct Release (proposed Rule 17 CFR 23.431(c)).

one security-based swap transaction with one another, should the SBS Entity be permitted to provide a single aggregate daily mark for all of the security-based swaps, allowing for netting between the parties? Why or why not?

• Should the Commission require an SBS Entity to provide additional disclosures including, as appropriate: (1) That the daily mark may not necessarily be a price at which either the counterparty or the SBS Entity would agree to replace or terminate the security-based swap; (2) that, depending upon the agreement of the parties, calls for margin may be based on considerations other than the daily mark provided to the counterparty; and (3) that the daily mark may not necessarily be the value of the security-based swap that is recorded in the books of the SBS Entity? [115] In addition to disclosing any material changes to data sources, methodology or assumptions used, should an SBS Entity be required to disclose the impacts of these material changes? Are there any other disclosures that the Commission should require the SBS Entity to provide in connection with the daily mark?

• We do not intend the proposed disclosures regarding the data sources and description of the methodologies and assumptions used to prepare the daily marks to require the disclosure of information considered proprietary in nature in order for an SBS Entity to discharge its obligations. Is such disclosure a concern under the current formulation of the rule? If so, what types of proprietary information might be subject to disclosure under the proposed rule? Is there other information that could adequately substitute for purposes of meaningful disclosure? What mechanisms, if any, could be used to protect proprietary information implicated by the daily mark requirement while providing adequate disclosure to counterparties?

• Should access to a Web site or electronic platform be considered sufficient for disclosure of the daily mark? Why or why not? Should other forms of Internet-based or electronic disclosure be addressed, and if so, how?

• Should we require that the daily mark for both cleared and uncleared security-based swaps should be provided without charge and with no restrictions on internal use by the recipient, although restrictions on dissemination to third parties are permissible? Why or why not?

[115] *Cf.* CFTC External Business Conduct Release (proposed § 23.431(c)).

f. Clearing Rights

Proposed Rule 15Fh–3(d) would require an SBS Entity, before entering into a security-based swap with a counterparty, to disclose to the counterparty its rights under Section 3C(g) of the Exchange Act concerning submission of a security-based swap to a clearing agency for clearing.[116] Although they are not required by the Dodd-Frank Act, we preliminarily believe that such disclosures would promote the objectives of Section 3C(g).

The counterparty's rights, and thus the proposed disclosure obligations, would differ depending on whether the clearing requirement of Section 3C(a) applies to the relevant transaction.[117] When the clearing requirements of Section 3C(a)(1) apply to a security-based swap, proposed Rule 15Fh–3(d)(1)(i) would require the SBS Entity to disclose to the counterparty the clearing agencies that accept the security-based swap for clearing and through which of those clearing agencies the SBS Entity is authorized or permitted, directly or through a designated clearing member, to clear the security-based swap. The SBS Entity would also be required to notify the counterparty of the counterparty's sole right to select which clearing agency is to be used to clear the security-based swap, provided it is a clearing agency at which the SBS Entity is authorized or permitted, directly or through a designated clearing member, to clear the security-based swap.[118] We note that, while proposed Rule 15Fh–3(d) would not require an SBS Entity to become a member or participant of a specific clearing agency, an SBS Entity could not enter into security-based swaps that are subject to a mandatory clearing requirement without having some arrangement in place to clear the transaction.[119]

For security-based swaps that are not subject to the clearing requirement under Exchange Act Section 3C(a)(1), proposed Rule 15Fh–3(d)(2) would require the SBS Entity to determine whether the security-based swap is accepted for clearing by one or more clearing agencies and, if so, to disclose to the counterparty the counterparty's right to elect clearing of the security-based swap.[120] Proposed Rule 15Fh–3(d)(2)(ii) would require the SBS Entity to disclose to the counterparty the clearing agencies that accept the type, category, or class of security-based swap transacted and whether the SBS Entity is authorized or permitted, directly or through a designated clearing member, to clear the security-based swap through such clearing agencies. Proposed Rule 15Fh–3(d)(2)(iii) would require the SBS Entity to notify the counterparty of the counterparty's sole right to select the clearing agency at which the security-based swap would be cleared, provided it is a clearing agency at which the SBS Entity is authorized or permitted, directly or through a designated clearing member, to clear the security-based swap. Once again, the proposed rule would not require an SBS Entity to become a member or participant of a particular clearing agency, notwithstanding the election of the counterparty to clear the transaction.

The proposed rule would require that disclosure be made before a transaction occurs. The Commission believes that it would be appropriate for a counterparty to exercise its statutory right to select the clearing agency at which its security-based swaps would be cleared (as provided above) on a transaction-by-transaction basis, on an asset-class-by-asset-class basis, or in terms of all

[116] *See* Section 15F(h)(1)(D) of the Exchange Act (authorizing the Commission to prescribe business conduct standards that relate to ''such other matters as the Commission determines to be appropriate''); *see also* Dodd-Lincoln Letter (describing anticipated benefits of clearing as a means of ''bringing transactions and counterparties into a sound, conservative and transparent risk management framework''). Public Law 111–203, 124 Stat. 1376, 1789 (to be codified at 15 U.S.C. 78o–10(h)(1)(D)).

[117] Section 3C(a)(1) of the Exchange Act provides that: ''It shall be unlawful for any person to engage in a security-based swap unless that person submits such security-based swap for clearing to a clearing agency that is registered under this Act or a clearing agency that is exempt from registration under this Act if the security-based swap is required to be cleared.'' Public Law 111–203, 124 Stat. 1376, 1762 (to be codified at 15 U.S.C. 78c–3(a)(1)).

[118] Proposed Rule 15Fh–3(d)(1)(ii). *See* Exchange Act 3C(g)(5)(A), Public Law 111–203, 124 Stat. 1376, 1766–1777 (to be codified at 15 U.S.C. 78c–3(g)(5)(A)):

With respect to any security-based swap that is subject to the mandatory clearing requirement under subsection (a) and entered into by a security-based swap dealer or a major security-based swap participant with a counterparty that is not a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant, the counterparty shall have the sole right to select the clearing agency at which the security-based swap will be cleared.

[119] *See* Exchange Act Section 3C(a), Public Law 111–203, 124 Stat. 1376, 1762, § 763(a) (to be codified at 15 U.S.C. 78c–3(a)).

[120] *See* Exchange Act Section 3C(g)(5)(B), Public Law 111–203, 124 Stat. 1376, 1767, (to be codified at 15 U.S.C. 78c–3(g)(5)(B)):

With respect to any security-based swap that is not subject to the mandatory clearing requirement under subsection (a) and entered into by a security-based swap dealer or a major security-based swap participant with a counterparty that is not a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant, the counterparty—(i) may elect to require clearing of the security-based swap; and (ii) shall have the sole right to select the clearing agency at which the security-based swap will be cleared.

potential transactions the counterparty may execute with the SBS Entity.

Request for Comments

The Commission requests comments generally on all aspects of this provision. In addition, we request comments on the following specific issues:

- Should the Commission require SBS Entities to disclose a counterparty's rights to select a clearing agency, as provided above? What benefits would this requirement provide? Would the proposed disclosure requirement impose an undue burden on SBS Entities? If so, what would the burden be, and are there other ways to ensure that a counterparty is aware of its rights with respect to clearing?
- Would the SBS Entity be in a position to know, in all cases, the information that would be required to be disclosed under proposed Rule 15Fh–3(d)? If not, why? Would the time needed to gather the required information affect the transaction process for security-based swaps to any material extent? If so, how?
- Should the Commission require SBS Entities to disclose any other information to counterparties regarding their rights or obligations in connection with the clearing of security-based swap transactions? For example, under Section 3C(g) of the Exchange Act, certain ''end users'' have the option not to have their security-based swaps cleared, even if those security-based swaps have been made subject to a mandatory clearing requirement.[121] Should an SBS Entity be required to disclose to such end users that they may elect not to have their security-based swaps cleared under these circumstances? Why or why not?
- Should an SBS Entity be permitted to allow its counterparties to elect the clearing agency at which its security-based swaps would be cleared on a transaction-by-transaction basis, on an asset-class-by-asset-class basis, or in terms of all potential transactions? If not, what restrictions should apply to the SBS Entity in this context?

3. Know Your Counterparty

Proposed Rule 15Fh–3(e) would establish a ''know your counterparty'' requirement for SBS Dealers.[122] The proposed rule would require an SBS Dealer to have policies and procedures reasonably designed to obtain and retain a record of the essential facts that are necessary for conducting business with each counterparty that is known to the SBS Dealer.[123] For purposes of the proposed rule, ''essential facts'' would be: (i) Facts necessary to comply with applicable laws, regulations and rules, (ii) facts necessary to effectuate the SBS Dealer's credit and operational risk management policies in connection with transactions entered into with such counterparty, (iii) information regarding the authority of any person acting for such counterparty, and (iv) if the counterparty is a special entity, such background information regarding the independent representative as the SBS Dealer reasonably deems appropriate.[124]

The ''know your counterparty'' obligations under the proposed rule are a modified version of the ''know your customer'' obligations imposed on other market professionals, such as broker-dealers, when dealing with customers.[125] Although the statute does not require the Commission to adopt a ''know your counterparty'' standard, we preliminarily believe that such a standard would be consistent with basic principles of legal and regulatory compliance, operational and credit risk management, and authority. Further, we preliminarily believe that entities that currently operate as SBS Dealers typically would already have in place, as a matter of their normal business practices, ''know your counterparty'' policies and procedures that could potentially satisfy the requirements of the proposed rule. We are proposing to apply the requirement in proposed Rule 15Fh–3(e) to SBS Dealers but not to Major SBS Participants because we do not anticipate that Major SBS Participants would serve a dealer-type role in the market.

Request for Comments

The Commission requests comments generally on all aspects of proposed 15Fh–3(e). In addition, we request comments on the following specific issues:

- Should the Commission impose a ''know your counterparty'' requirement? If not, why not? Does the Commission need to clarify any of the proposed requirements? If so, how? Are there any specific categories of information that an SBS Dealer should be required to obtain from a counterparty? Should the Commission specify how any such information should be obtained from the counterparty?
- Should the ''know your counterparty'' obligations apply to Major SBS Participants, as well as to SBS Dealers? If so, why?
- To what extent would the current business practices of SBS Dealers, including their compliance procedures and their credit and operational risk management procedures, comply with the proposed ''know your counterparty'' requirements? To what extent would the proposed rule require SBS Dealers to change their current business practices? Would the proposed requirements impose any particular burdens on market participants?
- Should SBS Dealers be required to obtain any particular or additional information regarding their counterparty beyond what would be required under the proposed rule? If so, what specific information should SBS Dealers be required to obtain?
- Should the proposed requirement track more closely the ''know your customer'' requirement imposed under SRO rules? In particular, should the proposed rule require an SBS Dealer to obtain information necessary to effectively ''service the counterparty,'' to implement a counterparty's ''special instructions,'' or to evaluate the counterparty's security-based swaps experience, financial wherewithal and

[121] Exchange Act Section 3C(g), Public Law 111–203, 124 Stat. 1376, 1767, § 763(a) (to be codified at 15 U.S.C. 78c–3(g)). *See* End-User Exception to Mandatory Clearing of Security-Based Swaps, Exchange Act Release No. 63556 (Dec. 15, 2010), 75 FR 79992 (Dec. 21, 2010) (proposing new Rule 3Cg–1 under the Exchange Act governing the exception to mandatory clearing of security-based swaps available for counterparties meeting certain conditions).

[122] *See* Section 15F(h)(1)(D) of the Exchange Act, Public Law 111–203, 124 Stat. 1376, 1789, (to be codified at 15 U.S.C. 78o–10(h)(1)(D)) (authorizing, but not explicitly mandating, the Commission to prescribe business conduct standards that relate to ''such other matters as the Commission determines to be appropriate'').

[123] The proposed rule would not apply to security-based swaps for which the SBS Dealer does not know the identity of the counterparty, as is the case, for example, for many security-based swaps traded on a SEF or an exchange.

[124] The Commission is considering the minimum requirements for an SBS Dealer's operational and credit risk management practices and expects to address any such matters in a separate rulemaking.

[125] *Cf.* FINRA Rule 2090 (''Every member shall use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer''). Supplementary Material .01 to FINRA Rule 2090 defines the ''essential facts'' for purposes of the FINRA rule to include certain information not required by our proposed rule. For purposes of FINRA Rule 2090, facts ''essential'' to ''knowing the customer'' are those required to (a) effectively service the customer's account, (b) act in accordance with any special handling instructions for the account, (c) understand the authority of each person acting on behalf of the customer, and (d) comply with applicable laws, regulations, and rules. *See also* 14 CFR 13.5 (requiring a bank that is a government securities broker or dealer to make reasonable efforts to obtain information concerning the customer's financial status, tax status and investment objectives, and such other information used or considered to be reasonable by the bank in making recommendations to the customer).

trading objectives? [126] If so, how should such terms be interpreted in the context of SBS Dealers and the security-based swap market?

• Are there any circumstances in which it would not be appropriate to apply a ''know your counterparty'' obligation? What circumstances and why?

• Should ''know your counterparty'' requirements apply differently with respect to cleared and uncleared swaps? If so, how and why?

4. Recommendations by SBS Dealers

Proposed Rule 15Fh–3(f) would generally require an SBS Dealer that makes a ''recommendation'' to a counterparty to have a reasonable basis for believing that the recommended security-based swap or trading strategy involving security-based swaps is suitable for the counterparty.

In determining whether to propose Rule 15Fh–3(f), a business conduct requirement not expressly addressed by the statute, the Commission considered the suitability obligations imposed when other market professionals recommend a security or trading strategy to customers, including institutional customers.[127] The obligation to make only suitable recommendations is a core business conduct requirement for broker-dealers.[128] Municipal securities dealers also have a suitability obligation when recommending municipal securities transactions to a customer.[129] Federally regulated banks have a suitability obligation as well when acting as a broker or dealer in connection with the purchase or sale of government securities.[130] Depending on the scope of its activities, an SBS Dealer may be subject to one of these other suitability obligations, in addition to those under our proposed rule. In particular, if an SBS Dealer is also a registered broker-dealer and a FINRA member, it would be subject as well to FINRA suitability requirements in connection with the recommendation of a security-based swap or trading strategy involving a security-based swap, as well as the anti-fraud provisions of the Exchange Act.[131] Proposed Rule 15Fh–3(f) is intended to ensure that all SBS Dealers that make recommendations are subject to this obligation, tailored as appropriate in light of the nature of the security-based swap markets.[132]

Proposed Rule 15Fh–3(f) would only apply when an SBS Dealer makes a ''recommendation'' to a counterparty. The Commission preliminarily believes that the determination of whether an SBS Dealer has made a recommendation that triggers a suitability obligation should turn on the facts and circumstances of the particular situation and, therefore, whether a recommendation has taken place is not susceptible to a bright line definition. This is consistent with the FINRA approach to what constitutes a recommendation. In the context of the FINRA suitability standard, factors considered in determining whether a recommendation has taken place include whether the communication ''reasonably could be viewed as a 'call to action' '' and ''reasonably would influence an investor to trade a particular security or group of securities.'' [133] The more individually tailored the communication to a specific customer or a targeted group of customers about a security or group of securities, the greater the likelihood that the communication may be viewed as a ''recommendation.'' The Commission preliminarily believes that this approach should apply in the context of proposed Rule 15Fh–3(e) as well.

An SBS Dealer typically would 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.[134] Furthermore, compliance with the requirements of the proposed rules, in particular, Rule 15Fh–3(a) (verification of counterparty status), 15Fh–3(b) (disclosures of material risks and characteristics, and material incentives or conflicts of interest), 15Fh–3(c) (disclosures of daily mark), and 15Fh–3(d) (disclosures regarding clearing rights) would not, in and of itself, result in an SBS Dealer being deemed to be making a ''recommendation.''

When the suitability obligation of proposed Rule 15Fh–3(f) applies, the SBS Dealer must, as a threshold matter, understand the security-based swap or trading strategy that it is recommending. Proposed Rule 15Fh–3(f)(1)(i) would require an SBS Dealer to have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some counterparties. In general, what constitutes reasonable diligence will vary depending on, among other things, the complexity of and risks associated with the security-based swap or trading strategy and the SBS Dealer's familiarity with the security-based swap or trading strategy. An SBS Dealer's reasonable diligence must provide it with an understanding of the potential risks and rewards associated with the recommended security-based swap or trading strategy. An SBS Dealer that lacks this understanding would not be able to meet its obligations under the proposed rule.[135] In addition, under

[126] *Cf.* Supplementary Material .01 to FINRA Rule 2090 (''For purposes of this Rule, facts 'essential' to 'knowing the customer' are those required to (a) Effectively service the customer's account, (b) act in accordance with any special handling instructions for the account, (c) understand the authority of each person acting on behalf of the customer, and (d) comply with applicable laws, regulations, and rules.'').

[127] *See* Section 15F(h)(1)(D) of the Exchange Act, Public Law 111–203, 124 Stat. 1376, 1789 (to be codified at 15 U.S.C. 78o–10(h)(1)(D)) (authorizing, but not explicitly requiring, the Commission to prescribe business conduct standards that relate to ''such other matters as the Commission determines to be appropriate''), and Section 15F(h)(3)(D) of the Exchange Act, Public Law 111–203, 124 Stat. 1376, 1790 (to be codified at 15U.S.C. 78o–10(h)(3)(D)) (authorizing the Commission to establish ''such other standards and requirements as the Commission may determine are appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this Act'').

[128] *See, e.g.*, FINRA Rules 2090 and 2111 (effective July 9, 2012). *See also Charles Hughes & Co.* v. *SEC*, 139 F.2d 434 (2d Cir. 1943) (enforcing suitability obligations under the antifraud provisions of the Exchange Act).

[129] MSRB Rule G–19(c) provides that:

In recommending to a customer any municipal security transaction, a broker, dealer, or municipal securities dealer shall have reasonable grounds: (i) Based upon information available from the issuer of the security or otherwise, and (ii) based upon the facts disclosed by such customer or otherwise known about such customer, for believing that the recommendation is suitable.

[130] *See* Trading & Capital-Markets Manual § 2150 (imposing a suitability obligation on federally regulated banks acting as a government securities broker or government securities dealer); Government Securities Sales Practices, 62 FR 13276 (Mar. 19, 1997) (codified at 12 CFR parts 13, 208, 211, and 368).

[131] *See* Section II.A, *supra*. *See also* FINRA Rule 2111 (effective July 9, 2012). Under FINRA rules, unless a counterparty had total assets of at least $50 million, he or she would be entitled to the protections provided by retail suitability obligations in the broker-dealer context. *See* FINRA Rule 2111(b) (referring to NASD Rule 3110(c)(4)).

[132] Some dealers have indicated that they already apply ''institutional suitability'' principles to their swap business. *See, e.g.,* Letter from Richard Ostrander, Managing Director and Counsel, Morgan Stanley, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, and David A. Stawick, Secretary, Commodity Futures Trading Commission (Dec. 3, 2010) at 5; Report of the Business Standards Committee, Goldman Sachs (Jan. 2011), *http://www2.goldmansachs.com/our-firm/business-standards-committee/report.pdf.*

[133] *See* FINRA Notice to Members 01–23 (Mar. 19, 2001), and Notice of Filing of Proposed Rule Change to Adopt FINRA Rules 2090 (Know Your Customer) and 2111 (Suitability) in the Consolidated FINRA Rulebook, Exchange Act Release No. 62718 (Aug. 13, 2010), 75 FR 51310 (Aug. 19, 2010), as amended, Exchange Act Release No. 62718A (Aug. 20, 2010), 75 FR 52562 (Aug. 26, 2010) (discussing what it means to make a ''recommendation'').

[134] *Cf.* Supplementary Material .03 to FINRA Rule 2090.

[135] *See, e.g., Michael F. Siegel*, 2007 NASD Discip. LEXIS 20 (2007), *aff'd,* Exchange Act

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proposed Rule 15Fh–3(f)(1), in order to establish a reasonable basis for a recommendation to a particular counterparty, the SBS Dealer would need to have or obtain relevant information regarding the counterparty, including the counterparty's investment profile (including trading objectives) and its ability to absorb potential losses associated with the recommended security-based swap or trading strategy.[136]

Proposed Rule 15Fh–3(f)(2) would provide an alternative to the general suitability requirement, under which an SBS Dealer could fulfill its obligations with respect to a particular counterparty if: (1) The SBS Dealer reasonably determines that the counterparty (or its agent) is capable of independently evaluating investment risks with regard to the relevant security-based swap or trading strategy involving a security-based swap; (2) the counterparty (or its agent) affirmatively represents in writing that it is exercising independent judgment in evaluating the recommendations by the SBS Dealer; and (3) the SBS Dealer discloses that it is acting in the capacity of a counterparty, and is not undertaking to assess the suitability of the security-based swap or trading strategy.[137] We preliminarily believe that parties should be able to make these disclosures on a transaction-by-transaction basis, on an asset-class-by-asset-class basis, or in terms of all potential transactions between the parties.[138]

If an SBS Dealer cannot rely on the alternative provided by proposed Rule 15Fh–3(f)(2), it would need to make an independent determination that the recommended security-based swap or trading strategy involving security-based swaps is suitable for the counterparty.[139]

We preliminarily believe that an SBS Dealer, for purposes of Rule 15Fh–3(f)(2), reasonably could determine that the counterparty (or its agent) is capable of independently evaluating investment risks with regard to the relevant security-based swap (or trading strategy involving a security-based swap) through a variety of means, including the use of written representations from its counterparty. For example, absent special circumstances described below, we preliminarily believe it would be reasonable for an SBS Dealer to rely on written representations by its counterparty that the counterparty (or its agent) is capable of independently evaluating investment risks with regard to any security-based swap (or trading strategy involving a security-based swap). Upon receiving such a representation (or the representation required by Rule 15Fh–3(f)(2)(ii) with respect to the counterparty's exercise of independent judgment), the SBS Dealer would be entitled to rely on the representation without further inquiry, absent special circumstances described below.

To solicit input on when it would no longer be appropriate for an SBS Dealer to rely on such representations without further inquiry, the Commission is proposing for comment two alternative approaches. One approach would permit an SBS Dealer to rely on a representation from a counterparty for purposes of Rule 15Fh–3(f)(2)(i) or (ii) unless it knows that the representation is not accurate. The second would permit an SBS Dealer to rely on a representation unless the SBS Dealer has information that would cause a reasonable person to question the accuracy of the representation.

Under either approach, an SBS Dealer could not ignore information in its possession as a result of which the SBS Dealer would know that a representation is inaccurate. In addition, under the second approach, an SBS Dealer also could not ignore information that would cause a reasonable person to question the accuracy of a representation and, if the SBS Dealer had such information, it would need to make further reasonable inquiry to verify the accuracy of the representation.

We are proposing to apply the requirement in proposed Rule 15Fh–3(f) to SBS Dealers but not to Major SBS Participants because we do not anticipate that Major SBS Participants will serve a dealer-type role in the market.[140] Further, under the proposed rule, the obligation would not apply to an SBS Dealer in dealings with an SBS Entity, swap dealer, or major swap participant.[141] We preliminarily believe that these types of counterparties, which are professional intermediaries or major participants in the swaps or security-based swap markets, would not need the protections that would be afforded by this rule.

In addition, when an SBS Dealer is acting as an advisor to a special entity, we are proposing that the suitability requirement will be deemed satisfied by compliance with the requirements of Rule 15Fh–4(b). Under Section 15F(h)(4), an SBS Dealer that acts as an advisor to a special entity is required to make a reasonable determination that its recommendations are in the best interests of the counterparty.[142] The statute and proposed Rule 15Fh–4(b)(2) set forth specific information that an SBS Dealer must make reasonable efforts to obtain as necessary when making that determination. As explained more fully in Section II.D.3, *infra,* the proposed rule would further

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Release No. 58737 (Oct. 6, 2008), *vacated in part and remanded on other grounds*, 592 F.3d 147 (10th Cir. 2010) (finding that registered representative lacked any reasonable basis for recommending securities because he did not have sufficient understanding of what he was recommending). *See also* Distribution by Broker-Dealers of Unregistered Securities, Exchange Act Release No. 6721 (Feb. 2, 1962) (''the making of recommendations for the purchase of a security implies that the dealer has a reasonable basis for such recommendations which, in turn, requires that, as a prerequisite, he shall have made a reasonable investigation''). *Cf.* Supplementary Material .03 to FINRA Rule 2090.

[136] Under FINRA Rule 2111(a) (effective July 9, 2012), a customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation. *See also* FINRA Rule 2360(b)(19)(B) (''No member or person associated with a member shall recommend to a customer an opening transaction in any option contract unless the person making the recommendation has a reasonable basis for believing, at the time of making the recommendation, that the customer * * * is financially able to bear the risks of the recommended position in the option contract.'').

[137] As discussed in Section II.D.3, the standards for determining that an SBS Dealer is not acting as an advisor under proposed Rule 15Fh–2(a) would be substantially the same as the standards that an SBS Dealer must satisfy to qualify for the alternative to the general suitability standard under proposed Rule 15Fh–3(f). Accordingly, as described more fully below, we are also proposing that the general suitability requirement be deemed satisfied if an SBS Dealer is deemed not to be acting as an advisor to a special entity in accordance with proposed Rule 15Fh–2(a).

[138] This approach is consistent with FINRA's approach to institutional suitability. *See* Supplementary Material .07 to FINRA Rule 2111 (effective July 9, 2012) (''With respect to having to indicate affirmatively that it is exercising independent judgment in evaluating the member's or associated person's recommendations, an institutional customer may indicate that it is exercising independent judgment on a trade-by-trade basis, on an asset-class-by-asset-class basis, or in terms of all potential transactions for its account.'').

[139] This also is consistent with FINRA's approach to institutional suitability. *See id.*

[140] *See* discussion in Section I.C.4, *supra.* If a Major SBS Participant is, in fact, recommending security-based swaps to counterparties, we believe it is likely that person is engaged in other activities that would cause it to come within the definition of an SBS Dealer (and therefore no longer able to qualify as a Major SBS Participant) or other regulated entity that historically has been subject to a suitability obligation.

[141] *See* proposed Rule 15Fh–3(f).

[142] Section 15F(h)(4)(C) (''Any security-based swap dealer that acts as an advisor to a special entity shall make reasonable efforts to obtain such information as is necessary to make a reasonable determination that any security-based swap recommended by the security-based swap dealer is in the best interests of the special entity''). Public Law 111–203, 124 Stat. 1376, 1790–1791 (to be codified at 15 U.S.C. 78o–10(h)(4)(C)).

require that the SBS Dealer act in the ''best interests'' of the special entity, which goes beyond and encompasses the general suitability requirements of proposed Rule 15Fh–3(f). Accordingly, we preliminarily believe that the general suitability requirement of proposed Rule 15Fh–3(f) should be deemed satisfied by compliance with the requirements of proposed Rule 15Fh–4(b).

Request for Comments

The Commission requests comments generally on all aspects of proposed Rule 15Fh–3(f). In addition, we request comments on the following specific issues:

• As noted above, the term ''recommendation'' has been interpreted in the context of the FINRA suitability requirement. Should the Commission define or describe more fully what is a ''recommendation'' in this context, and if so, what should the definition or description be and why? In what specific circumstances, if any, would additional guidance as to the meaning of a ''recommendation'' be useful? Does the existing FINRA guidance provide sufficient clarity in this regard? Why or why not? Would a different approach be appropriate given the differences in the market for security-based swaps? Why or why not? Should the Commission expressly address the application of any part of the FINRA guidance in this context? If so, how?

• Should the Commission permit an SBS Dealer to rely on the institutional suitability alternative that would be available under proposed Rule 15Fh–3(f)(2)? Why or why not? Should additional or different requirements be placed upon an SBS Dealer's use of this alternative? If so, what requirements should be added or changed and why?

• Is FINRA's guidance regarding the customer information a broker-dealer should have available in order to make a suitability determination an appropriate model for security-based swap markets? How, if at all, should that guidance be modified? Should the SBS Dealer be required to obtain different or additional information regarding the counterparty?

• Should the suitability obligations apply to Major SBS Participants, as well as to SBS Dealers? Why or why not?

• Should the suitability obligations apply to recommendations made to SBS Entities, swap dealers and major swap participants? Why or why not?

• Should the suitability obligations apply when recommendations are made to a counterparty that is a broker-dealer?[143] Another type of market intermediary? Why or why not? Are there any other circumstances in which the proposed suitability requirement should not apply, or should apply in a different way?

• Are there any particular types of security-based swap transactions for which heightened or otherwise modified suitability requirements should apply? If so, what types of transactions? What requirements should apply to these transactions?

• Should different categories of ECPs be treated differently under the proposed rules for purposes of suitability determinations? If so, how? For example, under our proposed rules an SBS Entity would be subject to the suitability requirement of proposed Rule 15F–3(f)(2) when entering into security-based swaps with any person that qualified as an ECP, a category that includes persons with $5 million or more invested on a discretionary basis that enter into the security-based swap ''to manage risks.''[144] In contrast, under FINRA rules, in order to apply an analogous suitability standard, a broker-dealer must be dealing with an entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least $50 million.[145] Should the Commission apply a different standard of suitability depending on whether the counterparty would be protected as a retail investor under FINRA rules when the SBS Dealer is also a registered broker-dealer?[146] If so, what should the standard be and to whom should it apply? In what ways should the similarities and differences between security-based swaps and the types of securities transactions otherwise subject to FINRA rules inform the standard applied by the Commission in this context?

• Is it appropriate for the Commission to exclude from the scope of the proposed rule situations in which an SBS Dealer is making recommendations to a special entity, since recommendations to those entities are subject to separate and heightened suitability requirements? Why or why not?

• Should the proposed alternative available under proposed Rule 15Fh-3(f)(2) be limited to counterparties that would not be protected as retail investors under FINRA rules or another category of counterparties?[147] If not, should we require that the proposed alternative be addressed on a transaction-by-transaction basis (*i.e.,* not generally on a relationship basis or asset-class-by-asset-class) for counterparties that would otherwise be protected as retail investors under FINRA rules or another category of counterparties? Why or why not?

• Should the suitability obligation be limited to recommendations to counterparties that would be protected as retail investors under FINRA rules or another subset of counterparties? If so, should these counterparties be covered by a suitability rule similar to FINRA Rule 2360 regarding options suitability? Should this requirement be limited to another category of counterparties?[148] Why or why not?

• Should the Commission provide guidance on other methods by which an SBS Dealer can assess a counterparty's capability to independently evaluate investment risks and exercise independent judgment? If so, what alternative approaches, and what would be the advantages and disadvantages for SBS Dealers and counterparties?

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[143] FINRA ''know your customer'' obligations do not apply to a broker-dealer's dealings with another broker or dealer. *See* NASD Rule 0120(g) (''[t]he term 'customer' shall not include a broker or dealer'').

[144] *See* Section 1a(18)(A)(xi) of the Commodity Exchange Act, as amended by the Dodd-Frank Act.

[145] *See* FINRA Rule 2111(b) (referring to NASD Rule 3110(c)(4)).

[146] Under FINRA rules, a retail customer would generally be an entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of less than $50 million). *See* NASD Rule 3110(c)(4). An SBS Dealer that is also a broker-dealer would need to have a reasonable basis to believe that any recommendation of security-based swap or trading strategy to such a person is suitable for that person, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the counterparty's investment profile. This general suitability obligation under current FINRA rules would apply regardless of whether the SBS Dealer could otherwise rely on the alternative under proposed Rule 15Fh–3(f)(2).

[147] *See id.*

[148] FINRA Rule 2360(b)(19) (Suitability) provides that:

(A) No member or person associated with a member shall recommend to any customer any transaction for the purchase or sale of an option contract unless such member or person associated therewith has reasonable grounds to believe upon the basis of information furnished by such customer after reasonable inquiry by the member or person associated therewith concerning the customer's investment objectives, financial situation and needs, and any other information known by such member or associated person, that the recommended transaction is not unsuitable for such customer.

(B) No member or person associated with a member shall recommend to a customer an opening transaction in any option contract unless the person making the recommendation has a reasonable basis for believing, at the time of making the recommendation, that the customer has such knowledge and experience in financial matters that he may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position in the option contract.

• Should the Commission impose specific requirements with respect to the level of detail that should be required for representations? If so, what requirements and why?

• Should the Commission permit SBS Dealers to rely on disclosures made by counterparties for purposes of proposed Rule 15Fh–3(f)(2) on a transaction-by-transaction basis, on an asset-class-by-asset-class basis, or in terms of all potential transactions between the parties? Why or why not? What are the potential advantages and disadvantages of such an approach?

• What are the advantages and disadvantages of the two alternative proposed approaches to guidance on when an SBS Dealer may not rely on a representation? Which alternative would strike the best balance among the potential disadvantages to market participants, the regulatory interest (including protecting counterparties in security-based swap transactions) and promoting the sound functioning of the security-based swap market? What, if any, other alternatives should the Commission consider (*e.g.,* a recklessness standard) and why?

• Are there particular categories of counterparties for which an SBS Dealer should be required to undertake further review or inquiry to establish a counterparty's capability? Should additional information be required when, for example, a potential counterparty is a natural person? If so, what review or inquiry should be required in what circumstances?

• Are there other potential reasonable methods of establishing a counterparty's capability to independently evaluate investment risks and exercise independent judgment besides written representations? Should the Commission consider providing guidance regarding these other methods? If so, what methods should such guidance address and how?

5. Fair and Balanced Communications

Proposed Rule 15Fh–3(g) would implement the statutory requirement that SBS Entities communicate with counterparties in a fair and balanced manner based on principles of fair dealing and good faith.[149] This obligation would apply in connection with entering into security-based swaps, and would continue to apply over the term of a security-based swap.[150] The standard is consistent with the similarly worded requirement in the FINRA customer communications rule, which is designed to ensure that any customer communications reflect a balanced treatment of potential benefits and risks.[151] As we explained in Section I.C.2, *supra,* when a business conduct standard is based on a similar SRO standard, we generally expect to interpret our standard consistently with SRO interpretations of their rules, recognizing that we may need to account for functional differences between the security-based swap market and other securities markets. Accordingly, we are proposing three additional standards, drawn from FINRA regulation, to clarify the statutory requirement.[152] These standards do not represent an exclusive list of considerations that an SBS Entity must make in determining whether a communication with a counterparty is fair and balanced.

We propose to require that communications must provide a sound basis for evaluating the facts with respect to any security-based swap or trading strategy involving a security-based swap that the communication is designed to cover.[153] In addition, we propose to prohibit communications that imply that past performance would recur, or that make any exaggerated or unwarranted claim, opinion, or forecast.[154] Finally, we propose to require that any statement referring to the potential opportunities or advantages presented by a security-based swap or trading strategy involving a security-based swap be balanced by a statement of the corresponding risks having the same degree of specificity as the statement of opportunities.[155] SBS Entities should also avoid broad generalities in their communications, to the extent appropriate and practicable under the circumstances.

We note that, regardless of the scope of the rules proposed herein, all communications by SBS Entities will be subject to the specific anti-fraud provisions added to the Exchange Act under Title VII of the Dodd-Frank Act, [156] as well as general anti-fraud provisions under the federal securities laws.[157]

Request for Comments

The Commission requests comments generally on all aspects of this provision. In addition, we request comments on the following specific issues:

• Should the Commission further clarify any proposed requirements to engage in fair and balanced communications? If so, how? Are there specific circumstances regarding the application of the proposed requirements that the Commission should address? If so, which circumstances, and what guidance is required?

• Should the Commission specify any additional requirements for the duty to engage in fair and balanced communications? If so, what requirements and why?

• Should an SBS Entity be able to rely on SRO guidance with respect to communications for purposes of compliance with the proposed rule? If so, how would such reliance function as both the security-based swap market and the broader securities markets continue to evolve?

• Should the Commission provide additional guidance with respect to the nature of fair and balanced communications for purposes of furthering compliance with the proposed rule and providing greater

[149] *See* Exchange Act Section 15F(h)(3)(C), Pub. L. 111–203, 124 Stat. 1376, 1790 (to be codified at 15 U.S.C. 78o–10(h)(3)(C)).

[150] *See* proposed Rule 15Fh–1.

[151] NASD Rule 2210(d). *See* IM–2210–1(1), Guidelines to Ensure That Communications with the Public Are Not Misleading (''Members must ensure that statements are not misleading within the context in which they are made. A statement made in one context may be misleading even though such a statement could be appropriate in another context. An essential test in this regard is the balanced treatment of risks and potential benefits.'').

[152] *Cf.* SIFMA/ISDA 2010 Letter at 4 (requesting the Commission clarify the standards for fair and balanced communication by reference to the existing FINRA standards for customer communication, subject to appropriate modifications to reflect the heightened standards for participation in the swap markets).

[153] Proposed Rule 15Fh–3(g)(1). *Cf.* NASD Rule 2210(d)(1)(A) (''All member communications with the public shall be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service.'').

[154] Proposed Rule 15Fh–3(g)(2). *Cf.* NASD Rule 2201(d)(1)(D) (''Communications with the public may not predict or project performance, imply that past performance will recur or make any exaggerated or unwarranted claim, opinion or forecast. A hypothetical illustration of mathematical principles is permitted, provided that it does not predict or project the performance of an investment or investment strategy.''). Proposed Rule 15Fh–3(e)(4) does not constitute a blanket prohibition of communications such as scenario or profitability analyses that are required or advisable under other provisions of these rules.

[155] Proposed Rule 15Fh–3(g)(3). *Cf.* NASD IM–2210–1(1) (''An essential test in this regard is the balanced treatment of risks and potential benefits.'').

[156] *See* Sections 9(j) and 15F(h)(4)(A) of the Exchange Act, Public Law 111–203, 124 Stat. 1376, 1777–1778 and 1790 (to be codified at 15 U.S.C. 78i(j) and 15 U.S.C. 78o–10(h)(4)(A)). *See also* Prohibition Against Fraud, Manipulation, and Deception in Connection with Security-Based Swaps, Exchange Act Release No. 63236 (Nov. 3, 2010), 75 FR 68560 (Nov. 8, 2010) (proposing Rule 9j–1 to implement the anti-fraud prohibitions of Section 9(j) of the Exchange Act).

[157] *See, e.g.,* 15 U.S.C. 77q and 78i, and, if the SBS Entity is registered as a broker-dealer, 15 U.S.C. 78o.

legal certainty to market participants? If so, what guidance and why?

• What are the specific practical effects, advantages and disadvantages that market participants identify in considering how to comply with the proposed rules? Are there modifications or clarifications to the proposed rules that would better balance the advantages and disadvantages of the statutory requirement while furthering the Commission's regulatory objectives?

• Are there any particular differences between the traditional securities markets and the markets for security-based swaps that need to be taken into account in clarifying the statutory requirement to communicate in a fair and balanced manner based on principles of fair dealing and good faith? If so, what are these differences, and how should the Commission's proposal be modified to take them into account?

• Should we distinguish between the fair and balanced communication requirements applicable to an SBS Dealer and those applicable to a Major SBS Participant? If so, how should the requirements applicable to a Major SBS Participant differ from those that are being proposed?

• Are there any circumstances in which the fair and balanced communications requirements should not apply? Which circumstances, and why?

• We preliminarily believe that proposed Rule 15F–3(g) would provide additional investor protection beyond what would otherwise arise by virtue of applicable anti-fraud rules. Will the proposed communications requirements have the effect of reducing communications between SBS Entities and their counterparties? In what respects, and why? What alternative approaches might the Commission consider to effectively implement the statutory requirement without unduly discouraging effective communication between market participants?

6. Obligation Regarding Diligent Supervision

Exchange Act Section 15F(h)(1)(B) authorizes the Commission to adopt rules for the diligent supervision of the business of SBS Entities. Proposed Rule 15Fh–3(h) would establish supervisory obligations that incorporate principles from both Exchange Act Section 15(b) and existing SRO rules.[158] As we discussed earlier, the concept of diligent supervision is consistent with business conduct standards for broker-dealers that have historically been established by SROs for their members, subject to Commission approval. We anticipate that certain SBS Entities may also be registered broker-dealers and thus subject to substantially similar requirements under SRO rules.[159] More generally, we believe that the SRO requirements provide a useful point of reference that has been implemented by a wide range of firms in the U.S. financial services industry.

Under proposed Rule 15Fh–3(h)(1), each SBS Entity would be required to establish, maintain and enforce a system to supervise, and would be required to supervise diligently, the business of the SBS Entity involving security-based swaps.[160]This system would be required to be reasonably designed to achieve compliance with applicable federal securities laws and the rules and regulations thereunder.[161] Proposed Rule 15Fh–3(h) would provide a baseline requirement for an effective supervisory system, although a particular system may need additional elements in order to be effective. For that reason, proposed Rule 15Fh–3(h)(2) would state that it establishes only minimum requirements; by implication, the list would not be exhaustive. These obligations are based on SRO standards and we generally expect to interpret these obligations taking into account SRO interpretations of their rules, recognizing that we are not bound by SRO interpretations and may need to account for functional differences between the security-based swap market and other securities markets.

Proposed Rule 15Fh–3(h)(2)(i) would require an SBS Entity to designate at least one qualified person with supervisory responsibility for security-based swap transactions.[162] Proposed Rule 15Fh–3(h)(2)(ii) would require an SBS Entity to use reasonable efforts to determine that all supervisors are qualified and have sufficient training, experience, and competence to adequately discharge their responsibilities.[163] Proposed Rule 15Fh–3(h)(2)(iii) would require an SBS Entity to adopt written policies and procedures addressing the types of security-based swap business in which the SBS Entity is engaged. The policies and procedures would need to be reasonably designed to achieve compliance with applicable securities laws and the rules and regulations thereunder,[164] and include, at a minimum: (1) Procedures for the review by a supervisor of all transactions for which registration as an SBS Entity is required; [165] (2) procedures for the

[158] The Commission's policy regarding failure to supervise is well established. 15 U.S.C. 78o(b)(4)(E) and 15 U.S.C. 78o(b)(6)(A). As we have explained in other contexts:

The Commission has long emphasized that the responsibility of broker-dealers to supervise their employees is a critical component of the federal regulatory scheme. * * * In large organizations it is especially imperative that those in authority exercise particular vigilance when indications of irregularity reach their attention. The supervisory obligations imposed by the federal securities laws require a vigorous response even to indications of wrongdoing. Many of the Commission's cases involving a failure to supervise arise from situations where supervisors were aware only of ''red flags'' or ''suggestions'' of irregularity, rather than situations where, as here, supervisors were explicitly informed of an illegal act.

Even where the knowledge of supervisors is limited to ''red flags'' or ''suggestions'' of irregularity, they cannot discharge their supervisory obligations simply by relying on the unverified representations of employees. Instead, as the Commission has repeatedly emphasized, ''[t]here must be adequate follow-up and review when a firm's own procedures detect irregularities or unusual trading activity. * * *'' Moreover, if more than one supervisor is involved in considering the actions to be taken in response to possible misconduct, there must be a clear definition of the efforts to be taken and a clear assignment of those responsibilities to specific individuals within the firm.

John H. Gutfreund, Exchange Act Release No. 31554 (Dec. 3, 1992) (report pursuant to Section 21(a) of the Exchange Act) (footnotes omitted).

[159] *See, e.g.,* NASD Rules 3010 and 3012.

[160] We will consider consolidating any recordkeeping obligations proposed as part of this rule into a separate recordkeeping rule that we are required to adopt under the Dodd-Frank Act. *See* Section 15F(f)(2) of the Exchange Act, 15 U.S.C. 78o–10(f)(2) (''The Commission shall adopt rules governing reporting and recordkeeping for security-based swap dealers and major security-based swap participants.'').

[161] Proposed Rule 15Fh–3(h)(2). *See* NASD Rule 3010(a) (''Each member shall establish and maintain a system to supervise the activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules.'').

[162] *Cf.* NASD Rule 3010(a)(2) (requiring ''[t]he designation, where applicable, of an appropriately registered principal(s) with authority to carry out the supervisory responsibilities of the member for each type of business in which it engages for which registration as a broker/dealer is required'').

[163] *Cf.* NASD Rule 3010(a)(6) (requiring members to use ''[r]easonable efforts to determine that all supervisory personnel are qualified by virtue of experience or training to carry out their assigned responsibilities'').

[164] *Cf.* NASD Rule 3010(b)(1) (''Each member shall establish, maintain, and enforce written procedures to supervise the types of business in which it engages and to supervise the activities of registered representatives, registered principals, and other associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with the applicable Rules of NASD.'').

[165] Proposed Rule 15Fh–3(h)(2)(iii)(A). *Cf.* NASD Rule 3010 (d)(1) (''Each member shall establish procedures for the review and endorsement by a registered principal in writing, on an internal record, of all transactions and for the review by a registered principal of incoming and outgoing written and electronic correspondence of its registered representatives with the public relating to the investment banking or securities business of such member. Such procedures should be in writing and be designed to reasonably supervise each registered representative.'').

review by a supervisor of written correspondence with counterparties and potential counterparties and internal written (including electronic) communications relating to the securities-based swap business; [166] (3) procedures for a periodic review of the security-based swap business in which it engages; [167] (4) procedures to conduct reasonable investigation into the background of associated persons; [168] (5) procedures to monitor employee personal accounts held at another SBS Dealer, broker, dealer, investment adviser, or other financial institution; [169] (6) a description of the supervisory system, including identification of the supervisory personnel; [170] (7) procedures prohibiting supervisors from supervising their own activities or reporting to, or having their compensation or continued employment determined by, a person or persons they are supervising; [171] and (8) procedures preventing the standards of supervision from being reduced due to any conflicts of interest that may be present with respect to the associated person being supervised.[172] Proposed Rule 15Fh–3(h)(4) would require SBS Entities to promptly update their supervisory procedures as legal or regulatory changes warrant. Proposed Rule 15Fh–3(h)(2)(iii)(F) would require SBS Entities to maintain records identifying supervisory personnel.

As part of the required system reasonably designed to achieve compliance with applicable federal securities laws and regulations, proposed Rule 15Fh–3(h)(2)(iv) would require an SBS Entity to adopt written policies and procedures reasonably designed, taking into consideration the nature of such SBS Entity's business, to comply with the duties set forth in Section 15F(j) of the Exchange Act.[173] Section 15F(j) of the Exchange Act requires an SBS Entity to comply with obligations concerning: (1) Monitoring of trading to prevent violations of applicable position limits; (2) establishing sound and professional risk management systems; (3) disclosing to regulators information concerning its trading in security-based swaps; (4) establishing and enforcing internal systems and procedures to obtain any necessary information to perform any of the functions described in Section 15F of the Exchange Act, and providing the information to regulators, on request; (5) implementing conflict-of-interest systems and procedures that establish structural and institutional safeguards to ensure that the activities of any person within the firm relating to research or analysis of the price or market for any security-based swap, or acting in the role of providing clearing activities, or making determinations as to accepting clearing customers are separated by appropriate informational partitions within the firm from the review, pressure, or oversight of persons whose involvement in pricing, trading, or clearing activities might potentially bias their judgment or supervision and contravene the core principles of open access and the business conduct standards addressed in Title VII of the Dodd-Frank Act; and (6) addressing antitrust considerations such that the SBS Entity does not adopt any process or take any action that results in any unreasonable restraint of trade or impose any material anticompetitive burden on trading or clearing.

Under proposed Rule 15Fh–3(h)(3), an SBS Entity or associated person would not have failed diligently to supervise a person that is subject to the supervision of that SBS Entity or associated person, if two conditions are met. First, the SBS Entity must have established 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 thereunder related to security-based swaps. Second, such person 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 were not being followed. However, the absence of either or both of these conditions would not necessarily mean that an SBS Entity or associated person failed to diligently supervise any other person.

Request for Comments

The Commission requests comments generally on all aspects of this provision. In addition, we request comments on the following specific issues:

- Should supervisory requirements be imposed on Major SBS Participants? Why or why not?
- Should different supervisory requirements apply to SBS Dealers and Major SBS Participants? If so, how should the requirements differ, and why?
- Should we require a specific means by which an SBS Entity must determine whether a supervisor is qualified and has sufficient training, experience, and competence to adequately discharge his or her responsibilities? If so, what means? For example, should we require that supervisors pass exams comparable to FINRA Series 24? Should any such requirement apply to supervisors at Major SBS Participants as well, or only to supervisors at SBS Dealers?
- Should the Commission consider imposing a testing requirement comparable to FINRA Series 7 for all associated persons of an SBS Dealer or Major SBS Participant? Why or why not? Are there other models the Commission should consider? Which models, and why?

[166] Proposed Rule 15Fh–3(h)(2)(iii)(B). *Cf.* NASD Rule 3010(d)(2) (which provides in part that ''[e]ach member shall develop written procedures that are appropriate to its business, size, structure, and customers for the review of incoming and outgoing written (*i.e.,* non-electronic) and electronic correspondence with the public relating to its investment banking or securities business, including procedures to review incoming, written correspondence directed to registered representatives and related to the member's investment banking or securities business to properly identify and handle customer complaints and to ensure that customer funds and securities are handled in accordance with firm procedures'').

[167] Proposed Rule 15Fh–3(h)(2)(iii)(C). *Cf.* NASD Rule 3010(c)(1) (''Each member shall conduct a review, at least annually, of the businesses in which it engages, which review shall be reasonably designed to assist in detecting and preventing violations of, and achieving compliance with, applicable securities laws and regulations, and with applicable NASD rules.'').

[168] Proposed Rule 15Fh–3(h)(2)(iii)(D). *Cf.* NASD Rule 3010(e) (''Each member shall have the responsibility and duty to ascertain by investigation the good character, business repute, qualifications, and experience of any person prior to making such a certification in the application of such person for registration with this Association.'').

[169] Proposed Rule 15Fh–3(h)(2)(iii)(E).

[170] Proposed Rule 15Fh–3(h)(2)(iii)(F). *Cf.* NASD Rule 3010(b)(3) (''The member's written supervisory procedures shall set forth the supervisory system established by the member pursuant to paragraph (a) above, and shall include the titles, registration status and locations of the required supervisory personnel and the responsibilities of each supervisory person as these relate to the types of business engaged in, applicable securities laws and regulations, and the Rules of this Association.'').

[171] Proposed Rule 15Fh–3(h)(2)(iii)(G). *Cf.* NASD Rule 3012(a)(2)(A)(i) (''General Supervisory Requirement. A person who is either senior to, or otherwise independent of, the producing manager must perform such supervisory reviews.'').

[172] Proposed Rule 15Fh–3(h)(2)(iii)(H). These conflicts could arise from the position of the associated person being supervised, the revenue that person generates for the SBS Entity, or any compensation that the person conducting the supervision may derive from the associated person being supervised. *Cf.* NASD Rule 3012(a)(2)(C) (requiring ''procedures that are reasonably designed to provide heightened supervision over the activities of each producing manager who is responsible for generating 20% or more of the revenue of the business units supervised by the producing manager's supervisor. For the purposes of this subsection only, the term 'heightened supervision' shall mean those supervisory procedures that evidence supervisory activities that are designed to avoid conflicts of interest that serve to undermine complete and effective supervision because of the economic, commercial, or financial interests that the supervisor holds in the associated persons and businesses being supervised.'').

[173] Public Law 111–203, 124 Stat. 1376, 1792–1793 (to be codified at 15 U.S.C. 78o–10(j)).

• Would any of these proposed supervisory requirements be more appropriately assigned to the chief compliance officer, and if so, which ones and why?
• Should certain obligations not be imposed on a supervisor of an SBS Entity? If so, which ones and why?
• Should an SBS Entity be able to rely on SRO guidance with respect to supervision for purposes of compliance with the proposed rule? Is that guidance sufficiently clear under the circumstances? Should that guidance be adopted or modified for purposes of its application to SBS Entities in the context of the security-based swap markets? If so, how and why?
• Do any of these proposed supervisory obligations conflict with current supervisory obligations, and if so, which ones and how?
• Should the Commission impose explicit supervision obligations with respect to the requirements of Section 15F(j), and if so, which ones and why? In particular, should the Commission impose explicit obligations with respect to the monitoring of trading to prevent violations of applicable position limits? Should the Commission impose explicit obligations with respect to establishing sound and professional risk management systems? Should the Commission impose explicit obligations to disclose to regulators information concerning trading in security-based swaps? Should the Commission impose explicit obligations with respect to establishing and enforcing internal systems and procedures to obtain any necessary information to perform any of the functions described in Section 15F of the Act? Should the Commission impose explicit obligations with respect to providing the information to regulators, on request? Should the Commission impose explicit obligations with respect to implementing conflict-of-interest systems and procedures to ensure that activities relating to research or analysis of the price or market for any security-based swap, clearing activities, and determinations as to accepting clearing customers are separated from the review, pressure, or oversight of persons whose involvement in pricing, trading, or clearing activities might potentially bias their judgment or supervision and contravene the core principles of open access and the business conduct standards addressed in the Act? Should the Commission impose explicit obligations with respect to addressing antitrust considerations such that the SBS Entity does not adopt any process or take any action that results in any unreasonable restraint of trade; or impose any material anticompetitive burden on trading or clearing?
• Should an SBS Entity be required to have policies and procedures reasonably designed to prevent the improper use or disclosure of counterparty information? [174]

D. Proposed Rules Applicable to Dealings With Special Entities

Congress has provided certain additional protections under Sections 15F(h)(4) and (5) of the Exchange Act for ''special entities'' in connection with security-based swaps.[175] Under the terms of Section 15F(h)(7) of the Exchange Act, Section 15F(h) would not apply to a transaction that is initiated by a special entity on an exchange or SEF and the SBS Entity does not know the identity of the counterparty to the transaction. The statute does not define the term ''initiated''. We preliminarily believe that there may be circumstances in which it may be unclear which party, in fact, ''initiated'' the communications that resulted in the parties entering into a security-based swap transaction. Accordingly, we are proposing to read Section 15F(h)(7) to apply to any transaction with a special entity on a SEF or an exchange where the SBS Entity does not know the identity of its counterparty. We recognize that, under this reading, the exemption under Section 15F(h)(7) would be available regardless of which side ''initiates'' a transaction, so long as the other conditions are met. We are seeking comment on whether this reading is appropriate or whether another possible reading of this provision should be made.

Request for Comments

The Commission requests comments generally on all aspects of this provision. In addition, we request comments on the following specific issues:

• Should the Commission adopt a different interpretation of Section 15F(h)(7)? If so, what interpretation and why?
• Should the exemption be limited to situations in which the special entity takes specific steps, such as submitting a request for quote or some other communication regarding a potential transaction on an exchange or SEF? Are there other communications or circumstances of entry into a security-based swap that should be regarded as the ''initiation'' of a transaction by a special entity? If so, which ones?
• Should the exemption continue to apply if the SBS Entity learns the identity of the special entity? If so, under what conditions and why?

1. Scope of the Definition of ''Special Entity''

Exchange Act Section 15F(h)(2)(C) defines a ''special entity'' as: (i) A Federal agency; [176] (ii) a State, State agency, city, county, municipality, or other political subdivision of a State; [177] (iii) any employee benefit plan, as defined in section 3 of ERISA; [178] (iv) any governmental plan, as defined in section 3 of ERISA; [179] or (v) any

[174] As noted above, proposed Rule 15Fh–3(h)(2)(iv) would require SBS Entities to adopt written policies and procedures reasonably designed, taking into consideration the nature of such SBS Entity's business, to comply with the duties set forth in Section 15F(j) of the Exchange Act, including implementing conflict-of-interest systems and procedures that establish structural and institutional safeguards to ensure that the activities of any person within the firm relating to research or analysis of the price or market for any security-based swap, or acting in the role of providing clearing activities, and or making determinations as to accepting clearing customers are separated by appropriate informational partitions within the firm from the review, pressure, or oversight of persons whose involvement in pricing, trading, or clearing activities might potentially bias their judgment or supervision and contravene the core principles of open access and the business conduct standards described in Title VII of the Dodd-Frank Act.

[175] *See* discussion in Section I.C.5, *supra.*

[176] The definition of ''security-based swap'' excludes an ''agreement, contract or transaction a counterparty of which is a Federal Reserve bank, the Federal Government, or a Federal agency that is expressly backed by the full faith and credit of the United States.'' Section 3(a)(68) of the Exchange Act, by reference to Section 1a of the Commodity Exchange Act. Accordingly, the Commission expects that special entities that are Federal agencies will be a narrow category for purposes of these rules.

[177] *Cf.* Exchange Act Section 15B(e)(8), Pub. L. 111–203, 124 Stat. 1376, 1790–1791 (to be codified at 15 U.S.C. 78o–4(e)(8)) (defining ''municipal entity'' to include ''any agency, authority, or instrumentality of the States, political subdivision, or municipal corporate entity''); 17 CFR 275.206(4)–(5) (defining ''governmental entity'' to include ''any agency, authority, or instrumentality of the state or political subdivision'').

[178] 29 U.S.C. 1002. The term ''special entity'' includes employee benefit plans defined in section 3 of ERISA. This class of employee benefit plans is broader than the category of plans that are ''subject to'' ERISA for purposes of Section 15F(h)(5)(A)(i)(VII) of the Exchange Act. Employee benefit plans not ''subject to'' regulation under ERISA include: (1) Governmental plans; (2) church plans; (3) plans maintained solely for the purpose of complying with applicable workmen's compensation laws or unemployment compensation or disability insurance laws; (4) plans maintained outside the U.S. primarily for the benefit for persons substantially all of whom are nonresident aliens; or (5) unfunded excess benefit plans. *See* 29 U.S.C. 1003(b).

[179] Section 3(32) of ERISA defines ''governmental plan'' as a ''plan established or maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing.'' 29 U.S.C. 1002(32).

endowment, including an endowment that is an organization described in section 501(c)(3) of the Internal Revenue Code of 1986.[180] Commenters have raised a number of questions about the scope of the definition, as to which we are soliciting further comment below.[181]

Request for Comments

The Commission requests comment on all aspects of the definition of ''special entity.'' In particular, we are seeking comment as to what clarifications to the definition may be required and why. Commenters should also explain why any suggested clarification is consistent with both the express statutory language and the policies underlying Section 764 of the Dodd-Frank Act. In addition, the Commission requests comments on the following specific issues.

- Should the Commission interpret ''employee benefit plan, as defined in section 3'' of ERISA to mean a plan that is subject to regulation under ERISA? [182] Why or why not?
- Should the Commission interpret ''government plan'' to include government investment pools or other plans, programs or pools of assets? Why or why not?
- Should the Commission define ''endowment''? If so, how? What organizations should be included in or excluded from the definition, and why? [183] Should the Commission interpret ''endowment'' to include funds that are not separate legal entities? Why or why not? Should the term ''endowment'' include legal entities or funds that are not organized or located in the United States? Should the term ''endowment'' be limited to those organizations described in Section 501(c)(3) of the Internal Revenue Code?
- Should the Commission interpret ''endowment'' to include an organization that uses the assets of its endowment to pledge or maintain collateral obligations, or otherwise enhance or support the organization's obligations under a security-based swap? [184] Why or why not?
- Should the Commission interpret ''special entity'' to exclude a collective investment vehicle in which one or more special entities have invested? [185] Should a collective investment vehicle be considered a special entity if the fund manager, for example, becomes subject to fiduciary duties under ERISA with respect to plan assets in the fund? Why or why not?
- Should the Commission exclude from the definition of ''special entity'' any foreign entity?
- Should the Commission interpret ''special entity'' to include a master trust holding the assets of one or more funded plans of a single employer and its affiliates? [186] Why or why not?

2. Best Interests

Section 15F(h) of the Exchange Act uses the term ''best interests'' in several instances with respect to special entities. Section 15F(h)(4)(B) imposes on an SBS Dealer that ''acts as an advisor'' to a special entity a duty to act in the ''best interests'' of the special entity. In addition, Section 15F(h)(4)(C) requires the SBS Dealer that ''acts as an advisor'' to a special entity to make ''reasonable efforts to obtain such information as is necessary to make a reasonable determination'' that any swap recommended by the SBS Dealer is in the ''best interests'' of the special entity. Finally, Section 15F(h)(5) of the Exchange Act requires an SBS Entity that is a counterparty to a special entity to have a ''reasonable basis'' to believe that the special entity has an independent representative that undertakes to act in the best interests of the special entity.[187]

The term ''best interests'' is not defined in the Dodd-Frank Act. The Commission is not proposing to define ''best interests'' in this rulemaking. Instead we are seeking comment on whether we should define that term, and if so, whether such definition should use formulations based on the standards applied to investment advisers,[188] municipal advisors,[189] or ERISA fiduciaries,[190] or some other formulation.[191]

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[180] The term ''endowment'' is not defined in the Dodd-Frank Act, or in the securities laws generally.

[181] *See, e.g.,* SIFMA/ISDA 2010 Letter at 2 (requesting confirmation that ''collective investment vehicles do not become 'Special Entities' merely as a result of the investment by Special Entities in such vehicles,'' and asserting that ''master trusts holding the assets of one or more funded plans of a single employer should be considered 'Special Entities' '').

[182] *See, e.g., id.* (requesting confirmation that ''plans not subject to the Employee Retirement Income Security Act of 1974 ('ERISA') (unless they are covered by another applicable prong of the ''Special Entity'' definition (*e.g.,* governmental plans)) are not 'Special Entities' ''). Section 4 of ERISA provides that the provisions of ERISA shall not apply to an employee benefit plan that is a governmental plan (as defined in section 1002(32) of ERISA); a church plan (as defined in section 1002(33) of ERISA) with respect to which no election has been made under 26 U.S.C. section 410(d); a plan that is maintained solely for the purpose of complying with applicable workmen's compensation laws or unemployment compensation or disability insurance laws; a plan that is maintained outside of the United States primarily for the benefit of persons substantially all of whom are nonresident aliens; or a plan that is an excess benefit plan (as defined in section 1002(36) of ERISA) and is unfunded.

See Letter from Daniel Crowley, Partner, K&L Gates on behalf of the Church Alliance, to David A. Stawick, Secretary, CFTC (Feb. 22, 2011) (on file with the CFTC), *http://comments.cftc.gov/PublicComments/CommentList.aspx?id=935* (requesting clarification that church plans be included in the definition of special entity).

[183] For accounting purposes, the term ''endowment'' is defined to mean ''[a]n established fund of cash, securities, or other assets to provide income for the maintenance of a not-for-profit organization. The use of the assets of the fund may be permanently restricted, temporarily restricted, or unrestricted. Endowment funds generally are established by donor-restricted gifts and bequests to provide a permanent endowment, which is to provide a permanent source of income, or a term endowment, which is to provide income for a specified period.'' Financial Accounting Standards Board ASC Section 958–205–20, Glossary, Non-for-Profit Entities.

[184] *See* Swap Financial Group Presentation at 8 (concerning the scope of this prong of the definition of ''special entity'').

[185] *See* note 181, *supra.*

[186] *See id.*

[187] Section 15F(h)(5)(A)(i)(IV) of the Exchange Act, Public Law 111–203, 124 Stat. 1376, 1791 (to be codified at 15 U.S.C. 78o–10(h)(5)(A)(i)(IV)).

[188] We recently stated that, under the Advisers Act, an adviser is a fiduciary whose duty is to serve the best interests of its clients, which includes an obligation not to subordinate clients' interests to its own. An adviser must deal fairly with clients and prospective clients, seek to avoid conflicts with its clients and, at a minimum, make full disclosure of any material conflict or potential conflict. *See* Amendments to Form ADV, Investment Advisers Act Release No. 3060 (July 28, 2010), 75 FR 49234 (Aug. 12, 2010), *citing SEC* v. *Capital Gains Research Bureau, Inc.,* 375 U.S. 180, 191–194 (1963) (holding that investment advisers have a fiduciary duty enforceable under Section 206 of the Advisers Act, that imposes upon investment advisers the ''affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts,' as well as an affirmative obligation to 'employ reasonable care to avoid misleading' '' their clients and prospective clients).

[189] *See, e.g.,* Exchange Act Section 15B(b)(2)(L), Public Law 111–203, 124 Stat. 1376, 1919 (to be codified at 15 U.S.C. 78o–4(b)(2)(L)) (requiring the MSRB to prescribe means reasonably designed to prevent acts, practices, and courses of conduct that are not consistent with a municipal advisor's fiduciary duty to its municipal entity clients). The MSRB requested comment on draft Rule G–36 concerning the fiduciary duty of municipal advisors, and a draft interpretive notice under Rule G–36. *See* MSRB Notice 2011–14 (Feb. 14, 2011).

[190] *See, e.g.,* 29 U.S.C. 1104(a)(1)(A) (''a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and for the exclusive purpose of: (i) Providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan'') and 29 U.S.C. 1104(a)(1)(B) (a fiduciary must act ''with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims'').

[191] We note that Section 913 of the Dodd-Frank Act authorizes the Commission to promulgate rules to provide that the standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide) shall be to act in the best interest of the customer without regard to the financial or other interest of the intermediary providing the advice. Public Law 111–203, 124 Stat. 1376, 1827–1829.

Request for Comments

The Commission is seeking comment generally on whether and how it should clarify the meaning of the term ''best interests'' under Section 15F(h). In addition, we request comments on the following specific issues:

- Should the Commission define the term ''best interests'' in this context? If so, what definitions should the Commission consider and why? What are the advantages and drawbacks of particular definitions in this context? What factors should be included in the determination of a special entity's ''best interests''?
- Should the Commission adopt a definition of ''best interests'' that is based on the fiduciary duty applicable to investment advisers under the Investment Advisers Act of 1940 (''Advisers Act'')? [192] Why or why not?
- Should the Commission adopt a definition of ''best interests'' that is based on the fiduciary duty applicable to municipal advisors under the Exchange Act? [193] Why or why not?
- Should the Commission adopt a definition of ''best interests'' that is based on the fiduciary duty applicable to fiduciaries under ERISA? [194] Why or why not?
- Should the Commission define ''best interests'' in a manner consistent with how it may define ''best interests'' in any rulemaking it may choose to propose under Section 913 of the Dodd-Frank Act, if any? Why or why not?

3. Anti-Fraud Provisions: Proposed Rule 15Fh–4(a)

Section 15F(h)(4)(A) of the Exchange Act provides that it shall be unlawful for an SBS Entity to: (i) Employ any device, scheme, or artifice to defraud any special entity or prospective customer who is a special entity; (ii) engage 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 (iii) to engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative. Consistent with the guidance in our previous order regarding the effective date of this provision, we are proposing a rule to render the statutory standard effective.[195]

4. Advisor to Special Entities: Proposed Rules 15Fh–2(a) and 15Fh–4(b)

Exchange Act Section 15F(h)(4) imposes a duty on an SBS Dealer that acts as an advisor to a special entity to act in the best interests of the special entity.[196] The Dodd-Frank Act does not define ''advisor.'' Commenters have urged us to establish a clear standard for determining when an SBS Dealer is acting as an advisor within the meaning of Section 15F(h)(4).[197] These commenters have expressed concern that compliance with the ''best interests'' standard applicable to advisors would create significant burdens and potential legal liability for SBS Dealers, and therefore SBS Dealers need certainty as to when they would or would not be acting as an advisor. For example, commenters have expressed concern that the business conduct obligations imposed by the Dodd-Frank Act might cause an SBS Dealer to be a ''fiduciary'' under ERISA, and therefore effectively prohibit SBS Dealers from entering into security-based swaps with pension plans that are subject to ERISA.[198] We recognize the importance of this issue, both for dealers and for the pension plans that may rely on security-based swaps to manage risk and reduce volatility. The determination whether an SBS Dealer is acting as an advisor for purposes of Section 15F(h)(4) and proposed Rule 15Fh–4(b) is not intended to prejudice the determination whether the SBS Entity is otherwise subject to regulation as an ERISA fiduciary.[199] Although each regulatory regime applies independently, we anticipate that Commission staff will continue to consult with representatives of the Department of Labor to facilitate a full understanding of how the regulatory regimes interact with one another, and to determine whether any modifications to our proposed rules may be necessary or appropriate in light of these interactions.

An SBS Dealer that is acting as an advisor must in any case comply with the requirements of the Dodd-Frank Act. If an SBS Dealer is acting as an advisor, then under Section 15F(h)(4) and proposed Rule 15Fh–4(b), it must act in the best interests of the special entity. As part of its duty to act in the best interests of the special entity, the SBS Dealer would be required to provide suitable advice.[200] Consistent with Section 15F(h)(4)(C), proposed Rule 15Fh-4(b)(2) would require an SBS Dealer in these circumstances to make reasonable efforts to obtain the information it considers necessary to make a reasonable determination that any recommended security-based swap or trading strategy involving a security-based swap is in the best interests of the special entity. The proposed rule would identify specific types of information that the SBS Dealer should take into account in making this determination. This information would include, but not be limited to, the authority of the special entity to enter into a security-based swap; the financial status of the

[192] *See supra* note 188.

[193] *See supra* note 189.

[194] *See supra* note 190.

[195] *See* Order Pursuant to Sections 15F(b)(6) and 36 of the Securities Exchange Act of 1934 Granting Temporary Exemptions and Other Temporary Relief, Together with Information on Compliance Dates for New Provisions of the Securities Exchange Act of 1934 Applicable to Security-Based Swaps, and Request for Comment, Securities Act Release No. 64678 (June 15, 2011), 76 FR 36287 (June 22, 2011) at note 192:

Section 15F(h)(6) of the Exchange Act, 15 U.S.C. 78o–10(h)(6), directs the Commission to ''prescribe rules under this subsection [(h) of the Exchange Act, 15 U.S.C. 78o–10(h),] governing business conduct standards.'' Accordingly, business conduct standards pursuant to section 15F(h) of the Exchange Act, 15 U.S.C. 78o–10(h), will be established by rule and compliance will be required on the compliance date of the Commission rule establishing these business conduct standards.

[196] Section 15F(h)(2)(A) of the Exchange Act requires all SBS Entities to comply with the requirements of Section 15F(h)(4). Public Law 111–203, 124 Stat. 1376, 1789 (to be codified at 15 U.S.C. 78o–10(h)(2)(A)). The anti-fraud prohibitions of Section 15F(h)(4)(A) apply by their terms to all SBS Entities. Sections 15F(h)(4)(B) and (C) impose certain ''best interests'' obligations on an SBS Dealer that acts as an advisor to a special entity. See also Section II.D.2, *infra.*

[197] *See, e.g.,* SIFMA/ISDA 2010 Letter at 2 (''It is essential that the Commissions articulate a clear standard for the circumstances that give rise to 'advisor' status and the corresponding imposition of the statutory 'fiduciary-like' duty to act in the best interests of a Special Entity.'')

[198] As discussed in note 99, *supra,* the Department of Labor is proposing amendments to the definition of a fiduciary under ERISA that would provide a limited exception for a person that renders ''investment advice'' for compensation if that person ''can demonstrate that the recipient of the advice knows or, under the circumstances, reasonably should know, that the person is providing the advice or making the recommendation in its capacity as a purchaser or seller of a security or other property, or as an agent of, or appraiser for, such a purchaser or seller, whose interests are adverse to the interests of the plan or its participants or beneficiaries, and that the person is not undertaking to provide impartial investment advice.'' The Department of Labor in its proposing release explained that it had determined that ''such communications ordinarily should not result in fiduciary status * * * if the purchaser knows of the person's status as a seller whose interests are adverse to those of the purchaser, and that the person is not undertaking to provide impartial investment advice.'' Definition of the Term ''Fiduciary,'' 75 FR 65263, 65267 (Oct. 22, 2010).

[199] *See* Letter from Phyllis C. Borzi, Assistant Secretary, Employee Benefits Security Administration, Department of Labor, to Gary Gensler, Chairman, CFTC (Apr. 28, 2011) (''In [the Department of Labor's] view, a swap dealer or major swap participant that is acting as a plan's counterparty in an arm's length bilateral transaction with a plan represented by a knowledgeable independent fiduciary would not fail to meet the terms of the counterparty exception solely because it complied with the business conduct standards set forth in the CFTC's proposed regulation.''), *http://comments.cftc.gov/PublicComments/CommentList.aspx?id=935.*

[200] *See* Section II.C.4, *infra* (discussing the interaction of the ''best interests'' and ''suitability'' standards).

special entity, as well as future funding needs; the tax status of the special entity; the investment or financing objectives of the special entity; the experience of the special entity with respect to entering into security-based swaps, generally, and security-based swaps of the type and complexity being recommended; whether the special entity has the financial capability to withstand changes in market conditions during the term of the security-based swap; and such other information as is relevant to the particular facts and circumstances of the special entity, market conditions and the type of security-based swap or trading strategy involving a security-based swap being recommended.

Proposed Rule 15Fh–2(a) would generally define ''act as an advisor'' in the context of an SBS Dealer to mean recommending a security-based swap or a trading strategy involving a security-based swap to a special entity.[201] For these purposes, ''recommending'' would have the same meaning as that discussed above in connection with proposed Rule 15Fh–3(f). An SBS Dealer would not be deemed an ''advisor'' to a special entity with a duty under Section 15F(h)(4) and proposed Rule 15Fh–4(b) to act in the ''best interests'' of the special entity if it did not make a ''recommendation'' to a special entity. Commenters have advised us that, in order to avoid making a ''recommendation'' and unintentionally becoming an ''advisor'' to a special entity SBS Dealers may simply refrain from interacting with special entities—particularly to the extent that they perceive any uncertainty in the determination of whether a particular communication would constitute a ''recommendation.'' [202]

It is important to note that the duties imposed on an SBS Dealer that is ''acting as an advisor''—as well as the definition of that phrase in proposed Rule 15Fh–2(a)—are specific to this advisory context, and are in addition to any duties that may be imposed under other applicable law. Among other things, an SBS Dealer that acts as an advisor to a special entity may fall within the definition of ''investment adviser'' under Section 202(a)(11) of the Advisers Act unless it can rely on the exclusion provided by Section 202(a)(11)(C) for a broker-dealer whose advice is ''solely incidental'' to the conduct of its business as a broker dealer and who receives no special compensation therefor, or other applicable exclusion.[203] An SBS Dealer that acts as an advisor to a municipal entity may also be a ''municipal advisor'' under Section 15B(e) of the Exchange Act.[204]

Commenters have suggested that the standard established by Section 15F(h)(4) for an SBS Dealer acting as an advisor to a special entity could ''have the effect of chilling a critical element of the customary commercial interactions'' with special entities, absent some greater legal certainty about when an SBS Dealer would, in fact, be deemed to be ''acting as advisor'' to a special entity.[205] Accordingly, proposed Rule 15Fh–2(a) would provide this legal certainty by permitting an SBS Dealer to establish that it is not acting as an advisor where certain conditions are met. Under the proposed rule, the special entity must represent, in writing, that it will not rely on recommendations provided by the SBS Dealer and that it instead will rely on advice from a ''qualified independent representative,'' as defined in proposed Rule 15Fh–5(a) and discussed more fully below in Section II.D.4.c. In addition, the SBS Dealer must disclose to the special entity that by obtaining the special entity's written representation as described above, the SBS Dealer is not undertaking to act in the best interests of the special entity, as would otherwise be required under Section 15F(h)(4).[206] Finally, the SBS Dealer must have a reasonable basis to conclude that the special entity has a qualified independent representative.[207]

The Commission believes that the SBS Dealer could form this reasonable basis through a variety of means, including relying on written representations from the special entity to the same extent as discussed below in connection with an SBS Dealer acting as a counterparty to a special entity.[208] Upon receiving such representations, the SBS Dealer would be entitled to rely on these representations without further inquiry, absent special circumstances described below.

To solicit input on when it would no longer be appropriate for an SBS Dealer to rely on such representations without further inquiry, the Commission is proposing for comment two alternative approaches. One approach would permit an SBS Dealer to rely on a representation from a special entity for purposes of Rule 15Fh–2(a) unless it knows that the representation is not accurate. The second would permit an SBS Dealer to rely on a representation unless the SBS Dealer has information that would cause a reasonable person to question the accuracy of the representation.

Under either approach, an SBS Dealer could not ignore information in its possession as a result of which the SBS Dealer would know that a representation is inaccurate. In addition, under the second approach, an SBS Dealer also could not ignore information that would cause a reasonable person to question the accuracy of a representation and, if the SBS Dealer had such information, it would need to make further reasonable inquiry to verify the accuracy of the representation.

While the Dodd-Frank Act does not preclude an SBS Dealer from acting as both advisor and counterparty, commenters have argued that it could be impracticable for an SBS Dealer that is acting as a counterparty to a special entity to meet the ''best interests'' standards that would be imposed by Section 15F(h)(4) if it were also acting as an advisor to the special entity.[209] We recognize the potential tension in the statute itself between the role of a party acting as a principal in a security-based swap transaction, and the obligation imposed by Section 15F(h)(4) for an advisor to determine that a transaction is in the ''best interests'' of the special entity. We are seeking comment on whether we should further clarify the obligations of an SBS Dealer that is seeking to act both as an advisor and a counterparty to a special entity. We also are seeking comment on the need to define ''best interests'' in this context. Finally, as noted above, we understand that there are concerns arising from the potential interaction between the requirements of the Dodd-Frank Act

[201] *See* Section II.C.4 regarding what would or would not generally be considered a recommendation.

[202] *See, e.g.,* SIFMA 2011 Letter.

[203] *See* 15 U.S.C. 80b–2(a)(11).

[204] *See* Public Law 111–203, 124 Stat. 1376, 1921–1922 (to be codified at 15 U.S.C. 78o–4).

[205] SIFMA/ISDA 2011 Letter at 33.

[206] Proposed Rule 15Fh–2(a).

[207] As noted above, an SBS Dealer in these circumstances must separately determine whether it is subject to regulation as an investment adviser, a municipal advisor or other regulated entity.

[208] *See* Section II.D.4.c, *infra.*

[209] *See* SIFMA/ISDA 2010 Letter at 8:

Dealers will almost certainly refuse to engage in any swap activity in which they could potentially be deemed an ''advisor.'' The actions that a Dealer acting as an ''advisor'' would be required to take pursuant to Dodd-Frank are the very actions that could lead the Dealer to be deemed a fiduciary under ERISA. The penalties that would result were the Dealer deemed a fiduciary under ERISA are draconian, including that a swap between the Dealer and the plan would be deemed a prohibited transaction in violation of ERISA and would be subject to rescission and an excise tax equal to 15% of the amount involved in the transaction for each year or part of a year that the transaction remains uncorrected (which, if not corrected upon notice, could escalate up to a 100% excise tax).

(and our rules thereunder) and the requirements of other applicable law, including ERISA.

Request for Comments

The Commission requests comments generally on all aspects of proposed Rules 15Fh–2(a) and 15Fh–4(b). In addition, we request comments on the following specific issues:

- Is the proposed definition of the term ''acts as an advisor'' appropriate? Why or why not? What, if any, material inconsistencies would the proposed definition create with respect to any other applicable laws? What specific practical effects, advantages or disadvantages may arise in connection with the proposed definition? How, if at all, should any definition or interpretation of ''recommendation'' in this context diverge from the meaning of the term for purposes of the suitability obligation under Proposed Rule 15Fh–3(f)?
- Should the Commission instead define ''advisor'' to mean ''any person who, for compensation, engages in the business of advising special entities, as to the value of security-based swaps or as to the advisability of security-based swaps or trading strategies involving security-based swaps,'' consistent with the definition of an investment adviser? [210] Why or why not?
- Should the Commission instead define ''act as an advisor'' as ''providing advice to or on behalf of a special entity with respect to a security-based swap or trading strategy involving a security-based swap,'' consistent with the definition of a municipal advisor? [211] Why or why not? What other definitions should be considered by the Commission and why?
- When, if at all, could an SBS Dealer, in fact, act as both an advisor and counterparty to a special entity in a securities-based swap transaction, consistent with the ''best interests'' requirements of Section 15F(h)(4) and proposed Rule 15Fh–4(b)? [212] In what way could disclosure help to address concerns about the potentially conflicting roles of an SBS Dealer in these circumstances? Should the Commission, for example, clarify that it would not be inconsistent with an SBS Dealer's duty to act in the best interests of the special entity if the SBS Dealer, as principal, were to earn a reasonable profit or fee from the transaction it enters into with the special entity?
- Should the Commission instead prohibit an SBS Dealer from acting as both an advisor and counterparty to a special entity? [213] Why or why not?
- Should the Commission define ''acts as an advisor'' to require an understanding among the parties that the SBS Dealer is undertaking to act as an advisor to the special entity? Why or why not? If such a definition should be contemplated, in what circumstances, if any, should such an understanding not be permitted? Should a written agreement be required to establish that the SBS Dealer is undertaking to ''act as an advisor''?
- How would the proposed rules with respect to acting as an advisor change current practice regarding recommending and entering into security-based swaps with special entities?
- Should the Commission impose specific requirements with respect to the level of detail that should be required for written representations? If so, what requirements and why?
- What are the advantages and disadvantages of the two alternative proposed approaches regarding when it would no longer be appropriate to rely on written representations? Which alternative would strike the best balance among the potential disadvantages to market participants, the regulatory interest in appropriate rules for advisory relationships, and the sound functioning of the security-based swap market? What, if any, other alternatives should the Commission consider (*e.g.,* a recklessness standard) and why?
- In light of the additional protections that are afforded special entities under the Dodd-Frank Act, as described in Section I.C.5 above, should an SBS Dealer be required to undertake diligence or further inquiry before it can rely on any representation from a special entity for purposes of Rules 15Fh–2(a) and 15Fh–4(b)? Why or why not? If such diligence or inquiry is not required, should an SBS Dealer be permitted to rely on representations from the special entity only where the SBS Dealer does not have information that would cause a reasonable person to question the accuracy of the representation? Why or why not? Would requiring such diligence or further inquiry—or allowing reliance on representations only in such a manner—unnecessarily limit the willingness or ability of SBS Dealers to provide special entities with the access to security-based swaps for the purposes described in Section I.C.5 above? Why or why not? What, if any, other measures should be required in connection with an SBS Dealer's satisfaction of the requirements of these rules?
- Are there particular circumstances under which an SBS Dealer should be required to obtain information or undertake further review or inquiry about a special entity's independent representative or other facts in addition to obtaining written representations from the special entity as described above? Are there particular categories of special entities for which an SBS Dealer should be required to undertake further review or inquiry? Which categories, and why? What review or inquiry should be required, and in what circumstances?
- Are there other potential reasonable methods of establishing the relationship between a special entity and an SBS Dealer, and if so, what guidance should the Commission consider providing with respect to such methods?

5. Counterparty to Special Entities: Proposed Rule 15Fh–5

Under Exchange Act Section 15F(h)(5)(A), any SBS Entity that offers to enter into or enters into a security-based swap with a special entity must comply with any duty established by the Commission requiring that SBS Entity to have a ''reasonable basis'' for believing that the special entity has an ''independent representative'' that meets certain requirements, including that it undertakes a duty to act in the best interests of the counterparty it represents. Proposed Rules 15Fh–2(c) and 15Fh–5(a) would implement this provision. In particular, proposed Rule 15Fh–2(c) would define an ''independent representative,'' and proposed Rule 15Fh–5(a) would require an SBS Entity to have a reasonable basis to believe that this independent representative is qualified to represent the special entity by virtue of satisfying certain specified requirements.

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[210] *See* Advisers Act Section 202(a)(11) (definition of ''investment adviser'').

[211] *See* Exchange Act Section 15B(e)(4), Public Law 111–203, 124 Stat. 1376, 1921–1922 (to be codified at 15 U.S.C. 78o–4(e)(4)); *see generally* Registration of Municipal Advisors, Exchange Act Release No. 63579 (Dec. 20, 2011), 76 FR 824 (Jan. 6, 2011).

[212] Commenting on a parallel provision in the Commodity Exchange Act, Senator Lincoln stated that:

[N]othing in [Commodity Exchange Act Section 4s(h)] prohibits a swap dealer from entering into transactions with Special Entities. Indeed, we believe it will be quite common that swap dealers will both provide advice and offer to enter into or enter into a swap with a special entity. However, unlike the status quo, in this case, the swap dealer would be subject to both the acting as advisor and business conduct requirements under subsections (h)(4) and (h)(5).

156 Cong. Rec. S5923 (daily ed. Jul. 15, 2010) (statement of Sen. Lincoln).

[213] Recently approved amendments to MSRB Rule G–23 would prohibit dealer-financial advisers from switching roles and becoming underwriters in the same municipal securities transactions. *See also* MSRB Notice 2011–29 (May 31, 2011) (discussing rule amendment and interpretive notice).

Request for Comments

The Commission requests comments generally on all aspects of proposed Rule 15Fh–5. In addition, we request comments on the following specific issues:

- Is it sufficiently clear what is meant by ''offers to enter into'' a security-based swap? If not, how should the Commission clarify the requirement?
- Should the proposed rule apply to all transactions with all special entities? Why or why not? Which, if any, transactions or special entities should be excluded from the scope of the proposed rule, and why?

a. Scope of Qualified Independent Representative Requirement

We are proposing to apply the qualified independent representative requirements to Major SBS Participants as well as to SBS Dealers because, although Section 15F(h)(2)(B) addresses only the requirement for SBS Dealers to comply with the requirements of Section 15F(h)(5), the specific requirements under Section 15F(h)(5)(A) apply by their terms to both SBS Dealers and Major SBS Participants that offer to or enter into a security-based swap with a special entity.

We are further proposing to apply the qualified independent representative requirement under Section 15F(h)(5) to security-based swap transactions with all special entities. There is a statutory ambiguity concerning the scope of this requirement. Section 15F(h)(5)(A) provides broadly that ''[a]ny security-based swap dealer or major security-based swap participant that offers to [enter into] or enters into a security-based swap with a special entity shall'' comply with certain requirements. These requirements are defined in Section 15F(h)(5)(A)(i) to include ''any duty established by the Commission * * * with respect to a counterparty that is an eligible contract participant within the meaning of subclause (I) or (II) of clause (vii) of section 1a(18) of the Commodity Exchange Act [*i.e.,* governmental or multinational or supranational entities].'' We are proposing standards that would apply whenever an SBS Entity is acting as counterparty to *any* special entity as defined in Section 15F(h)(1)(C), including a special entity that is an ECP within the meaning of subclause (I) or (II) of clause (vii) of Commodity Exchange Act Section 1a(18). The proposed rule would be consistent with categories of special entities mentioned in the legislative history.[214] It also would give meaning to the requirement of Section 15F(h)(5)(A)(i)(VII) concerning ''employee benefit plans subject to ERISA,'' that are not ECPs within the meaning of subclause (I) or (II) of clause (vii) of section 1a(18) of the Commodity Exchange Act but are included in the category of retirement plans identified in the definition of special entity.[215]

Request for Comments

The Commission requests comments generally on all aspects of this provision. In addition, we request comments on the following specific issues:

- Should proposed Rule 15Fh–5 apply to both SBS Dealers and Major SBS Participants? Why or why not?

b. Independent Representative—Proposed Rule 15Fh–2(c)

Proposed Rule 15Fh–5(a) would require that the SBS Entity have a reasonable basis to believe that a special entity has as qualified ''independent representative.'' Under proposed Rule 15Fh–2(c)(1), a representative of a special entity must be independent of the SBS Entity that is the counterparty to a proposed security-based swap. Proposed Rule 15Fh–2(c)(2) would provide that a representative of a special entity is ''independent'' of an SBS Entity if the representative does not have a relationship with the SBS Entity, whether compensatory or otherwise, that reasonably could affect the independent judgment or decision-making of the representative. This standard is similar to the ''no material relationship'' standard that is used or proposed in other contexts.[216] We preliminarily believe it would be an appropriate standard here because the SBS Entity would possess the necessary facts to determine if, in fact, there exists a relationship with the independent representative that would be likely to impair the independence of the independent representative in making decisions that may affect the SBS Entity.

Proposed Rule 15Fh–2(c)(3) would provide that a representative of a special entity will be deemed to be independent of an SBS Entity if two conditions are satisfied. First, the representative is not and, within one year, was not an associated person of the SBS Entity and second, the representative has not received more than ten percent of its gross revenues over the past year, directly or indirectly, from the SBS Entity. This latter restriction would apply, for example, with respect to revenues received as a result of referrals by the SBS Entity, and so is intended to address the situation in which a representative is hired by the special entity as a result of a recommendation by the SBS Entity. This restriction would apply as well to revenues received, directly or indirectly, from associated persons of the SBS Entity.

For the SBS Entity to form a reasonable basis to believe the percentage of the independent representative's gross revenues that is received directly or indirectly from the SBS Entity, the SBS Entity would likely need to obtain information regarding the independent representative's gross revenues from either the special entity or the independent representative. The Commission believes that an SBS Entity could use a variety of methods to gather this information. The SBS Entity may request the financial statements of the independent representative for the relevant periods. Another way to obtain this information would be to obtain written representations from the special entity or independent representative regarding the revenues received, directly or indirectly from the SBS Entity and that such revenues were less than ten percent of the independent representative's gross revenues. Upon receiving such representations, the SBS

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[214] *See* H.R. Conf. Rep. 111–517 (June 29, 2010) (''When *acting as counterparties to a pension fund, endowment fund, or state or local government,* dealers are to have a reasonable basis to believe that the fund or governmental entity has an independent representative advising them.'') (emphasis added).

[215] *See* Section 15F(h)(1)(C)(iii) of the Exchange Act, Pub. L. 111–203, 124 Stat. 1376, 1789 (to be codified at 15 U.S.C. 78o–10(h)(1)(C)(iii)).

[216] Proposed Rules 15Fh–2(c)(1) and (2). This proposed alternative standard of independence would be consistent with the standard for existing and currently proposed director independence in other contexts. *See* Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps under Regulation MC, Exchange Act Release No. 63107 (Oct. 14, 2010), 75 FR 65882, 65897 (Oct. 26, 2010) (proposed Rule 700(l)); Security-Based Swap Data Repository Registration, Duties, and Core Principles, Exchange Act Release No. 63347 (Nov. 19, 2010), 75 FR 77306, 77322 (Dec. 10, 2010); MSRB, Notice of Filing of Amendment No. 1 to and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment No. 1, to Amend Rule A–3, on Membership on the Board, to Comply with the Dodd-Frank Wall Street Reform and Consumer Protection Act, Exchange Act Release No. 63025 (Sep. 30, 2010), 75 FR 61806, 61808 (Oct. 6, 2010). It also would be consistent with the NYSE standard for director independence and how public companies have addressed this standard in their policies to determine director independence. *See* NYSE Rule 303A.02(A) (''No director qualifies as 'independent' unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company) .

Entity would be entitled to rely on them without further inquiry, absent special circumstances described below.

To solicit input on when it would no longer be appropriate for an SBS Entity to rely on such representations without further inquiry, the Commission is proposing for comment two alternative approaches. One approach would permit an SBS Entity to rely on a representation from a special entity for purposes of Rule 15Fh–2(c) unless it knows that the representation is not accurate. The second would permit an SBS Entity to rely on a representation unless the SBS Entity has information that would cause a reasonable person to question the accuracy of the representation.

Under either approach, an SBS Entity could not ignore information in its possession as a result of which the SBS Entity would know that a representation is inaccurate. In addition, under the second approach, an SBS Entity also could not ignore information that would cause a reasonable person to question the accuracy of a representation and, if the SBS Entity had such information, it would need to make further reasonable inquiry to verify the accuracy of the representation.

An SBS Entity may obtain information from the independent representative as part of its efforts to form a reasonable basis for its determination that it is independent of the independent representative. In order for the basis for its determination to be reasonable, however, the SBS Entity could not ignore information it possesses concerning whether the independent representative is or has been, an associated person of the SBS Entity, for example, if it were seeking to rely on the objective standard of proposed Rule 15Fh–2(c)(1), or whether there exists any other relationship with the SBS Entity that reasonably could affect the independent judgment or decision-making of the independent representative for purposes of proposed Rule 15Fh–2(c)(2).

A number of special entities have requested that the Commission confirm that the representative is only required to be independent of the SBS Entity and not independent of the special entity itself.[217] We preliminarily believe that Section 15F(h)(5)(A)(i)(III) requires only that the independent representative be independent of the SBS Entity. The Dodd-Frank Act is silent concerning the question of independence from the special entity, and nothing in the legislative history suggests that the Commission should preclude the use of a qualified independent representative that is affiliated with the special entity.[218]

Request for Comments

The Commission requests comments generally on all aspects of this provision. In addition, we request comments on the following specific issues:

- Should the Commission adopt a different definition of ''independent representative of a special entity'' in proposed Rule 15Fh–2(c), and if so, why? Are there other standards of independence that we should consider, such as standards that would be relevant to determining the independence of a fiduciary for ERISA purposes? Which standards and why? How should such standards be modified to address the particular concerns of Section 15F(h)(5)? Should the Commission require consideration of other or additional factors in determining the independence of the independent representative of a special entity? Which factors and why? Should such factors include consideration of relationships the independent representative may have with an SBS Entity on behalf of multiple special entities? Should the Commission also consider relationships the independent representative has entered into with an SBS Entity on behalf of a special entity outside of the security-based swap transaction context?
- Should the definition of ''independent representative of a special entity'' exclude certain categories of associated persons of the SBS Entity? Of the independent representative? Which ones and why?
- Should the gross revenues in the definition exclude the revenues of affiliates of the independent representative?
- Is ten percent of gross revenues an appropriate measure of independence? Should the percentage be increased or decreased, and why? Should the Commission adopt a standard that is consistent with that used by the Department of Labor, for example, under which the general standard of independence for fiduciaries in connection with prohibited transaction exemptions under ERISA is that no more than 1% of an independent fiduciary's annual income is derived from or attributable to the party in interest and its affiliates? [219] Should another financial or other quantifiable standard be used in lieu of gross revenues? Why or why not?
- Should the Commission consider a timeframe other than one year to determine whether a representative is independent of the SBS Entity? Should the timeframe be two years, consistent with the pay to play provisions of proposed Rule 15Fh–6? Should some other timeframe be used? If so, what timeframe and why?
- Should the Commission consider a different approach to independence based on, for example, audit committee independence standards under Section 10A(m)(3) [220] and Rule 10A–3(b),[221] or the concept of an ''interested person'' under Section 2(a)(1) of the Investment Company Act of 1940? [222] Why or why not? Should we consider other approaches? If so, which approaches and why?
- Should the Commission permit an independent representative that receives compensation from the proceeds of a security-based swap so long as the compensation is authorized by, and paid at the written direction of, the special entity? Why or why not?
- Should the Commission adopt a different definition of ''independent representative of a special entity'' for different types of special entities? For example, are there certain types of special entities, *e.g.,* a State, State agency, city, county, municipality, or

[217] Letter from Lynn D. Dudley, Senior Vice President, Policy, American Benefits Council, to Elizabeth M. Murphy, Secretary, Commission and David A. Stawick, Secretary, CFTC (Sept. 8, 2010) (''American Benefits Council Letter'') at 6.

[218] *See also* 156 Cong. Rec. S5903 (daily ed. Jul. 15, 2010) (statements of Sens. Lincoln and Harkin):

Mrs. LINCOLN. Our intention in imposing the independent representative requirement was to ensure that there was always someone independent of the swap dealer or the security-based swap dealer reviewing and approving swap or security-based swap transactions. However, we did not intend to require that the special entity hire an investment manager independent of the special entity. Is that your understanding, Senator Harkin?

Mr. HARKIN. Yes, that is correct. We certainly understand that many special entities have internal managers that may meet the independent representative requirement. For example, many public electric and gas systems have employees whose job is to handle the day-to-day hedging operations of the system, and we intended to allow them to continue to rely on those in-house managers to evaluate and approve swap and security-based swap transactions, provided that the manager remained independent of the swap dealer or the security-based swap dealer and meet the other conditions of the provision. Similarly, the named fiduciary or in-house asset manager (''INHAM'') for a pension plan may continue to approve swap and security-based swap transactions.

[219] *See* Exemption Procedures under Federal Pension Law, *http://www.dol.gov/ebsa/publications/exemption_procedures.html* (''While in certain cases the department has permitted an independent fiduciary to receive as much as 5% of its annual income from the party in interest and its affiliates, these cases have involved unusual circumstances, and the general standard of independence remains a 1% test.'').

[220] 15 U.S.C. 78j–1(m)(3).

[221] 17 CFR 240.10A–3(b).

[222] 15 U.S.C. 80a–2(a)(19).

other political subdivision of a State, or a governmental plan as defined in Section 3 of ERISA, for which the Commission should define independence to require that the independent representative is not and has not been an associated person of the SBS Entity within the last two years and has not received any of its gross revenues, directly or indirectly from the SBS Entity or an associated person of the SBS Entity within the last two years? [223] What if the time period outlined in the prior sentence was limited to one year? Should this stricter standard apply only with respect to special entities defined in clause (ii)? Are there any other classes of special entities to which this stricter standard should apply?

• Are there other standards of independence that would be more appropriate for independent representatives for special entities defined in clauses (ii) and (iv) of Section 15F(h)(2)(C) of the Exchange Act? Which standards and why?

• Are there certain types of relationships that, so long as they have been fully disclosed to the special entity and the special entity has consented to any conflicts of interest related thereto, should not be deemed to affect the independence of the representative? What types of relationships, and why? Are there some conflicts that are so significant that a special entity should not be able to consent to them? If so, what types of conflicts, and why?

• Is the interpretation of Section 15F(h)(5)(A)(i)(III) appropriate? Can and should independent representatives be required to be independent of the special entity entering into the security-based swap as well as independent of the SBS Entity? Why or why not? If an SBS Entity is relying on written representations from a special entity that is represented by an internal ''independent representative,'' should the SBS Entity be required to also obtain such representations from someone other than the independent representative?

• How, if at all, should the recommendation by an SBS Entity of a particular independent representative or group of independent representatives be deemed to affect the independent judgment or decision-making of the representative? Please explain. If such a recommendation could be deemed to affect the independence of a special entity, are there appropriate safeguards that should be required if an SBS Entity maintains a ''preferred list'' of independent representatives? What safeguards, and why?

c. Reasonable Basis To Believe the Qualifications of the Independent Representative

As noted above, proposed Rule 15Fh–5 would require the SBS Entity to reasonably determine that a special entity's independent representative is a ''qualified independent representative.'' The requirements for being a ''qualified independent representative'' are drawn primarily from the statute and are described in the following sections. The Commission believes that an SBS Entity could use a variety of methods to establish a ''reasonable basis'' to believe that a special entity's ''independent representative'' is ''qualified'' for purposes of proposed Rule 15Fh–5.[224]

We preliminarily believe that, except as specifically noted below, an SBS Entity could rely on written representations regarding the various qualifications of the independent representative to form a reasonable basis to believe that the independent representative is ''qualified''.[225] Upon receiving such representations, the SBS Entity would be entitled to rely on them without further inquiry, absent special circumstances described below.

To solicit input on when it would no longer be appropriate for an SBS Entity to rely on such representations without further inquiry, the Commission is proposing for comment two alternative approaches. One approach would permit an SBS Entity to rely on a representation from a special entity for purposes of Rule 15Fh–5 unless it knows that the representation is not accurate. The second would permit an SBS Entity to rely on a representation unless the SBS Entity has information that would cause a reasonable person to question the accuracy of the representation.

Under either approach, an SBS Entity could not ignore information in its possession as a result of which the SBS Entity would know that a representation is inaccurate. In addition, under the second approach, an SBS Entity also could not ignore information that would cause a reasonable person to question the accuracy of a representation and, if the SBS Entity had such information, it would need to make further reasonable inquiry to verify the accuracy of the representation.

Request for Comments

The Commission requests comments generally on all aspects of this provision. In addition, we request comments on the following specific issues:

• Commenters have suggested that an independent representative should be deemed ''qualified'' if it is ''a sophisticated, professional adviser such as a bank, Commission-registered investment adviser, insurance company or other qualifying [Qualified Professional Asset Manager (''QPAM'')] or INHAM for Special Entities subject to ERISA, a registered municipal advisor, or a similar qualified professional''.[226] Should the Commission permit this presumption? If so, the Commission asks commenters to address specifically how regulated status would inform the determination as to whether an independent representative satisfies the qualification requirements of Section 15F(h)(5) and proposed Rule 15Fh–5. If the Commission were to adopt a presumption, should it apply equally for all regulated persons? Should the

[223] *See* Exchange Act Sections 15F(h)(2)(C)(ii) (defining ''special entity'' to include ''a State, State agency, city, county, municipality, or other political subdivision of a State'') and 15F(h)(2)(C)(iv) (a governmental plan as defined in Section 3 of ERISA), Pub. L. 111–203, 124 Stat. 1376, 1789.

[224] The SBS Entity may also be provided a copy of the representations that the independent representative provides to the special entity regarding its qualifications. In the absence of language precluding the SBS Entity from relying on the representations, the Commission preliminarily believes that the SBS Entity could rely on the representations to form a reasonable basis for its determinations to the same extent it could if the special entity had provided the representations to the SBS Entity. Furthermore, we do not believe that such reliance would constitute a ''material business relationship'' between the SBS Entity and independent representative.

[225] In particular, absent the special circumstances described above, an SBS Entity would be permitted to rely on a representation that stated the independent representative:

(1) Had sufficient knowledge to evaluate the transaction and risks;

(2) Would undertake a duty to act in the best interests of the special entity;

(3) Would make appropriate and timely disclosures to the special entity of material information concerning the security-based swap;

(4) Would provide written representations to the special entity regarding fair pricing and the appropriateness of the security-based swap; and

(5) In the case of employee benefit plans subject to the Employee Retirement Income Security Act of 1974, was a fiduciary as defined in section 3(21) of that Act (29 U.S.C. 1002(21)); and

(6) In the case of a special entity defined in §§ 240.15Fh–2(e)(2) or (4), was a person that is subject to rules of the Commission, the CFTC or a self-regulatory organization subject to the jurisdiction of the Commission or the CFTC prohibiting it from engaging in specified activities if certain political contributions have been made.

It would not be appropriate, however, for an SBS Entity to rely on a general representation that merely states that the counterparty has a ''qualified independent representative'' for purposes of proposed Rule 15Fh–5.

The SBS Entity could also obtain a representation that that the independent representative was not subject to a statutory disqualification. However, as discussed below, the SBS Entity would also be expected to search publicly available databases such as BrokerCheck.

[226] SIFMA/ISDA 2011 Letter.

presumption instead be limited to certain types of regulated persons, ERISA fiduciaries, for example? Why, or why not? If the Commission does not permit the presumption, how, if at all, should the status of an independent representative be taken into account for purposes of determining whether the requirements of the proposed rule are satisfied? [227]

• Are there other approaches that the Commission should consider in permitting an SBS Entity to rely on a special entity's written representation that it has a ''qualified independent representative''? If so, what alternative approaches, if any, would be feasible in terms of market practice and the advantages and disadvantages for SBS Entities and special entities?

• Should the Commission require that the SBS Entity obtain written representations regarding the qualifications of the independent representative directly from the independent representative? From both the independent representative and the special entity? Why or why not?

• Should the Commission allow an SBS Entity to rely on written representations the independent representative provides to the special entity? What constraints, if any, should be placed on such reliance? For example, should an explicit statement regarding the SBS Entity's use of the representations be required to be included in the documentation of the security-based swap? What are the respective advantages and disadvantages of the proposed approaches to guidance on when it would not be appropriate to rely on a special entity's written representations? Which alternative would strike the best balance among the potential disadvantages to market participants, the regulatory interest in appropriate independent representation for special entities, and the sound functioning of the security-based swap market? What, if any, other alternatives should the Commission consider and why?

• Should an SBS Entity be required to undertake further review or inquiry for particular categories of special entities? If so, what review or inquiry should be required in what circumstances?

• In light of the additional protections that are afforded special entities under the Dodd-Frank Act described in Section I.C.5 above, should an SBS Entity be required to undertake diligence or further inquiry before it can rely on any representation from a special entity concerning the qualifications of its representative? Why or why not? If such diligence or inquiry is not required, should an SBS Entity be permitted to rely on representations from the special entity only where the SBS Entity does not have information that would cause a reasonable person to question the accuracy of the representation? Why or why not? Would requiring such diligence or further inquiry—or allowing reliance on representations only in such a manner—unnecessarily limit the willingness or ability of SBS Entities to provide special entities with the access to security-based swaps for the purposes described in Section I.C.5 above? Why or why not? What, if any, other measures should be required in connection with an SBS Entity's satisfaction of the requirements of proposed Rule 15Fh–5?

• Are there other potential reasonable means of establishing that a special entity's independent representative has the requisite qualifications, other than written representations, for which the Commission should consider providing guidance? If so, what means should such guidance address and how?

i. Qualified Independent Representative—Sufficient Knowledge To Evaluate Transaction and Risks

Proposed Rule 15Fh–5(a)(1) would require that the SBS Entity have a reasonable basis to believe that the independent representative has sufficient knowledge to evaluate the transaction and risks.[228] Industry groups have recognized that intermediaries should assess the sophistication of a counterparty—or its agent—including the counterparty's capability to understand the risk and return characteristics of the instrument.[229] The independent representative will play an important role in assessing and advising the special entity in this regard.[230]

Request for Comments

The Commission requests comments generally on all aspects of this provision. In addition, we request comments on the following specific issues:

• Should the Commission require the SBS Entity to reevaluate (or, as applicable require a new written representation regarding) the qualifications of the independent representative periodically? If so, how often? Should such reevaluation be required for specific types of security-based swaps or in certain circumstances? If so, with respect to which types and in what circumstances?

• Should the Commission specify particular facts or circumstances that might give rise to a requirement for further review or inquiry on the part of an SBS Entity, notwithstanding any representations from the counterparty? Why or why not? What facts or circumstances should be considered, if any?

• Should the Commission consider the development of a proficiency examination for independent representatives? [231] Should such testing requirement be mandatory? Should it apply to both in-house and third-party independent representatives? Why or why not?

• Should the Commission require that independent representatives be registered with the Commission as municipal advisors or investment advisers, or otherwise subject to regulation, such as banking regulation, for example?

ii. Qualified Independent Representative—No Statutory Disqualification

Proposed Rule 15Fh–5(a)(2) would require that the SBS Entity have a reasonable basis to believe that the independent representative is not subject to a statutory disqualification.[232] Although Exchange Act Section 15F(h) does not define ''subject to a statutory disqualification,'' the term has an established meaning under Section

[227] *See, e.g.,* Section II.D.4.c.iii (seeking comment on, among other things, whether an ERISA plan fiduciary should be deemed to act in the best interests of the special entity that is an employee benefit plan that is subject to regulation under ERISA).

[228] *See* Section 15F(h)(5)(A)(i)(I) of the Exchange Act, Public Law 111–203, 124 Stat. 1376, 1791 (to be codified at 15 U.S.C. 78o–10(h)(5)(A)(i)(I)). As noted above, an SBS Entity could rely on representations from the special entity to form this reasonable basis, as discussed in note 213 and related text.

[229] *See* CRMPG III Report at 57–59 (describing standards of sophistication for investors of high-risk complex financial instruments).

[230] *See* note 225, *supra,* and related text regarding an SBS Entity's reliance on a representation from the special entity to form this reasonable basis.

[231] *See* Letter from Joseph A. Dear, Chief Investment Officer, California Public Employees' Retirement System *et al.,* to David A. Stawick, Secretary, CFTC (Feb. 18, 2011) (suggesting that the CFTC consider an approach that would involve passage of a proficiency examination by the independent representative); Letter from Peter A. Shapiro, Managing Director, Swap Financial Group to David A. Stawick, Secretary, CFTC (Feb. 22, 2011); Letter from Frank Iacono, Partner, Riverside Risk Advisors LLC to David A. Stawick, Secretary, CFTC (Feb. 22, 2011). Comments submitted to the CFTC are available at *http://comments.cftc.gov/PublicComments/CommentList.aspx?id=935t.*

[232] *See* Section 15F(h)(5)(A)(i)(II) of the Exchange Act, Public Law 111–203, 124 Stat. 1376, 1791 (to be codified at 15 U.S.C. 78o–10(h)(5)(A)(i)(II)). As noted above, an SBS Entity could rely on representations from the special entity to form this reasonable basis, as discussed in note 213 and related text. See discussion above in Section II.B.

3(a)(39) of the Exchange Act,[233] which defines circumstances that would subject a person to a statutory disqualification with respect to membership or participation in, or association with a member of, an SRO. Although Section 3(a)(39) would not literally apply here, we are proposing to define ''subject to a statutory disqualification'' for purposes of proposed Rule 15Fh–5 by reference to Section 3(a)(39) of the Exchange Act.

Request for Comments

The Commission requests comments generally on all aspects of this provision. In addition, we request comments on the following specific issues:

- What, if any, other ''statutory disqualification'' models or definitions should the Commission consider, and why?
- Should the Commission specify particular facts or circumstances that require further review or inquiry on the part of an SBS Entity, notwithstanding written representations received?
- Should the Commission require an SBS Entity to check publicly available databases, such as FINRA's BrokerCheck and the Commission's Investment Adviser Public Disclosure program, to determine whether an independent representative is subject to a statutory disqualification? [234] Why or why not? If so, which databases should be required to be consulted? Should such databases include sources outside the Commission and self-regulatory organizations, such as databases maintained by other regulators or federal or state officials? Why or why not? If so, which outside databases should be required to be consulted? Should the Commission require an SBS Entity to conduct any other type of inquiry to determine whether an independent representative is subject to a statutory disqualification? Why or why not?

iii. Qualified Independent Representative—Acting in the Best Interests of the Special Entity

Proposed Rule 15Fh–5(a)(3) would require that the SBS Entity have a reasonable basis to believe that the independent representative ''undertakes a duty to act in the best interests'' of the special entity.[235] As discussed above, we are not proposing to define ''best interests.'' We also note that an independent representative may be subject to similar or additional obligations under other applicable law with respect to its activities on behalf of the special entity.[236]

Request for Comments

The Commission requests comments generally on all aspects of this provision. In addition, we request comments on the following specific issues:

- Should the independent representative be required to be subject to some form of regulation (*e.g.,* as an investment adviser or an ERISA plan fiduciary) under which the independent representative has a duty to act in the best interests of the special entity (or some similar requirement)?
- Should an in-house independent representative be deemed to act in the best interests of the special entity by virtue of its employment with the special entity? Why or why not?
- Should an ERISA plan fiduciary, as defined under Section 3(21) of ERISA, that meets the standards of ERISA be deemed to act in the best interests of a special entity that is an employee benefit plan subject to regulation under ERISA, for purposes of the proposed rule? Should a QPAM? [237] An INHAM? [238] Why or why not?

iv. Qualified Independent Representative—Appropriate Disclosures to Special Entity

Section 15F(h)(5)(A)(i)(V) requires that the SBS Entity comply with any rules promulgated by the Commission requiring the SBS Entity to have a reasonable basis to believe that the independent representative will make appropriate disclosures. The Dodd-Frank Act is silent concerning the content of these disclosures. Proposed Rule 15Fh–5(a)(4) would require that the SBS Entity have a reasonable basis to believe that the independent representative will make appropriate and timely disclosures to the special entity of material information regarding the security-based swap.[239]

Request for Comments

The Commission requests comments generally on all aspects of this provision. In addition, we request comments on the following specific issues:

- Should the Commission impose specific requirements with respect to this obligation, such as the content of the disclosures that should be made by the independent representative? If so, what requirements and why? Should the ''appropriate disclosures'' include disclosures regarding the qualifications of the independent representative, in addition to disclosures regarding the security-based swap? Why or why not? Should such disclosures address other subjects not directly related to the security-based swap? Which ones and why?
- If the SBS Entity is not relying on written representations, should the Commission allow a presumption that an in-house independent representative, by virtue of its employment with the special entity, will make appropriate disclosures of material information to the special entity? Why or why not?
- Should the Commission also require that the SBS Entity have a reasonable basis to believe that the independent representative will make appropriate and timely disclosures to the special entity of any potential conflicts of interest that the representative may have in connection with the security-based swap transaction? Why or why not? Would such disclosures be considered part of the ''best interests'' undertaking of an independent representative? Why or why not?

v. Qualified Independent Representative—Written Representations

Proposed Rule 15Fh–5(a)(5) would require that the SBS Entity have a reasonable basis to believe that the independent representative will provide written representations to the special entity regarding fair pricing and the appropriateness of the security-based

[233] 15 U.S.C. 78c(a)(39).

[234] *See, e.g., http://www.finra.org/Investors/ToolsCalculators/BrokerCheck/index.htm,* and *http://www.adviserinfo.sec.gov/(S(b3d5ktvihzlhai45hknxzk45))/IAPD/Content/Search/iapd_Search.aspx.*

[235] *See* Section 15F(h)(5)(A)(i)(IV) of the Exchange Act, Pub. L. 111–203, 124 Stat. 1376, 1791 (to be codified at 15 U.S.C. 78o–10(h)(5)(A)(i)(IV)). *See* note 225, *supra,* and related text regarding an SBS Entity's reliance on a representation from the special entity to form this reasonable basis.

[236] As noted above, depending on the circumstances, an independent representative may be an ''investment adviser'' within the meaning of Section 202(a)(11) of the Advisers Act, a ''municipal advisor'' within the meaning of Section 15B(e) of the Exchange Act, or a fiduciary for purposes of ERISA. A municipal advisor, for example, ''shall be deemed to have a fiduciary duty to any municipal entity for whom such municipal advisor acts as a municipal advisor.'' 15 U.S.C. 78o–4(c)(1).

[237] *See* Department of Labor Prohibited Transaction Exemption (''PTE'') 84–14, 70 FR 49305 (Aug. 23, 2005); Amendment to PTE 84–14 for Plan Asset Transactions Determined by Independent Qualified Professional Asset Managers, 75 FR 38837 (July 6, 2010).

[238] *See* Department of Labor PTE 96–23, 61 FR 15975 (Apr. 10, 1996); Proposed Amendment to PTE 96–23 for Plan Asset Transactions Determined by In-House Asset Managers, 75 FR 33642 (proposed June 14, 2010).

[239] *See* note 225, *supra,* and related text regarding an SBS Entity's reliance on a representation from the special entity to form this reasonable basis.

swap.[240] Commenters have suggested that a written representation ''should be sufficient if the representation states that the representative is obligated, by law and/or contract, to review pricing and appropriateness with respect to any swap transaction in which the representative serves as such with respect to the plan''.[241] We are not proposing a specific means by which this standard must be satisfied. We preliminarily believe, however, the approach described above would be reasonable. Another way for an SBS Entity to form a reasonable basis for its determination would be relying on a written representation that the independent representative will document the basis for its conclusion that the transaction was fairly priced and appropriate for the plan, and that the independent representative or the special entity will maintain that documentation in its records for an appropriate period of time, and make such records available to the plan upon request.

Request for Comments

The Commission requests comments generally on all aspects of this provision. In addition, we request comments on the following specific issues:

- Should the Commission impose specific requirements with respect to this obligation? If so, what requirements and why?

vi. Qualified Independent Representative—ERISA Fiduciary

Proposed Rule 15Fh–5(a)(6) would require an SBS Entity to have a reasonable basis to believe that the independent representative, in the case of a special entity that is an employee benefit plan subject to ERISA, is a ''fiduciary'' as defined in section 3(21) of that Act (29 U.S.C. 1002).[242] None of the requirements set forth in the proposed rule is intended to limit, restrict, or otherwise affect the fiduciary's duties and obligations under ERISA.[243]

Request for Comments

The Commission requests comments generally on all aspects of this provision. In addition, we request comments on the following specific issues:

- Should the Commission impose specific requirements with respect to this obligation? If so, what requirements and why?
- Should other independent representative qualifications under proposed Rule 15Fh–5(a)(1) be deemed satisfied if the independent representative in the case of employee benefit plans subject to ERISA, is a fiduciary as defined in section 3(21) of ERISA? If so, which requirements and why?

vii. Qualified Independent Representative—Subject to ''Pay To Play'' Prohibitions

We are proposing to include an additional requirement, not expressly addressed by the Dodd-Frank Act, that the SBS Entity have a reasonable basis for believing that the independent representative is subject to ''pay to play'' rules if the special entity is a State, State agency, city, county, municipality, or other political subdivision of a State, or a governmental plan, as defined in Section 3(32) of ERISA.[244] We believe that, unless exempted or excepted, an independent representative in these circumstances would likely be either a municipal advisor, or an investment adviser.[245] A registered municipal advisor would be subject to pay to play prohibitions under MSRB rules.[246] An investment adviser that is registered with the Commission would be subject to existing Commission rules regarding these practices.[247]

We do not, however, intend to prohibit other qualified persons from acting as independent representatives so long as those persons are similarly subject to pay to play restrictions. As discussed in Section II.D.5 below, pay to play practices may result in significant harm to these types of special entities in connection with security-based swap transactions.[248] The concern is heightened here because of the fiduciary role that Congress has envisaged for independent representatives to special entities. In the case of independent representatives, the concern would be that a person might make contributions in order to be chosen as an independent representative (and obtain the fees commensurate with that role), and then not act as an impartial advisor with respect to the transaction. The proposed rule is intended to deter SBS Entities from participating, even indirectly, in such practices. Accordingly, proposed Rule 15Fh–5(a)(7) would require an SBS Entity to have a reasonable basis for believing that the independent representative is a person that is subject to rules of the Commission, the CFTC or an SRO subject to the jurisdiction of the Commission or the CFTC prohibiting it from engaging in specified activities if certain political contributions have been made, unless the independent representative is an employee of the special entity.[249]

Request for Comments

The Commission requests comments generally on all aspects of this provision. In addition, we request comments on the following specific issues:

- Are there circumstances in which an independent representative that is advising a special entity that is a State, State agency, city, county, municipality, or other political subdivision of a State, or a governmental plan, as defined in Section 3(32) of ERISA, other than an employee of the special entity, would not be subject to pay to play restrictions?
- Should the Commission consider a different requirement, for example, that the independent representative be

[240] *See* Section 15F(h)(5)(A)(i)(VI) of the Exchange Act, Pub. L. 111–203, 124 Stat. 1376, 1791 (to be codified at 15 U.S.C. 78o–10(h)(5)(A)(i)(VI)). *See* note 225, *supra,* and related text regarding an SBS Entity's reliance on a representation from the special entity to form this reasonable basis.

[241] American Benefits Council Letter at 9.

[242] *See* Section 15F(h)(5)(A)(i)(VII) of the Exchange Act, Pub. L. 111–203, 124 Stat. 1376, 1791 (to be codified at 15 U.S.C. 78o–10(h)(5)(A)(i)(VII)). *See* note 225, *supra,* and related text regarding an SBS Entity's reliance on a representation from the special entity to form this reasonable basis.

[243] *See* notes 99, 198 and 189, *supra,* regarding the Department of Labor's proposal to amend definition of ''fiduciary'' for purposes of ERISA.

[244] *See* Exchange Act Section 15F(h)(1)(C), Public Law 111–203, 124 Stat. 1376, 1789 (to be codified at 15 U.S.C. 78o–10(h)(1)(C)) (authorizing the Commission to prescribe business conduct standards that relate to ''such other matters as the Commission determines to be appropriate''). For a discussion of abuses associated with pay to play practices, see Section II.D.5 below. *See* note 213 above and related text regarding an SBS Entity's reliance on a representation from the special entity to form this reasonable basis.

[245] *See* 15 U.S.C. 80b–2(a)(11) (defining ''investment adviser''), and 15 U.S.C. 78o–4(3) (defining ''municipal advisor''). Exchange Act Section 15B(4)(C) excludes from the definition of ''municipal advisor'' any investment adviser that is registered under the Advisers Act, and persons associated with the investment adviser who are providing investment advice.'' 15 U.S.C. 78o–4(4)(C).

[246] *See, e.g.* MSRB Notice 2011–04, Request for Comment on Pay to Play Rules for Municipal Advisors (Jan. 14, 2011) (requesting comment on a draft proposal to establish ''pay to play'' and related rules relating to municipal advisors and to make certain conforming changes to existing pay to play rules for brokers, dealers and municipal securities dealers).

[247] *See, e.g.,* 17 CFR 275.206(4)–5 (prohibiting certain political contributions by investment advisers providing or seeking to provide investment advisory services to public pension plans and other government investors).

[248] *See* note 32, *supra.*

[249] *See* Exchange Act Section 15B(e)(4), Public Law 111–203, 124 Stat. 1376, 1921–1922 (to be codified at 15 U.S.C 78o–4(e)(4)) (defining ''municipal advisor'' as a person ''other than a municipal entity or an employee of a municipal entity'' that engages in the specified activities).

subject to specific prohibitions, such as those described in Advisers Act Rule 206(4)–5 (prohibiting investment advisers that are registered, or required to be registered with the Commission, from providing or seeking to provide investment advisory services to public pension plans and other government investors when certain political contributions have been made)?

• Should the Commission require that the independent representative be a registered municipal advisor or Commission registered investment adviser?

d. Disclosure of Capacity

Proposed Rule 15Fh–5(b) would require that, before initiation of a security-based swap with a special entity, an SBS Dealer must disclose in writing the capacity or capacities in which it is acting.[250] An SBS Dealer that is acting as a counterparty but not an advisor to a special entity, for example, would need to make clear to the special entity the capacity in which it is acting (*i.e.,* that it is acting as a counterparty, but not as an advisor).

Commenters have noted that a firm may be acting in multiple capacities in relation to a special entity, for example, as underwriter in a bond offering as well as counterparty to a security-based swap used to hedge the financing transaction.[251] In these circumstances, the SBS Dealer's duty to the special entity could vary depending upon the capacity in which it is acting, and so it is important for a special entity and its independent representative to understand the roles in which the SBS Dealer is acting.[252] The proposed rule, therefore, would require an SBS Dealer that engages in business, or has engaged in business within the last twelve months, with the counterparty in more than one capacity to disclose the material differences between such capacities in connection with the security-based swap and any other financial transaction or service involving the counterparty.[253]

We are proposing to apply the requirement in proposed Rule 15Fh–5(b) to SBS Dealers but not Major SBS Participants because the statutory requirement, by its terms, requires disclosure in writing of ''the capacity in which the security-based swap dealer is acting.'' [254]

Request for Comments

The Commission requests comments generally on all aspects of this provision. In addition, we request comments on the following specific issues:

• Are there specific capacities in which an SBS Dealer may act that merit more detailed types of disclosures? If so, which capacities, and what types of disclosures should be required? Should the Commission define in further detail the specific categories of ''capacities'' in which SBS Dealers may act that would need to be disclosed under the proposed rule—*e.g.,* as advisor, counterparty, underwriter, etc? If so, which capacities should be identified and disclosed?

• Should the Commission require similar disclosures by Major SBS Participants? Why or why not?

• Are there certain capacities for which disclosures should not be required? If so, which capacities, and why?

• Should the required disclosure be limited to other ''capacities'' within a timeframe other than twelve months? If so, what would be the appropriate time frame? Why?

• Should there be a *de minimis* exclusion from the required disclosure? If so, what would be an appropriate threshold? Are there certain ''capacities'' that should be disclosed regardless of the dollar amount involved?

• We understand that some SBS Dealers may utilize a single relationship point of contact to manage the multiple capacities in which they may act with regard to a special entity. Does this relationship management model increase the likelihood that the special entity would be confused as to the standard of conduct with which each associated person is required to comply? Should the SBS Dealer be required to disclose the material differences in capacities that are managed separate and apart from this centralized relationship point? If an SBS Dealer has information barriers in place between certain associated persons or affiliates, should the SBS Dealer still be required to disclose to the special entity any material differences in the capacities in which these associated persons are acting? Would these types of information barriers impair the customer service that a special entity might otherwise receive?

• Are there any circumstances in which an affiliate of the SBS Dealer should be treated as an independent entity or third party, for the purposes of this disclosure rule?

6. Prohibition on Certain Political Contributions by SBS Dealers: Proposed Rule 15F–6

We are proposing a rule that would prohibit an SBS Dealer from engaging in security-based swap transactions with a ''municipal entity'' if certain political contributions have been made to officials of the municipal entity.[255] Pay to play occurs when persons seeking to do business with state and municipal governments make political contributions, or are solicited to make political contributions, to elected officials or candidates in order to influence the selection process.[256] In making such contributions, interested persons hope to benefit from officials who ''award the contracts on the basis of benefit to their campaign chests rather than to the governmental

[250] *See* Section 15F(h)(5)(A)(2)(i) of the Exchange Act, Pub. L. 111–203, 124 Stat. 1376, 1791 (to be codified at 15 U.S.C. 78o–10(h)(5)(A)(2)(i)).

[251] *See* Swap Financial Group Presentation at 55.

[252] In the case of special entities that are municipal entities, MSRB Rule G–23 generally prohibits dealer-financial advisors from acting in multiple capacities in the same municipal securities transactions. *See also* MSRB Notice 2011–29 (May 31, 2011) (discussing rule amendment and interpretive notice).

[253] *See* proposed Rule 15Fh–5(b).

[254] We making this statement because the introductory clause of Section 15F(h)(5) imposes disclosure obligations on both SBS Dealers and Major SBS Participants and thus could be read to impose the capacity disclosure obligation on all SBS Entities. *See* Section 15F(h)(5)(A)(2)(ii) of the Exchange Act, Public Law 111–203, 124 Stat. 1376, 1791 (to be codified at15 U.S.C. 78o–10(h)(5)(A)(2)(ii)). We also note that the obligation in the text of the statute does not require Commission rulemaking.

[255] *See* Section 15F(h)(1)(D) of the Exchange Act, Public Law 111–203, 124 Stat. 1376, 1789, 15 U.S.C. 78o–10(h)(1)(D) (authorizing the Commission to prescribe business conduct standards that relate to ''such other matters as the Commission determines to be appropriate'').

The proposed restrictions would apply to dealings with a ''municipal entity,'' which is defined in Exchange Act Section 15B(e)(8) (15 U.S.C. 78o–4(e)(8)) as: ''any State, political subdivision of a State, or municipal corporate instrumentality of a State, including—(A) any agency, authority, or instrumentality of the State, political subdivision, or municipal corporate instrumentality; (B) any plan, program, or pool of assets sponsored or established by the State, political subdivision, or municipal corporate instrumentality or any agency, authority, or instrumentality thereof; and (C) any other issuer of municipal securities.''

[256] *See, e.g., Blount* v. *SEC,* 61 F. 3d 938 (D.C. Cir. 1995), *cert. denied,* 116 S. Ct. 1351 (1996) (holding that ''underwriters' campaign contributions self-evidently create a conflict of interest in state and local officials who have power over municipal securities contracts and a risk that they will award the contracts on the basis of benefit to their campaign chests rather than to the governmental entity''); Testimony of Martha Mahan Haines before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, Subcommittee on Securities, Insurance, and Investment (May 21, 2009) (stating that pay to play practices may result in an unqualified financial advisor being chosen because of his political contributions). *See also* Political Contributions by Certain Investment Advisers, *supra,* note 32 at notes 18 through 25, citing examples of more recent Commission and criminal actions against investment advisers and other parties for violations involving pay to play arrangements.

entity.'' [257] Pay to play practices may take a variety of forms, including an SBS Dealer's direct contributions to government officials, an SBS Dealer's solicitation of third parties to make contributions or payments to government officials or political parties in the state or locality where the SBS Dealer seeks to provide services, or an SBS Dealer's payments to third parties to solicit (or as a condition of obtaining) security-based swap business.

In the context of security-based swaps, pay to play practices may result in municipal entities entering into transactions not because of hedging needs or other legitimate purposes, but rather because of campaign contributions given to an official with influence over the selection process. Where pay to play exists, SBS Dealers may compete for security-based swap business based on their ability and willingness to make political contributions, rather than on their merit or the merit of a proposed transaction. We believe these practices may result in significant harm to municipalities and others in connection with security-based swap transactions, just as they do in connection with other municipal securities transactions.[258]

By its nature, pay to play is covert because participants do not broadcast that contributions or payments are made or accepted for the purpose of influencing the selection of a financial services provider. As one court noted, ''[w]hile the risk of corruption is obvious and substantial, actors in this field are presumably shrewd enough to structure their relations rather indirectly.'' [259] Consequently, pay to play practices are often hard to prove because it is difficult to prove that contributions were made for the purpose of obtaining government business, and that those contributions then drove the selection of a particular entity.

Absent implementation of specific rules prohibiting pay to play practices, it is likely such practices would continue undeterred, given that such practices pose a ''collective action'' problem.[260] That is, government officials who engage in pay to play practices may have an incentive to continue accepting contributions to support their campaigns, for fear of being disadvantaged relative to their opponents. In addition, SBS Dealers may have an incentive to participate out of concern that they may be overlooked if they fail to make contributions. Both the stealthy nature of these practices and the inability of markets to properly address them strongly support the need for a prophylactic measure to address them, such as proposed Rule 15Fh–6.[261]

Proposed Rule 15Fh–6 is modeled on, and intended to complement, existing restrictions on pay to play practices under Advisers Act Rule 206(4)–5, which imposes pay to play restrictions on investment advisers providing or seeking to provide investment advisory services to public pension plans and other government investors,[262] and under MSRB Rules G–37 and G–38, which impose pay to play restrictions on municipal securities dealers and broker-dealers engaging or seeking to engage in the municipal securities business. The proposed rule would create a comparable regulatory framework, as there are no existing federal pay to play restrictions that would apply to all SBS Dealers in their dealings with municipal entities. The proposed rule is intended to deter SBS Dealers from engaging in pay to play practices.

The proposed rule itself does not attempt to stamp out corruption by public officials or to regulate local elections, nor is it a ban on political contributions. Rather, the proposed rule would bar SBS Dealers from entering into contracts after they make contributions, with the aim of eliminating motivation to engage in pay to play.

We have closely drawn proposed Rule 15Fh–6 to accomplish its goal of preventing *quid pro quo* arrangements while avoiding unnecessary burdens on the protected speech and associational rights of SBS Dealers and their covered employees.[263] The proposed rule would address only direct contributions to officials—it is not intended in any way to impinge on a wide range of expressive conduct in connection with elections. It would be triggered only when a business relationship exists or will be established in the near future. It would target those employees of SBS Dealers whose contributions raise the greatest danger of *quid pro quo* exchanges, and it would cover only contributions to those government officials who would be the most likely targets of a *quid pro quo* because of their authority to influence the award of government contracts. Finally, the proposed rule would not prevent anyone from making contributions at or below a specified *de minimis* level.

We are proposing to apply the requirements in proposed Rule 15Fh–6 to SBS Dealers but not to Major SBS Participants because we do not anticipate that Major SBS Participants would serve a dealer-type role in the market.[264]

a. Prohibitions

Proposed Rule 15Fh–6(b)(1) would generally make it unlawful for an SBS Dealer to offer to enter or to enter into a security-based swap with a municipal entity for a two-year period after the SBS Dealer or any of its covered associates makes a contribution to an official of the municipal entity.[265]

Proposed Rule 15Fh–6(b)(3)(i) would prohibit an SBS Dealer from paying a third party to solicit municipal entities to enter into a security-based swap, unless the third party is a ''regulated person'' that is itself subject to a pay to

[257] *Blount,* 61 F.3d at 944–45.

[258] *See id. See SEC* v. *Larry P. Langford,* Litigation Release No. 20545 (Apr. 30, 2008) and *SEC* v. *Charles E. LeCroy,* Litigation Release No. 21280 (Nov. 4, 2009) (charging Alabama local government officials and J.P. Morgan employees with undisclosed payments made to obtain municipal bond offering and swap agreement business from Jefferson County, Alabama). *See also J.P. Morgan Securities Inc.,* Securities Act Release No. 9078 (Nov. 4, 2009) (instituting administrative and cease-and-desist proceedings against a broker-dealer that the Commission alleged was awarded bond underwriting and interest rate swap agreement business by Jefferson County in connection with undisclosed payments by employees of the firm).

[259] *Blount* v. *SEC,* 61 F.3d at 945.

[260] As we explained in our release adopting Advisers Act Rule 206(4)–5, a collective action problem exists when participants who prefer to abstain from pay to play nonetheless feel compelled to participate due to concern that they will be locked out of the market unless they take part. *See* Political Contributions by Certain Investment Advisers, note 33, *supra.*

[261] *Cf. Blount,* 61 F.3d at 945 (''no smoking gun is needed where, as here, the conflict of interest is apparent, the likelihood of stealth great, and the legislative purpose prophylactic'').

[262] 17 CFR 275.206(4)–5. *See* Political Contributions by Certain Investment Advisers, note 32, *supra.* (adopting Advisers Act Rule 206(4)–5). *See also* Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 3110 (Nov. 19, 2010), 75 FR 77052 (Dec. 10, 2010) (proposing amendments to Investment Advisers Act Rule 206(4)–5).

[263] The proposed rule is closely modeled on the MSRB Rule G–37 upheld by the Court of Appeals for the District of Columbia Circuit in *Blount* v. *SEC,* 61 F.3d at 947–48.

[264] *See* discussion in Section I.C.4, *supra.*

[265] Proposed Rule 15Fh–6(a)(5) would define the term ''official'' of a municipal entity for purposes of the proposed rule to mean:

A person (including any 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:

(i) Is directly or indirectly responsible for, or can influence the outcome of, the selection of a security-based swap dealer or major security-based swap participant by a municipal entity; or

(ii) Has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the selection of a security-based swap dealer or major security-based swap participant by a municipal entity.

play restriction under applicable law.[266] We are concerned that the adoption of a rule addressing pay to play practices by security-based swap dealers would lead to the use of solicitors by security-based swap dealers to circumvent the rule. Proposed Rule 15Fh–6(b)(3)(i) is intended to deter SBS Dealers from participating, even indirectly, in such practices.

Third, proposed Rule 15Fh–6(b)(3)(ii) would ban an SBS Dealer from soliciting or coordinating contributions to an official of a municipal entity with which the SBS Dealer is seeking to enter into, or has entered into a security-based swap, or payments to a political party of a state or locality with which the SBS Dealer is seeking to enter into, or has entered into, a security–based swap. These proposed prohibitions are similar to those contained in Advisers Act Rule 206(4)–5, and MSRB Rules G–37 and G–38.

Proposed Rule 15Fh–6(c) would make it unlawful for an SBS Dealer to do indirectly or through another person or means anything that would, if done directly, result in a violation of the prohibitions contained in the proposed rule.

b. Two-Year ''Time Out''

Proposed Rule 15Fh–6(b)(1) would prohibit an SBS Dealer from offering to enter into, or entering into, a security-based swap with a municipal entity within two years after a contribution to an official of such municipal entity has been made by the SBS Dealer or any of its covered associates. We believe the two-year time out requirement strikes an appropriate balance, as it is sufficiently long to act as a deterrent but not so long as to be unnecessarily onerous. The two-year time out is consistent with the time out provisions contained in Advisers Act Rule 206(4)–5 and MSRB Rule G–37.

c. Covered Associates

Political contributions made to influence the selection of a firm are typically made not by the firm itself, but by officers and employees of the firm who have a stake in the business relationship with the municipal entity.[267] For this reason, the restrictions under proposed Rule 15Fh–6(b)(1) would apply to contributions by any ''covered associate'' of an SBS Dealer, which is defined to include: (i) Any general partner, managing member or executive officer, or other person with a similar status or function; [268] (ii) any employee who solicits a municipal entity to enter into a security-based swap with the SBS Dealer and any person who supervises, directly or indirectly, such employee; and (iii) any political action committee controlled by the SBS Dealer or any of its covered associates.[269] This definition is consistent with a similar provision in Advisers Act Rule 206(4)–5.[270]

Because the proposed rule would attribute to a firm those contributions made by a person even prior to becoming a covered associate of the firm, SBS Dealers would need to ''look back'' in time to determine whether the time out applies when an employee becomes a covered associate. For example, if the contribution was made less than two years (or six months, as applicable) before an individual becomes a covered associate, the proposed rule would prohibit the firm from entering into a security-based swap with the relevant municipal entity until the two-year time out period has expired.

d. Officials

The restrictions would apply when contributions are made to an ''official'' of a municipal entity. Proposed Rule 15Fh–6(a)(5) would define ''official'' to mean any person (including any 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 is directly or indirectly responsible for, or can influence the outcome of, the selection of an SBS Dealer by a municipal entity; or has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the selection of an SBS Dealer by a municipal entity.

e. Exceptions

i. De Minimis Contributions

The proposed rule would permit an individual who is a covered associate to make aggregate contributions without being subject to the two-year time out period, of up to $350 per election, for any one official for whom the individual is entitled to vote, and up to $150 per election, to an official for whom the individual is not entitled to vote.[271] We are proposing this two-tier approach because, while we recognize persons can have a legitimate interest in contributing to campaigns of people for whom they are unable to vote, we are concerned that contributions by covered associates living in distant jurisdictions may be less likely to be made for purely civic purposes. Accordingly, the proposed *de minimis* exception for contributions to candidates for whom a covered associate is not entitled to vote is lower than the *de minimis* exception for candidates for whom a covered associate is entitled to vote. We believe that the $150 exception for contributions to a candidate for whom the covered associate is not entitled to vote is appropriate because of the more remote interest a covered associate is likely to have in contributing to such a person.

ii. New Covered Associates

The prohibitions of the proposed rule would not apply to contributions by an individual made more than six months prior to becoming a covered associate of the SBS Dealer, unless such individual solicits the municipal entity after becoming a covered associate.[272]

iii. Exchange and SEF Transactions

The prohibitions of proposed Rule 15Fh–6 would not apply to a security-based swap that is initiated by a municipal entity on a registered national securities exchange or SEF, for which the SBS Dealer does not know the identity of the counterparty at any time up to and including the time of execution of the transaction.[273]

f. Exception and Exemptions

We are proposing a provision that would provide an SBS Dealer a limited ability to cure the consequences of an inadvertent political contribution to an official for whom the covered associate is not entitled to vote. The exception would apply to contributions that, in the aggregate, do not exceed $350 to any one official per election. The SBS Dealer

[266] Proposed Rule 15Fh–6(a)(7) would define ''regulated person,'' for purposes of the rule, to mean generally a person that is subject to rules of the Commission, the CFTC or an SRO subject to the jurisdiction of the Commission or the CFTC prohibiting it from engaging in specified activities if certain political contributions have been made, or its officers or employees.

[267] *See* Political Contributions by Certain Investment Advisers, *supra,* note 33.

[268] Proposed Rule 15Fh–6(a)(3) would define ''executive officer'' of an SBS Dealer to mean, for purposes of the rule:

- The president;
- Any vice president in charge of a principal business unit, division or function (such as sales, administration or finance);
- Any other officer of the SBS Dealer who performs a policy-making function; or
- Any other person who performs similar policy-making functions for the SBS Dealer.

[269] Proposed Rule 15Fh–6(a)(2).

[270] 17 CFR 275.206(4)–5(f)(2).

[271] Proposed Rule 15Fh–6(b)(2)(i).

[272] Proposed Rule 15Fh–6(b)(2)(ii).

[273] Proposed Rule 15Fh–6(a)(2)(iii).

must have discovered the contribution that resulted in the prohibition within four months of the date of the contribution, and obtained the return of the contribution to the contributor within 60 calendar days of the date of discovery. In addition, an SBS Dealer would not be able to rely on this exception more than twice in any 12-month period, or more than once for any covered associate, regardless of the time between contributions.[274] This automatic exception mirrors similar provisions contained in Advisers Act Rule 206(4)–5 and MSRB Rule G–37.

The scope of this exception would be limited to the types of contributions we believe are less likely to raise pay to play concerns. The prompt return of the contribution would provide an indication that the contribution would not affect an official's decision to enter into a transaction with the SBS Dealer. The relatively small amount of the contribution, in conjunction with the other conditions of the exception, should help to mitigate concerns that the contribution was made for purposes of influencing the municipal entity's selection process. The restrictions on repeated triggering contributions should reinforce the need for effective compliance controls. Because the proposed exception would operate automatically, we preliminarily believe that it should be subject to conditions that are objective and limited in order to capture only those contributions that are less likely to raise pay to play concerns.

In addition, we are proposing a provision under which an SBS Dealer may apply to the Commission for an exemption from the two-year ban. In determining whether to grant the exemption, the Commission would consider, among other factors: (i) Whether the exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes of the Exchange Act; (ii) whether the SBS Dealer, (a) Before the contribution resulting the prohibition was made, had adopted and implemented policies and procedures reasonably designed to prevent violations of the proposed rule, (b) prior to or at the time the contribution, had any actual knowledge of the contribution, and (c) after learning of the contribution, had taken all available steps to cause the contributor to obtain return of the contribution and such other remedial or preventative measures as may be appropriate under the circumstances; (iii) whether, at the time of the contribution, the contributor was a covered associate or otherwise an employee of the SBS Dealer, or was seeking such employment; (iv) the timing and amount of the contribution; (v) the nature of the election (*e.g.,* state or local); and (vi) the contributor's intent or motive in making the contribution, as evidenced by the facts and circumstances surrounding the contribution.[275] This exemption is similar to the exemption-by-application provisions contained in Advisers Act Rule 206(4)–5 and MSRB Rule G–37.

Request for Comments

The Commission requests comments generally on all aspects of this provision. In addition, we request comments on the following specific issues:

- Do security-based swap transactions with municipal entities present the same risks of pay to play abuses as other securities transactions involving municipal securities dealers and investment advisers? If not, why not?
- Do the same risks of pay to play abuses exist when a Major SBS Participant, rather than an SBS Dealer, is seeking to enter into a security-based swap with a municipal entity? If not, why not? Should the proposed rule apply to Major SBS Participants, as well as to SBS Dealers? If so, why?
- Is the term ''municipal entity'' appropriately defined? If not, should the definition refer to ''a State, State agency, city, county, municipality, or other political subdivision of a State, or any governmental plan, as defined in section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002)'' within the meaning of Exchange Act Section 15F(h)(2)(C)? Should the Commission use the definition of ''government entity'' from Advisers Act Rule 206(4)–5?[276] Should the Commission instead follow the approach of MSRB Rule G–37?[277]
- Should the requirements of proposed Rule 15Fh–6 be deemed satisfied if an SBS Dealer can establish that it is subject to other regulation that similarly prohibits it from engaging in security-based swap activities if certain political contributions have been made? Should an SBS Dealer's ability to rely on other regulation be conditioned on a Commission finding that the other regulation imposes substantially equivalent or more stringent restrictions than proposed Rule 15Fh–6 would impose on SBS Dealers, and that such other rules are consistent with the objectives of proposed Rule 15Fh–6? Why or why not?
- Proposed Rule 15Fh–6(b)(3)(i) is intended to prevent SBS Dealers from participating, even indirectly, in pay to play practices. What would be the advantages and disadvantages of such an approach? Is there another approach that the Commission should consider? Are there differences between the operations of SBS Dealers and other securities firms that would make the third-party solicitor provision unnecessary? If so, what are they? Would the provision impose any collection of information obligations? If so, what would they be? What would be the costs and benefits of this approach?

E. Chief Compliance Officer: Proposed Rule 15Fk–1

Section 15F(k) of the Exchange Act requires an SBS Entity to designate a chief compliance officer (''CCO''), and imposes certain duties and responsibilities on that CCO. Proposed Rule 15Fk–1 would codify the provisions of Exchange Act Section 15F(k) with some modifications based on the current compliance obligations applicable to CCOs of other Commission-regulated entities. The proposed requirements underscore the central role that sound compliance programs play to ensure compliance with the Exchange Act and rules and regulations thereunder applicable to security-based swaps.[278]

Proposed Rule 15Fk–1(a) would require an SBS Entity to designate a CCO on its registration form, and proposed Rule 15Fk–1(b) would impose certain duties on the CCO. Proposed Rule 15Fk–1(b)(1) would require that the CCO report directly to the board of directors, a body performing a function similar to the board, or to the senior

[274] Proposed Rule 15Fh–6(e)(1).

[275] Proposed Rule 15Fh–6(e).

[276] As used in 17 CFR 275.206(4)–5, the term ''government entity'' means any state or political subdivision of a state, including:

(i) Any agency, authority, or instrumentality of the state or political subdivision;

(ii) A pool of assets sponsored or established by the state or political subdivision or any agency, authority or instrumentality thereof, including, but not limited to a ''defined benefit plan'' as defined in section 414(j) of the Internal Revenue Code (26 U.S.C. 414(j)), or a state general fund;

(iii) A plan or program of a government entity; and

(iv) Officers, agents, or employees of the state or political subdivision or any agency, authority or instrumentality thereof, acting in their official capacity.

[277] MSRB Rule G–37 references ''the governmental issuer specified in [Section 3(a)(29) of the Exchange Act]'' which would include ''a State or any political subdivision thereof, or any municipal corporate instrumentality of one more States.''

[278] *See* FINRA Rule 3130.

officer of the SBS Entity.[279] Proposed Rule 15Fk–1(b)(2) would require the CCO to review the compliance of the SBS Entity with respect to the requirements in Section 15F of the Exchange Act and the rules and regulations thereunder.[280] Rule 15Fk–1(b)(2) would further require that, as part of the CCO's obligation to review compliance by the SBS Entity, the CCO establish, maintain, and review policies and procedures that are reasonably designed to achieve compliance by the SBS Entity with Section 15F of the Exchange Act and the rules and regulations thereunder.[281]

Proposed Rule 15Fk–1(b)(3) would require that the CCO, in consultation with the board of directors, a body performing a function similar to the board, or the senior officer of the organization, resolve conflicts of interest that may arise.[282] We understand that the primary responsibility for the resolution of conflicts generally lies with the business units within the SBS Entities. As a result, we would anticipate that the CCO's role with respect to such resolution and mitigation of conflicts of interest would include the recommendation of one or more actions, as well as the appropriate escalation and reporting with respect to any issues related to the proposed resolution of potential or actual conflicts of interest, rather than decisions relating to the ultimate final resolution of such conflicts. Under proposed Rule 15Fk–1(b)(4), the CCO would be responsible for administering each policy and procedure that is required to be established pursuant to Section 15F of the Act and the rules and regulations thereunder.[283] The Commission would expect that a CCO should be competent and knowledgeable regarding Section 15F of the Exchange Act and the rules and regulations thereunder, and should be empowered with full responsibility and authority to execute his or her responsibilities.

Proposed Rule 15Fk–1(b)(5) would require the CCO to establish, maintain and review policies and procedures reasonably designed to ensure compliance with the provisions of the Exchange Act and the rules and regulations thereunder relating to the SBS Entity's business as an SBS Entity.[284] The title of CCO does not, in and of itself, carry supervisory responsibilities. Consistent with current industry practice, we generally would not expect a CCO appointed in accordance with proposed Rule 15Fk–1 to have supervisory responsibilities outside of the compliance department. Accordingly, absent facts and circumstances that establish otherwise, we generally would not expect that a CCO would be subject to a sanction by the Commission for failure to supervise other SBS Entity personnel. Moreover, a CCO who does have supervisory responsibilities could rely on the provisions of proposed Rule 15Fh–3(h)(3), under which a person associated with an SBS Entity shall not be deemed to have failed to reasonably supervise another person if such other person is not subject to the CCO's supervision, or if: (i) the SBS Entity has established and maintained written policies and procedures, and a documented system for applying those policies and procedures, that would reasonably be expected to prevent and detect, insofar as practicable, any violation of the federal securities laws and the rules and regulations thereunder relating to its business as an SBS Entity; and (ii) the supervising person has reasonably discharged the duties and obligations required by the written policies and procedures and documented system, and did not have a reasonable basis to believe that the written policies and procedures and documented system were not being followed.[285]

Proposed Rule 15Fk–1(b)(6) would require the CCO to establish, maintain and review policies and procedures reasonably designed to remediate promptly non-compliance issues identified by the CCO.[286] Proposed Rule 15Fk–1(b)(7) would require the CCO to establish and follow procedures reasonably designed for management response and resolution of non-compliance issues.[287]

Proposed Rule 15Fk–1(c)(1) would require that the CCO annually prepare and sign a report describing the compliance policies and procedures (including the code of ethics and conflicts of interest policies) and compliance of the SBS Entity with the Exchange Act and rules and regulations thereunder relating to its business as an SBS Entity.[288] Proposed Rule 15Fk–1(c)(2) would require that each compliance report also contain, at a minimum: A description of the SBS Entity's enforcement of its policies and procedures relating to its business as an SBS Entity; any material changes to the policies and procedures since the date of the preceding compliance report; any recommendation for material changes to the policies and procedures as a result of the annual review, the rationale for such recommendation, and whether such policies and procedures were or will be modified by the SBS Entity to incorporate such recommendation; and any material compliance matters identified since the date of the preceding compliance report.[289] Proposed Rule 15Fk–1(e)(4) would define ''material compliance matter'' to mean any compliance matter about which the board of directors of the SBS Entity would reasonably need to know

[279] *See* Section 15F(k)(2)(A) of the Exchange Act, Public Law 111–203, 124 Stat. 1376, 1793 (to be codified at 15 U.S.C. 78o–10(k)(2)(A)).

[280] *See* Section 15F(k)(2)(B) of the Exchange Act, Public Law. 111–203, 124 Stat. 1376, 1793 (to be codified at 15 U.S.C. 78o–10(k)(2)(B)).

[281] The requirement to establish, maintain and review policies and procedures reasonably designed to achieve compliance with Section 15F of the Exchange Act and the rules thereunder is based on FINRA Rule 3130, which requires certification that a member has in place processes to ''establish, maintain, and review policies and procedures reasonably designed to achieve compliance with applicable FINRA rules, MSRB rules and federal securities laws and regulations.'' Similar requirements appear in Rule 38a–1(a)(1) under the Investment Company Act of 1940, 17 CFR 270.38a–1(a)(1) (requiring registered investment companies to ''[a]dopt and implement written policies and procedures reasonably designed to prevent violation of the Federal Securities laws by the fund''); and Advisers Act Rule 206(4)–7(a), 17 CFR 275.206(4)–7(a) (requiring registered investment advisers to ''[a]dopt and implement written policies and procedures reasonably designed to prevent violation, by you and your supervised persons, of the [Advisers] Act, and the rules that the Commission has adopted under the [Advisers] Act'').

[282] *See* Section 15F(k)(2)(C) of the Exchange Act, Public Law 111–203, 124 Stat. 1376, 1793 (to be codified at 15 U.S.C. 78o–10(k)(2)(C)).

[283] *See* Section 15F(k)(2)(D) of the Exchange Act, Public Law 111–203, 124 Stat. 1376, 1793 (to be codified at 15 U.S.C. 78o–10(k)(2)(D)).

[284] *See* Section 15F(k)(2)(E) of the Exchange Act, Public Law 111–203, 124 Stat. 1376, 1793 (to be codified at 15 U.S.C. 78o–10(k)(2)(E)).

[285] *Cf.* Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204 (Dec. 17, 2003), 68 FR 74714 (Dec. 24, 2003) at note 78.

[286] *See* Section 15F(k)(2)(F) of the Exchange Act, Public Law 111–203, 124 Stat. 1376, 1793 (to be codified at 15 U.S.C. 78o–10(k)(2)(F)).

[287] *See* Section 15F(k)(2)(G) of the Exchange Act, Public Law 111–203, 124 Stat. 1376, 1793 (to be codified at 15 U.S.C. 78o–10(k)(2)(G)).

[288] *See* Section 15F(k)(3)(A) of the Exchange Act, Public Law 111–203, 124 Stat. 1376, 1794 (to be codified at 15 U.S.C. 78o–10(k)(3)(A)). We believe that there is a drafting error in the reference in Section 15F(k)(3)(A) of the Exchange Act to compliance of the ''major swap participant'' in this provision, and are proposing to apply the requirement with respect to the compliance of the ''major security-based swap participant.''

[289] This requirement is modeled on a similar requirement for chief compliance officers under Investment Company Act Rule 38a–1(4), 17 CFR 270.38a–1(a)(4). The report under the Investment Company Act, however, is not required to be filed with the Commission.

The Commission is proposing a similar requirement for chief compliance officers of security-based swap data repositories. *See* Security-Based Swap Data Repository Registration, Duties and Core Principles, Exchange Act Release No. 63347 (Nov. 19, 2010), 75 FR 77306 (Dec. 10, 2010) (''SDR Registration Release'') (proposing Exchange Act Rule 13n–11(d)(1)).

to oversee the compliance of the SBS Entity, and that involves, without limitation, a violation of the federal securities laws relating to its business as an SBS Entity by the SBS Entity or its officers, directors, employees or agents; a violation of the policies and procedures of the SBS Entity relating to its business as an SBS Entity; or a weakness in the design or implementation of the policies and procedures of the SBS Entity relating to its business as an SBS Entity.[290]

Proposed Rule 15Fk–1(c)(2)(ii)(D) would require the CCO to certify, under penalty of law, the accuracy and completeness of the report.[291] Proposed Rule 15Fk–1(c)(2)(ii)(A) would require that the CCO's annual report accompany each appropriate financial report of the SBS Entity that is required to be furnished or filed with the Commission.[292] To allow the annual report to accompany each appropriate financial report within the required timeframe, proposed Rule 15Fk–1(c)(2)(ii)(B) would require the CCO to provide a copy of the required annual report to the board of directors, the audit committee and the senior officer of the SBS Entity at the earlier of their next scheduled meeting or within 45 days of the date of execution of the certification.[293]

Proposed Rule 15Fk–1(c)(2)(ii)(C) would require that the CCO's annual report include a written representation that the chief executive officer(s) (or equivalent officers) has/have conducted one or more meetings with the CCO in the preceding 12 months, the subject of which addresses the SBS Entity's processes to comply with the obligations of the CCO as set forth in the proposed rules and in Exchange Act Section 15F.[294] To comply with the proposed rule, the subject of the meeting(s) between the chief executive officer and the CCO referenced in the written representation must include: (1) The matters that are the subject of the CCO's annual report; (2) the SBS Entity's compliance efforts with the provisions of Section 15F and the provisions of the Exchange Act and the rules and regulations thereunder relating to its business as an SBS Entity as of the date of such a meeting; and (3) significant compliance problems under Section 15F and plans in emerging business areas relating to its business as an SBS Entity.[295] Although not required by the Dodd-Frank Act, we believe that an annual compliance meeting would help to ensure and comprehensive compliance policies.[296] Under proposed Rule 15Fk–1(c)(2)(iii), if compliance reports are separately bound from the financial statements, the compliance reports shall be accorded confidential treatment to the extent permitted by law.

Finally, proposed Rule 15Fk–1(d) would require that the compensation and removal of the CCO be approved by a majority of the board of directors of the SBS Entity. We are proposing this measure, which is not required by the Dodd-Frank Act, to promote the independence and effectiveness of the CCO. We have proposed a similar requirement for the CCOs of security-based swap data repositories [297] and of investment companies and business development companies.[298] As we explained in proposing other CCO requirements, we are concerned that an entity's commercial interests might discourage a CCO from making forthright disclosure to the board or senior officer about any compliance failures. To help address this potential conflict of interest, the Commission preliminarily believes that only the board of directors of the SBS Entity should be able to set the CCO's compensation or remove an individual from the CCO position.[299]

Request for Comments

The Commission requests comments generally on all aspects of this provision. In addition, we request comments on the following specific issues:

- Would a CCO of an SBS Entity have difficulty discharging any of these obligations? If so, why?
- Should the Commission consider additional obligations to be imposed on a CCO of an SBS Entity? If so, which ones and why?
- Should the Commission define circumstances in which a CCO may report to a senior officer rather than to the board of directors? If so, what should those circumstances be? Why?
- Do any of the CCO obligations conflict with current obligations imposed on a CCO and, if so, why?
- Would the timing of the annual report create any problems for SBS Entities?
- Should the compliance report be furnished rather than filed with the Commission? Why or why not?
- Should the Commission permit a CCO to qualify its report by certifying, under penalty of law, that a report is accurate and complete ''in all material respects''? Why or why not? Is there another approach the Commission should consider to appropriately balance the practical need for SBS Entities to attract and retain qualified CCOs with the statutory provision to require CCOs to certify their reports under penalty of law?
- Should the Commission require the chief executive officer or another senior officer to certify the report, similar to the compliance certification required under FINRA Rule 3130, instead of or in addition to the CCO? [300] Why or why not?

[290] This definition is modeled on the definition of ''material compliance matter'' in Investment Company Act Rule 38a–1(e)(2), 270.38a–1(e)(2). The Commission proposed a similar definition in its rule governing chief compliance officers of security-based swap data repositories. *See* SDR Registration Release (proposing Exchange Act Rule 13n–11(b)(6)).

[291] *See* Section 15F(k)(3)(B)(ii) of the Exchange Act, Public Law 111–203, 124 Stat. 1376, 1794 (to be codified at 15 U.S.C. 78o–10(k)(3)(B)(ii)).

[292] *See* Section 15F(k)(3)(B)(i) of the Exchange Act, Public Law 111–203, 124 Stat. 1376, 1794 (to be codified at 15 U.S.C. 78o–10(k)(3)(B)(i)).

[293] *Id.* This timeframe is the same as that provided by FINRA Rule 3130(c) (regarding certification of compliance processes).

[294] *See* FINRA Rule 3130.

[295] This requirement is modeled on the obligations for broker-dealers under FINRA rules. *See* Supplementary Material .04 to FINRA Rule 3130, Content of Meetings between Chief Executive Officer and Chief Compliance Officer.

[296] *See* Exchange Act Sections 15F(h)(1)(B) (authorizing the Commission to prescribe duties for diligent supervision), and 15F(h)(3)(D) (providing authority to prescribe business conduct standards). Public Law 111–203, 124 Stat. 1376, 1789 and 1790 (to be codified at 15 U.S.C. 78o–10(h)(1)(B) and 78o–10(h)(3)(D)).

[297] *See* SDR Registration Release (proposing Exchange Act Rule 13n–11(a)).

[298] *See* 17 CFR 270.38a–1(a)(4).

[299] *See* SDR Registration Release (discussing proposed Exchange Act Rule 13n–11(a)).

[300] FINRA Rule 3130 requires the CEO to certify that:

1. The Member has in place processes to:

(A) Establish, maintain and review policies and procedures reasonably designed to achieve compliance with applicable FINRA rules, MSRB rules and federal securities laws and regulations;

(B) Modify such policies and procedures as business, regulatory and legislative changes and events dictate; and

(C) Test the effectiveness of such policies and procedures on a periodic basis, the timing and extent of which is reasonably designed to ensure continuing compliance with FINRA rules, MSRB rules and federal securities laws and regulations.

2. The undersigned chief executive officer(s) (or equivalent officer(s)) has/have conducted one or more meetings with the chief compliance officer(s) in the preceding 12 months, the subject of which satisfy the obligations set forth in FINRA Rule 3130.

3. The Member's processes, with respect to paragraph 1 above, are evidenced in a report reviewed by the chief executive officer(s) (or equivalent officer(s)), chief compliance officer(s), and such other officers as the Member may deem necessary to make this certification. The final report has been submitted to the Member's board of directors and audit committee or will be submitted to the Member's board of directors and audit committee (or equivalent bodies) at the earlier of their next scheduled meetings or within 45 days of the date of execution of this certification.

Continued

• How, if at all, would the proposed CCO requirements—including those that are not expressly addressed by the Dodd-Frank Act, *e.g.,* the proposed requirements that the CCO meet with the chief executive officer and that the compensation of the CCO be set by the Board—alter the role and function that CCOs may play within SBS Entities? Do the proposed requirements promote an effective compliance function while avoiding undue constraints on a firm's discretion in organizing its business, including that compliance function? Why or why not? How, if at all, could the proposed requirements be altered to provide SBS Entities and CCOs greater flexibility in implementing an effective compliance function?

• If the CCO reports to a senior officer, should the senior officer have the ability to remove the CCO? Should the senior officer have the ability to determine the compensation of the CCO? Under what circumstances and why? If the CCO reports to the board of directors, should the compliance meeting(s) required under proposed Rule 15Fk–1(c)(2)(i)(C) be held between the CCO and the board of directors or a committee of independent directors instead of with the senior officer?

• Should the board or audit committee be required to review the annual compliance report and approve any CCO-recommended remedial steps? Should the board or audit committee be required to authorize alternative remedial steps that the board or audit committee determines are more appropriate than those in the annual compliance report? Should the Commission require the SBS Entity to report to the Commission any alternative remedial steps taken? Why or why not?

III. Request for Comments

A. Generally

The Commission requests comments on all aspects of the proposed rules. The Commission particularly requests comment on the general impact the proposals would have on the market for security-based swaps and on the behavior of participants in that market. The Commission also seeks comment on the proposals as a whole, including their interaction with the other provisions of the Dodd-Frank Act and their advantages and disadvantages when considered in total. In addition, the Commission seeks comment on the following specific issues:

• Do the proposed rules clearly define the obligations to be imposed on SBS Dealers or Major SBS Participants? Are there clarifications or instructions to the proposed requirements that would be beneficial to make? If so, what are they, and what would be the benefits of adopting them?

• Do the proposed rules (considered individually and in their entirety) provide an efficient and effective way to implement the requirements of the Dodd-Frank Act relating to the business conduct of SBS Entities? Why or why not? Are the requirements under the proposed rules appropriately tailored so that the requirements of the Dodd-Frank Act can be met consistent with an SBS Entity's maintaining an economically viable business? Why or why not?

• Do the proposed rules (considered individually and in their entirety) give full effect to the additional protections for special entities contemplated by the statute while avoiding restrictions on SBS Entities that would unduly limit their willingness or ability to provide special entities with access to security-based swaps? Why or why not? How and to what extent will the proposed rules (considered individually and in their entirety) affect the ability of special entities to engage in security-based swaps? How and to what extent will the proposed rules (considered individually and in their entirety) afford special entities the protections contemplated by the Dodd-Frank Act in connection with their security-based swap transactions?

• Would the proposed rules require disclosure of information that that commenters believe should not, or need not, be disclosed? If so, what information, and what are the problems associated with its disclosure?

• Do any proposed requirements conflict with any existing requirement, including any requirement currently imposed by an SRO, such that it would be impracticable or impossible for an SBS Entity that is a member of an SRO to meet both obligations? If so, which one(s) and why?

• Should an SBS Entity be permitted to establish compliance with the proposed business conduct standards by demonstrating compliance with other regulatory standards that impose substantially similar requirements?

• Should any proposed requirements be modified with respect to security-based swaps that are traded on a registered SEF or on a registered national securities exchange? If so, which requirements should be modified, and why?

• Should any proposed requirements be modified with respect to security-based swaps that are cleared but not SEF- or exchange-traded? If so, which requirements and why?

• Should any proposed requirements for SBS Entities be modified? If so, which requirements and why? Should different standards apply to SBS Dealers and Major SBS Participants?

• Should any additional business conduct requirements be imposed on SBS Entities? If so, which requirements and why? Should different standards apply to SBS Dealers and Major SBS Participants? Under what circumstances, and why?

• Should any additional proposed requirements be modified when the counterparty is an SBS Dealer, a Major SBS Participant, a swap dealer or a major swap participant? Another type of market intermediary?

• Are there other counterparties for which certain proposed SBS Entity requirements should be modified? If so, which requirements, in what circumstances, and why?

• Should the Commission delay the compliance date of any of the proposed requirements to allow additional time to comply with those requirements? If so, which requirements, and how much additional time?

B. Consistency With CFTC Approach

The CFTC has proposed rules related to business conduct standards for swap dealers and major swap participants as required under Section 731 of the Dodd-Frank Act.[301] Understanding that the Commission and the CFTC regulate different products, participants and markets and thus, appropriately may take different approaches to various issues, we nevertheless are guided by the objective of establishing consistent and comparable requirements. Accordingly, we request comments generally on (i) The impact of any differences between the Commission and CFTC approaches to business conduct regulation in this area, (ii) whether the Commission's proposed business conduct regulations should be modified to conform to the proposals made by the CFTC, and (iii) whether any business conduct requirements proposed by the CFTC, but not proposed by the Commission, should be adopted by the Commission.

4. The undersigned chief executive officer(s) (or equivalent officer(s)) has/have consulted with the chief compliance officer(s) and other officers as applicable (referenced in paragraph 3 above) and such other employees, outside consultants, lawyers and accountants, to the extent deemed appropriate, in order to attest to the statements made in this certification.

[301] *See* CFTC External Business Conduct Release, *supra,* note 16.

Request for Comments

The Commission requests comments generally on all aspects of the proposed rules as they relate to CFTC rules and regulations. In addition, we request comments on the following specific issues:

- Do the regulatory approaches under the Commission's proposed rulemaking pursuant to Section 764 of the Dodd-Frank Act and the CFTC's proposed rulemaking pursuant to Section 731 of the Dodd-Frank Act result in duplicative or inconsistent obligations for market participants that are subject to both regulatory regimes, or result in gaps or different levels of regulation between those regimes? If so, in what ways should such duplication, inconsistencies or gaps be addressed?
- Are the approaches proposed by the Commission and the CFTC to regulate business conduct comparable? If not, why?
- Are there approaches that would make the regulation more comparable? If so, what?
- Would be appropriate for us to adopt any particular requirements proposed by the CFTC that differ from our proposal? If so, which ones?
- Should the Commission require SBS Entities to perform periodic portfolio reconciliations in which they exchange terms and valuations of each security-based swap with their counterparty and also resolve any discrepancies within a specified period of time? [302] If so, how frequently should portfolio reconciliations be performed and within what time period should all discrepancies be resolved? Should any specific policies and procedures be proposed regarding the method of performing a portfolio reconciliation? Should the Commission require any specific policies and procedures regarding the method of valuing security-based swaps for purposes of performing a portfolio reconciliation? Please explain the current market practice among dealers for performing portfolio reconciliations.
- Should the Commission require SBS Entities to periodically perform portfolio compressions in which the SBS Entity wholly or partially terminates some or all of its security-based swaps outstanding with a counterparty and replaces those security-based swaps with a smaller number of security-based swaps whose combined notional value is less than the combined notional value of the original security-based swaps included in the exercise? [303] If not, why not? Should the Commission require SBS Entities to periodically perform portfolio compressions among multiple counterparties? If not, why not? Please explain the current market practice among dealers for performing portfolio compressions.

We request commenters to provide data, to the extent possible, supporting any such suggested approaches.

IV. Paperwork Reduction Act

Certain provisions of the proposed rules would impose new ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995 (''PRA''). [304] The Commission is submitting the proposed collections of information to the Office of Management and Budget (''OMB'') for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The titles for these collections are ''Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants'' and ''Designation of Chief Compliance Officer of Security-Based Swap Dealers and Major Security-Based Swap Participants.'' An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. OMB has not yet assigned a control number to the proposed collections of information.

A. Summary of Collections of Information

1. Verification of Status

Proposed Rule 15Fh–3(a) would require an SBS Entity to verify that a counterparty, whose identity is known to the security-based swap dealer or a major security-based swap participant prior to the execution of the transaction, meets the eligibility standards for an ECP and whether the counterparty is a special entity. We expect that in order to verify the status of the counterparty, an SBS Entity would likely obtain written representations from the counterparty, conduct due diligence as part of its ''diligence checklist'' or as required by its internal policies and procedures, or some combination thereof, based upon prior dealings, if any, with the counterparty.

2. Disclosures by SBS Entities

Proposed Rule 15Fh–3(b) would require an SBS Entity to disclose to any counterparty (other than an SBS Entity, swap dealer, or major swap participant) information reasonably designed to allow the counterparty to assess: (1) The material risks and characteristics of a security-based swap; and (2) any material incentives or conflicts of interest that the SBS Entity may have in connection with the security-based swap. The proposed rule would also require that to the extent that these disclosures are not provided in writing prior to the execution of the transaction, the SBS Entity would be required to provide the counterparty with a written version of the disclosure no later than the time of delivery of the trade acknowledgement for the transaction. [305] Proposed Rule 15Fh–3(c) would require an SBS Entity to disclose to any counterparty (other than an SBS Entity, swap dealer, or major swap participant) the daily mark of the security-based swap. Proposed Rule 15Fh–3(d) would require an SBS Entity, before entering into a security-based swap with a counterparty other than an SBS Entity, swap dealer or major swap participant, to determine whether the security-based swap is subject to the mandatory clearing requirements of Section 3C(a) of the Exchange Act and disclose the determination to the counterparty, as well as clearing alternatives available to the counterparty. To the extent that the disclosures required by proposed Rule 15Fh–3(d) are not provided in writing prior to the execution of the transaction, the SBS Entity would be required to provide the counterparty with a written record of the disclosure no later than the delivery of the trade acknowledgement for the transaction.

3. Know Your Counterparty and Recommendations

Proposed Rule 15Fh–3(e) would require an SBS Dealer to establish, maintain and enforce policies and procedures reasonably designed to obtain and retain a record of the essential facts concerning each counterparty whose identity is known to the SBS Dealer prior to the execution of the transaction. The essential facts would be: (1) Facts required to comply with applicable laws, regulations and rules; (2) facts required to implement the SBS Dealer's credit and operational risk management policies in connection

[302] The CFTC has proposed to require periodic portfolio reconciliations. *See* Confirmation, Portfolio Reconciliation and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants, 75 FR 81519 (Dec. 28, 2010).

[303] The CFTC has proposed to require periodic portfolio compressions. *Id.*

[304] 44 U.S.C. 3501 *et seq.*

[305] The Commission is separately required to propose a rule regarding reporting and recordkeeping requirements for SBS Entities. *See* Exchange Act Section 15F(f)(2), Public Law 111–203, 124 Stat. 1376, 1788 (to be codified at 15 U.S.C. 78o–10(f)(2)) (''The Commission shall adopt rules governing reporting and recordkeeping for security-based swap dealers and major security-based swap participants'').

with transactions entered into with such counterparty; (3) information regarding the authority of any person acting for such counterparty; and (4) if the counterparty is a special entity, such background information regarding the independent representative as the SBS Dealer reasonably deems appropriate.

Proposed Rule 15Fh–3(f)(1) would require an SBS Dealer to have a reasonable basis to believe: (i) Based on reasonable diligence, that the recommended security-based swap or trading strategy involving a security-based swap is suitable for at least some counterparties; and (ii) that a recommended security-based swap or trading strategy involving a security-based swap is suitable for the counterparty. To establish a reasonable basis for a recommendation, an SBS Dealer would need to have or obtain relevant information regarding the counterparty, including the counterparty's investment profile, trading objectives, and its ability to absorb potential losses associated with the recommended security-based swap or trading strategy. Under proposed Rule 15Fh–3(f)(2), an SBS Dealer would fulfill its suitability obligation in proposed Rule 15Fh–3(f)(1) with respect to a particular counterparty if: (1) The SBS Dealer reasonably determines that the counterparty (or its agent) is capable of independently evaluating the investment risks related to the security-based swap or trading strategy; (2) the counterparty (or its agent) affirmatively represents that it is exercising its independent judgment in evaluating the recommendation; and (3) the SBS Dealer discloses to the counterparty that it is acting in its capacity as a counterparty and is not undertaking to assess the suitability of the security-based swap or trading strategy. The representations to document this ''institutional suitability'' must be in writing. The requirements of proposed Rule 15Fh–3(f) would not apply if the counterparty is an SBS Entity, swap dealer or major swap participant.[306] An SBS Dealer that is recommending a security-based swap or trading strategy involving a security-based swap to a special entity would be deemed to have satisfied its obligations pursuant to proposed Rule 15Fh–3(f) with respect to the special entity if: (1) The SBS Dealer is acting as an advisor to the special entity and complies with the requirements of proposed Rule 15Fh–4(b); or (2) the SBS Dealer is deemed not to be acting as an advisor to the special entity pursuant to proposed Rule 15Fh–2(a).[307]

[306] Proposed Rule 15Fh–3(f)(1).

[307] Proposed Rule 15Fh–3(f)(3).

4. Fair and Balanced Communications

Proposed Rule 15Fh–3(g) would require that an SBS Entity communicate with its counterparties in a fair and balanced manner based on principles of fair dealing and good faith. The proposed rule would require, among other things, that any statement of potential opportunities or advantages be balanced by a statement of the corresponding risks with the same degree of specificity.

5. Supervision

Proposed Rule 15Fh–3(h) would require an SBS Entity to establish, maintain and enforce a system to supervise, and to diligently supervise, its business and its associated persons with a view to preventing violations of the applicable federal securities laws and the rules and regulations thereunder relating to its business as an SBS Entity. The proposed rule would require the SBS Entity to designate a qualified person with supervisory responsibility for each type of business for which registration as an SBS Entity would be required. The SBS Entity would be required to: Designate at least one supervisor; use reasonable efforts to determine all supervisors are qualified; establish, maintain and enforce written policies and procedures that are reasonably designed to achieve compliance with applicable securities laws, rules and regulations; and establish and maintain written policies and procedures to comply with the duties set forth in Section 15F(j) of the Exchange Act. Such written policies and procedures would be required to include, at a minimum, procedures for: Review of security-based swap transactions; review of internal and external written communications; periodic review of the business; reasonable investigation of the background of associated persons; monitoring employee personal accounts away from the firm; a description of the supervisory system, including identification of the supervisory personnel and their scope of supervisory responsibility; preventing a supervisor from supervising his or her own activities or supervising an employee who determines the supervisor's compensation or continued employment; and preventing the standard of supervision from being reduced due to conflicts of interest with the person being supervised. These supervisory requirements are similar to existing supervision requirements for registered broker-dealers.

6. SBS Dealers Acting as Advisors to Special Entities

Proposed Rule 15Fh–4(b) would require an SBS Dealer acting as an advisor to make reasonable efforts to obtain such information as it considers necessary to make a reasonable determination that a security-based swap or trading strategy involving a security-based swap is in the best interests of the special entity. The information that would be required to be collected to make this determination includes, but is not limited to: The authority of the special entity to enter into the transaction; the financial status and future funding needs of the special entity; the tax status of the special entity; the investment or financing objectives of the special entity; the experience of the special entity with respect to security-based swap transactions generally and of the type and complexity being recommended; whether the special entity has the financial capability to withstand changes in market conditions during the term of the security-based swap; and other relevant information. In order for an SBS Dealer to establish that it is not acting as an advisor under proposed Rule 15Fh–2(a): (1) The special entity must represent in writing that the special entity will not rely on advice provided by the SBS Dealer and the special entity will rely on the advice of a qualified independent representative; (2) the SBS Dealer must have a reasonable basis to believe that the special entity has a qualified independent representative; and (3) the SBS Dealer must disclose to the special entity that the SBS Dealer would not be undertaking to act in the best interest of the special entity, as otherwise required by Section 15F(h)(4) of the Exchange Act. This proposed Rule 15Fh–4(b) would not apply if the transaction is executed on a SEF or an exchange and the SBS Dealer does not know the identity of the counterparty at the time of the transaction.

7. SBS Entities Acting as Counterparties to Special Entities

Proposed Rule 15Fh–5 would require an SBS Entity to have a reasonable basis to believe that the special entity has an independent representative that is independent of the SBS Entity and that meets certain specified qualifications, including that the independent representative: Has sufficient knowledge to evaluate the transaction and related risks; is not subject to a statutory disqualification; undertakes 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 security-based swap; will provide written representations to the special entity regarding fair pricing and appropriateness of the security-based swap; in the case of employee benefit plans subject to ERISA, is a fiduciary as defined in Section 3(21) of ERISA; and in the case of a State, State agency, city, county, municipality, other political subdivision of a State, or governmental plan, is subject to restrictions on certain political contributions. An SBS Entity could reasonably rely on written representations to form a reasonable basis to believe an independent representative meets certain of these qualifications. An SBS Entity would need to engage in reasonable due diligence for any qualification for which it could not reasonably rely on representations. In addition, with respect to the independence of the independent representative, the SBS Entity would need to undertake some additional inquiry, such as review of the SBS Entity's own books and records.

Proposed Rule 15Fh–5(b) would require that, before the initiation of a security-based swap, an SBS Dealer disclose in writing the capacity in which the SBS Dealer is acting. If the SBS Dealer is acting in more than one capacity with respect to the counterparty or has acted in more than one capacity with respect to the counterparty in the last twelve months, it must also disclose the material differences among such capacities. Proposed Rule 15Fh–5 would not apply if the transaction is executed on a SEF or an exchange and the SBS Entity does not know the identity of the counterparty at any time up to and including execution of the transaction.[308]

8. Political Contributions

Proposed Rule 15Fh–6 would prohibit an SBS Dealer from offering to enter into, or entering into security-based swaps with a municipal entity within two years after any contribution by the SBS Dealer or its covered associates to an official of such municipal entity, subject to certain exceptions. In order to determine compliance with the rule, the SBS Dealer would need to maintain certain records of contributions by the SBS Dealer and any of its covered associates.[309] The SBS Dealer would also need to collect information regarding contributions by its covered associates made within the six months prior to becoming covered associates.

9. Chief Compliance Officer

Proposed Rule 15Fk–1 would require an SBS Entity to designate an individual to serve as CCO. Under proposed Rule 15Fk–1, the CCO would be responsible for, among other things: Reviewing the compliance by the SBS Entity with the security-based swap requirements described in Section 15F of the Exchange Act; promptly resolving any conflicts of interest, in consultation with the board or the senior officer; administering policies and procedures required under Section 15F of the Exchange Act; establishing, maintaining and reviewing policies and procedures reasonably designed to ensure compliance with the Exchange Act and the rules and regulations thereunder relating to its business as an SBS Entity; establishing, maintaining and reviewing policies and procedures reasonably designed to remediate promptly non-compliance issues identified by the CCO; and establishing and following procedures reasonably designed for the prompt handling, management response, remediation, retesting, and resolution of non-compliance issues. The CCO would also be required under proposed Rule 15Fk–1 to submit annual compliance reports accompanying each appropriate financial report of the SBS Entity that is required to be furnished to or filed with the Commission and the board of directors and audit committee (or equivalent bodies) of the SBS Entity. These annual compliance reports are required to include a description of: (1) The compliance by the SBS Entity with the Exchange Act and rules and regulations thereunder relating to its business as an SBS Entity; (2) each policy and procedure of the SBS Entity described above; (3) the SBS Entity's enforcement of the policies and procedures relating to its business as an SBS Entity; (4) any material changes to the policies and procedures since the date of the prior report; (5) any recommendations for material changes to the policies and procedures as a result of the annual review, the rationale for the recommendations, and whether such recommendations would be incorporated; and (6) any material compliance matters. The compliance report must also include a written representation that the senior officer has conducted one or more meetings with the CCO in the preceding 12 months, and a certification that the compliance report is accurate and complete.

B. Proposed Use of Information

1. Verification of Status

Proposed Rule 15Fh–3(a) would require an SBS Entity to determine whether its counterparty is an ECP before the execution of a security-based swap other than on a registered national securities exchange or SEF. An SBS Entity would use this information to comply with Section 6(l) of the Exchange Act (15 U.S.C. 78(f)(l)), which prohibits a person from entering into a security-based swap with a counterparty that is not an ECP other than on a national securities exchange. We are not proposing to specify the means by which SBS Entities satisfy this requirement. The proposed rule also would require the SBS Entity to determine whether a counterparty is a special entity. An SBS Entity would use this information, in turn, to determine the need to comply with the requirements applicable to dealings with special entities under proposed Rules 15Fh–4(b) and 15Fh–5. In addition to assisting the CCO in determining compliance with the statute and proposed rules, this collection of information would be used by the Commission staff in its examination and oversight program.

2. Disclosures by SBS Entities

The disclosures required to be provided by SBS Entities to a counterparty (other than an SBS Entity or a swap dealer or major swap participant) would help the counterparty understand the material risks and characteristics of a particular security-based swap, as well as the material incentives or conflicts of interest that the SBS Entity may have in connection with the security-based swap. As a result, these disclosures would assist the counterparty in assessing the transaction. The disclosures would provide counterparties with a better understanding of the expected performance of the security-based swap under various market conditions. They would also give counterparties additional transparency and insight into the pricing and collateral requirements of security-based swaps. Proposed Rule 15Fh–3(d) would require SBS Entities to notify counterparties of the clearing alternatives available to them. In addition to assisting the SBS Entity with its internal supervision and the CCO to determine compliance with the statute and proposed rules, this collection of information would be used by the Commission staff in its examination and oversight program.

[308] Proposed Rule 15Fh–5(c).

[309] *See* notes 169 and 305, *supra,* regarding reporting and recordkeeping requirements generally for SBS Entities.

3. Know Your Counterparty and Recommendations

These collections of information would help an SBS Dealer to comply with applicable laws, regulations and rules. They would also assist an SBS Dealer in effectively dealing with the counterparty, including by making recommendations that are appropriate for the counterparty, and by collecting information from the counterparty necessary for the SBS Dealer's credit and risk management purposes. These collections of information would also assist an SBS Dealer in determining whether it would be reasonable to rely on various representations from a counterparty and evaluating the risks of trading with that counterparty. The information would also assist the CCO in determining that the SBS Entity had policies and procedures reasonably designed to obtain and retain essential facts concerning each known counterparty and to make suitable recommendations to its counterparties. The Commission staff would also use these collections of information in its examination and oversight program.

4. Fair and Balanced Communications

This collection of information concerning the risks of a security-based swap would assist an SBS Entity in communicating with counterparties in a fair and balanced manner. It would also assist an SBS Dealer in making suitable recommendations to counterparties, and assist the CCO in ensuring that the SBS Entity is communicating with counterparties in a fair and balanced manner based on principles of fair dealing and good faith. The receipt of information in a fair and balanced manner would assist the counterparty in making more informed investment decisions. The Commission staff would also use this collection of information in its examination and oversight program.

5. Supervision

The collection of information in connection with the establishment, maintenance and enforcement of a supervisory system would assist an SBS Entity in achieving compliance with all applicable securities laws, rules and regulations. The CCO may use these collections of information in discharging his or her duties under proposed Rule 15Fk–1 and determining whether remediation efforts are required. The collection of information would also be useful to supervisors in understanding and carrying out their supervisory responsibilities. The Commission staff would also use this collection of information in its examination and oversight program.

6. SBS Dealers Acting as Advisors to Special Entities

Certain information that would be collected under proposed Rule 15Fh–4(b) would assist an SBS Dealer that is acting as an advisor to a special entity to act in the best interests of the special entity. Other information collected under proposed Rule 15Fh–2(a) could assist an SBS Dealer seeking to establish that it is not acting as an advisor to a special entity. The collections of information would assist a CCO in determining compliance with the provisions of the Exchange Act by the SBS Dealer. The Commission staff would also use this collection of information in its examination and oversight program.

7. SBS Entities Acting as Counterparties to Special Entities

The information that would be collected under Proposed Rule 15Fh–5(a) would assist an SBS Entity in forming a reasonable basis that the special entity has an independent representative that meets the requirements of the rule. Disclosures under proposed Rule 15Fh–5(b) regarding the capacity in which an SBS Dealer is operating would reduce confusion by a special entity as to whether an SBS Dealer would be acting in the interests of the special entity or as a counterparty or principal on the other side of a transaction to the special entity with potentially adverse interests. These collections of information would also assist the CCO in determining compliance with the provisions of the Exchange Act by the SBS Entity. The Commission staff would also use this collection of information in its examination and oversight program.

8. Political Contributions

Proposed Rule 15Fh–6 is intended to deter SBS Dealers from participating, even indirectly, in pay to play practices. The information that would be collected under this proposed rule would assist the SBS Dealer and the Commission in verifying this deterrence. The proposed rule would also assist the chief compliance officer in determining compliance with the provisions of the Exchange Act by an SBS Dealer. The Commission staff would use this collection of information in its examination and oversight program.

9. Chief Compliance Officer

The information that would be collected under proposed Rule 15Fk–1 would assist the CCO in overseeing and administering compliance by the SBS Entity with the provisions of the Exchange Act and the rules and regulations thereunder relating to its business as an SBS Entity. The Commission staff would also use this collection of information in its examination and oversight program.

C. Respondents

The Commission preliminarily believes, based on data obtained from DTCC and conversations with market participants, that approximately 50 entities may fit within the definition of security-based swap dealer,[310] and as many as 10 entities may need to determine whether they come within the definition of major security-based swap participant.[311] The Commission does not expect that more than five entities will be major security-based swap participants. Accordingly, we are using this estimate for the purposes of calculating the reporting burdens. Further, because prior to the Dodd-Frank Act, market participants have not had to distinguish between swaps and security-based swaps for regulatory purposes, the Commission preliminarily believes that the majority of firms that may register as SBS Entities (approximately 35) also will be engaged in the swaps business, and will register with the CFTC as swap dealers or major swap participants. As a result, these entities would also be subject to the business conduct standards applicable to swap dealers and major swap participants. In addition, a broker-dealer may seek to register as an SBS Dealer so that it can enter into security-based swaps as a principal with customers who, among other things, may be holding securities positions and may wish to hedge those positions with security-based swaps. The Commission estimates that approximately 16 registered broker-dealers will also register as SBS Dealers.[312] Finally, the costs of registration and associated regulation may cause an entity that is not otherwise registered with the CFTC or the Commission to structure its business so as to not have to register as an SBS Entity. Consequently, the Commission estimates that fewer than eight firms not otherwise registered with the CFTC or the Commission will register as SBS Entities.

The Commission preliminarily believes, based on information currently

[310] Depending on capital and other requirements for SBS Dealers and how businesses choose to respond to such requirements, the actual number of SBS Dealers may be significantly fewer. *See also* Definitions Release.

[311] *See* Definitions Release.

[312] *Id.*

available to it, that there are and would continue to be approximately 8,500 market participants, of which approximately 1,200 are special entities.[313] Based upon the number of municipal advisors that have registered with the Commission, we estimate there will be approximately 325 third-party independent representatives for special entities.[314] The Commission also estimates that approximately 95% of special entities would use a third-party independent representative in their security-based swap transactions.[315] As a result, for the purposes of calculating reporting burdens, the Commission estimates that the remaining 5% of special entities, or 60 special entities, have employees who currently negotiate on behalf of, and advise, the special entity regarding security-based swap transactions and could likely fulfill the obligations of the independent representative.[316] Consequently, the Commission estimates a total of 385 potential independent representatives.[317] The Commission seeks comment on its estimates as to the number of participants in the security-based swap market that would be required to comply with the business conduct standards pursuant to proposed Rules 15Fh–1 through 15Fh–6 and proposed Rule 15Fk–1.

[313] The estimate is based on available market data for November 2006–September 2010 provided by DTCC. Commission staff has identified approximately 8,567 market participants and approximately 1,200 special entities during this time period, but we are using 8,500 market participants and 1,200 special entities as estimates for these purposes to allow for market participants and special entities that trade less frequently, no longer trade or trade under multiple designations. For the purposes of these estimates, we have included foreign pension plans and 501(c)(3) organizations generally within the category of special entity.

[314] As of April 15, 2011, approximately 307 entities that are registered as municipal advisors with the Commission indicated that they expected to provide advice with respect to swaps. We expect that many of these municipal advisors will also act as independent representatives for other special entities. We also expect that some number of these municipal swap advisors will limit their services to swaps and not security-based swaps. The Commission therefore estimates that approximately 325 municipal swap advisors will act as independent representatives to special entities with respect to security-based swaps, we solicit comments as to the accuracy of this information.

[315] The estimate is based on available market data for November 2006–September 2010 provided by DTCC that indicates approximately 95% of special entities used third-party investment advisers in connection with security-based swap transactions.

[316] *Id.*

[317] The estimate is based on the following calculation: 325 third-party independent representatives + 60 in-house independent representatives

D. Total Annual Reporting and Recordkeeping Burdens

Proposed Rules15Fh–1 to 15Fh–6 are intended to be very similar, to the extent practical, to the business conduct standards that would apply to swap dealers or major swap participants pursuant to the CFTC's proposed business conduct rules.[318] As a result, to the extent the SBS Entity complies with the CFTC's business conduct standards, the Commission expects there would be relatively little additional burden to comply with the requirements under the Commission's proposed business conduct standards.[319] A number of these standards are based on existing FINRA rules and, accordingly, the Commission expects that the estimated 16 SBS Entities that are also registered as broker-dealers are already complying with a number of these requirements. We expect that some SBS Dealers will be banks.[320] Banking agencies, such as the Office of the Comptroller of the Currency, have issued guidance to national banks that engage in financial derivatives transactions regarding business conduct procedures, and, accordingly, we expect that the banks that may register as SBS Entities are also already complying with these requirements.[321] In addition, to the extent that the requirements in proposed Rules 15Fh–3 and 15Fh–5 reflect industry best practices, a respondent that is already following industry best practices would already be collecting much, if not all, of this information, and would have systems in place to collect such information. We recognize that entities may need to modify existing practices and systems to comply with the specific requirements of the proposed rules. Further, while the Commission does not have information as to the number of SBS Entities that have already implemented these best practices, we understand that most of the large SBS Dealers have implemented many of the recommended best practices, and we have considered this information in developing its estimates.

[318] *See* CFTC External Business Conduct Release, *supra,* note 16.

[319] However, because the CFTC has not yet adopted final rules, we are using estimates that assume the CFTC rules are not in place and that the registrants have incurred a de novo burden to comply with the Commission rules.

[320] The estimate is based on available market data for November 2006–September 2010, the Commission estimates that approximately 240 banks executed security-based swaps during this time. The Commission anticipates that some, but not all of these banks will likely register as SBS Dealers.

[321] *See* Risk Management of Financial Derivatives, Office of Comptroller of the Currency Banking Circular No. 277 (Oct. 27, 1993).

In addition, the Commission notes that regulation of the security-based swap markets, including by means of these proposed rules, could impact market participant behavior.

1. Verification of Status

As discussed above, for the purposes of these requirements, the Commission estimates that approximately 55 SBS Entities would be required to verify whether a counterparty is an ECP or special entity, as required by proposed Rule 15Fh–3(a). This requirement is the same for the business conduct standards proposed by the CFTC.[322] The Commission also believes that many SBS Entities would not incur significant additional expense, because they already collect this information as part of their ''due diligence checklists.'' Some respondents may simply update their existing due diligence checklists. The Commission expects that to the extent an SBS Entity does not have an existing mechanism in place to determine the eligibility of the counterparty and whether it is a special entity, the SBS Entity may engage outside counsel to prepare for collecting this information. The Commission conservatively estimates that SBS Entities would need to engage outside counsel to review existing process and develop initial processes, if necessary, at a cost of $400 per hour for an average of 15 hours per respondent, resulting in a total outside initial cost burden of $6,000 for each of these SBS Entities.[323] The Commission preliminarily believes, based on information currently available to it, that there are and would continue to be a total of approximately 8,500 market participants.[324] The Commission estimates that the SBS Entities would take initially 1 hour per transaction to collect the information for an initial aggregate burden of approximately 47,000 hours or an average of approximately 855 hours per SBS Entity.[325]

[322] *See* CFTC External Business Conduct Release, 75 FR at 80658. Accordingly, the SBS Entities that would also be registered as a swap dealer or major swap participant with the CFTC would have verification procedures for engaging in swaps.

[323] The estimate is based on the Commission's experiences in similar matters such as a registrant's determination regarding whether an investor is an accredited investor for the purposes of Regulation D. The same estimate for the hourly cost for legal services was used by the Commission in the proposed consolidated audit trail rule. Consolidated Audit Trail, Exchange Act Release No. 62174, 75 FR 32556 (June 8, 2010).

[324] *See* note 313, *supra,* regarding the estimate for the number of market participants.

[325] The estimate is based on the number of unique SBS Dealer to non-SBS Dealer trading relationships identified in the market data for November 2006–

Continued

2. Disclosures by SBS Entities

The estimates in this paragraph reflect the Commission's experience with burden estimates for similar disclosure requirements and as a result of our discussions with market participants.[326] Pursuant to proposed Rule 15Fh–3(b), (c), and (d), SBS Entities would be required to provide certain disclosures to market participants. It is our understanding that most of the large SBS Dealers already provide their counterparties disclosures similar to those that would be required under proposed Rules 15Fh–3(b) and (c). Given that the material characteristics are generally included in the documentation of a security-based swap, such as the master agreement, credit support annex, trade confirmation or other documents, the Commission does not anticipate that any additional burden will be required for the disclosure of material characteristics.[327] For other required disclosures relating to material risks, incentives or conflicts of interest, the Commission anticipates that many SBS Entities would revise existing disclosures and tailor them to this context. For example, many SBS Dealers provide a statement of potential risks related to investing in certain security-based swaps in documents describing such instruments.

In some cases, such as disclosures about the daily mark for a cleared security-based swap, the proposed rules contemplate receiving the core valuation information from an external source with only limited administrative handling expected to be necessary to pass the disclosure to counterparties. For uncleared, security-based swaps, the Commission preliminarily believes that the SBS Entities may need to slightly modify the models used for calculating variation margin to calculate the daily mark required by proposed Rule 15Fh–3(c) for uncleared security-based swaps. The Commission does not currently have an expectation of the proportion of security-based swaps that will be cleared as a result of the Dodd-Frank Act and the rules promulgated thereunder.[328] Existing accounting standards and other disclosure requirements under the Exchange Act, such as FASB Accounting Standards Codification Topic 820, Fair Value Measurements and Disclosures, or Item 305 of Regulation S–K, already require the description of the methodology and assumptions with respect to models used in the derivatives context.

The Commission preliminarily believes that SBS Entities will use internal staff to revise existing disclosures to comply with proposed Rules 15Fh–3(b) and (c) and assist in preparing language to comply with proposed Rule 15Fh–3(d) regarding the clearing options available for the particular security-based swap. The Commission also anticipates that disclosures of material risks for similar types and classes of security-based swaps would be similar and subsequent transactions will require much less time to review and revise applicable disclosures.

Because the Commission is unaware of any definitive data regarding how many SBS Entities currently provide these disclosures, the Commission has conservatively estimated that all SBS Entities would require additional time to provide at least some of these disclosures. The Commission estimates that there has been an average of approximately 400,000 new security-based swap contracts traded annually between an SBS Dealer and a counterparty that is not an SBS Dealer, and these security-based swaps would likely require these disclosures.[329] In view of the factors discussed in the Cost-Benefit Analysis section and elsewhere in this release, the Commission recognizes that the time required to develop an infrastructure to provide these disclosures would vary significantly depending on, among other factors, the complexity and nature of the SBS Entity's security-based swap business, its market risk management activities, its existing disclosure practices, and other applicable regulatory requirements. Under the proposed rule, SBS Entities could use, where appropriate, standardized formats to make certain required disclosures of material information to their counterparties, and to include such disclosures in a master or other written agreement between the parties, if agreed by the parties. The Commission recognizes that some disclosures particularized to the transaction would likely be necessary to adequately meet all of an SBS Entity's disclosure obligations. The Commission also expects that because the reporting burden generally would require refining or revising existing disclosure processes, that the disclosures would be prepared internally.

As a result, the Commission estimates that SBS Entities would initially require three persons from trading and structuring, three persons from legal, two persons from operations, and four persons from compliance, for 100 hours each. This team would analyze the changes necessary to comply with the new disclosure requirements, including the redesign of current compliance systems if necessary, and the creation of functional requirements and system specifications for any systems development work that may be needed to automate the disclosure process.[330] This would amount to an initial cost burden of 66,000 hours.[331] Following the initial analysis and specifications development effort, the Commission estimates that half of these persons would be required to spend 20 hours annually to re-evaluate and modify the disclosures and system requirements as necessary, amounting to an ongoing annual burden of 6,600 hours.[332] The Commission also estimates that to create and maintain an information technology infrastructure to the specifications identified by the team above, each SBS Entity would require, on average, eight full-time persons for six months of systems development, programming and testing, amounting to a total initial

September 2010 provided by DTCC. This estimate includes each SBS Dealer affiliate with the same non-SBS Dealer entity as a separate trading relationship. As a result, this number may overestimate the actual number of trading relationships with non-SBS Dealers.

[326] *See* Disclosure of Accounting Policies for Derivative Financial Instruments and Derivative Commodity Instruments and Disclosure of Quantitative and Qualitative Information about Market Risk Inherent in Derivative Financial Instruments, Other Financial Instruments and Derivative Commodity Instruments, Securities Act Release No. 7386 (Jan. 31, 1997), 62 FR 6044 (Feb. 10, 1997).

[327] To the extent that disclosure of material characteristics is initially provided orally, the additional burden of providing a written version of the disclosure at or before delivery of the trade confirmation will be considered in connection with the overall reporting and recordkeeping burdens of the SBS Entity. *See* notes 160 and 305, *supra*.

[328] The Commission has obtained data from DTCC on new and assigned CDS trades in U.S. dollars during the month of November 2010 for ICE Trust. Cleared CDS trades were 5.24% by notional amount of all new or assigned single name trades, and 20.69% by notional amount of all new or assigned index trades.

[329] Available market data for November 2006–September 2010 provided by DTCC indicated approximately 4,000,000 transactions between SBS Entities and non-SBS Entities during that time period. Of these, approximately 40% (or 1,600,000) are new trades; the remaining are assignments and terminations, which may not require the same level of disclosure. To obtain an approximate average annual number of transactions, we divided 1,600,000 transactions by 47 (months) and multiplied by 12 and rounded to 400,000.

[330] Some SBS Entities may choose to utilize in-house counsel to review, revise and prepare these disclosures. The Commission does not currently have an estimate as to the proportion of SBS Entities that would use outside counsel, but has considered the alternative in developing its estimates.

[331] The estimate is based on the following calculation: (55 SBS Entities) × (12 persons) × (100 hours).

[332] The estimate is based on the following calculation: (55 SBS Entities) × (6 persons) × (20 hours).

burden of 440,000 hours.[333] The Commission further estimates that maintenance of the system will require two full-time persons for a total of ongoing burden of 220,000 hours annually.[334]

3. Know Your Counterparty and Recommendations

Proposed Rules 15Fh–3(e) and (f) are based on existing FINRA rules.[335] However, the ''know your counterparty'' requirement in proposed Rule 15Fh–3(e) would also require an SBS Dealer to consider its credit and operational risk management policies in determining the information to collect from its counterparty. If the SBS Dealer is a counterparty to a special entity, proposed Rule 15Fh–3(e) would also require the SBS Dealer to obtain and retain a record of the relevant background of the independent representative.[336] The Commission expects that given the institutional nature of the participants involved in security-based swaps, most SBS Dealers would obtain the representations in proposed Rule 15Fh–3(f)(2) or proposed Rule 15Fh–3(f)(3)(ii) to comply with proposed Rule 15Fh–3(f).

In addition, many SBS Dealers already collect this type of information in connection with their due diligence checklists. Banking agencies have also issued guidance to national banks regarding similar procedures.[337] However, the Commission does not currently have an estimate of how many SBS Entities are expected to be subject to this banking guidance.[338] The Commission also preliminarily believes that other SBS Dealers generally already create and maintain these records under prudent recordkeeping procedures. However, as is true in the broker-dealer context, because each SBS Dealer is likely to tailor its procedures to its particular corporate culture and existing policies and procedures, we expect that the practices of SBS Dealers in complying with the proposed rule would vary greatly. In addition, the SBS Dealer may collect the information required at various points in the relationship with its counterparty, including at the establishment of the account, periodic updates, or with the execution of each security-based swap. The Commission has considered all of the foregoing in preparing the estimate regarding reporting burdens.

The estimates in this paragraph reflect the Commission's experience with and burden estimates for similar collections of information, as well as our discussions with market participants.[339] The Commission preliminarily believes that most SBS Dealers currently have policies and procedures in place for knowing their counterparties, either through due diligence checklists or for compliance with FINRA standards. The Commission estimates that, on average, these records would require each SBS Dealer to spend approximately three to five hours initially to review existing policies and procedures and document the collection of information necessary to comply with its ''know your counterparty'' obligations for a total initial burden of 250 hours.[340] The Commission also estimates an SBS Dealer would spend an average of approximately 30 additional minutes each year per unique non-SBS Dealer counterparty to assess whether the SBS Dealer is in compliance with the requirements to make suitable recommendations, a total ongoing burden of approximately 23,500 hours annually,[341] or an average of 470 hours annually per SBS Dealer.[342] The Commission also believes that many SBS Dealers will not incur significant additional expense because they already collect this information as part of current practices.[343]

The Commission expects that much of the information relating to the background and experience of the independent representative is already included in the marketing materials of the third-party independent representatives and as a result, would only require a minimal amount of time for the independent representative to provide to the special entity and/or SBS Dealer.

4. Fair and Balanced Communications

Proposed Rule 15Fh–3(g)(3) would require that statements of potential opportunities must be balanced by an equally detailed statement of corresponding risks. In addition, we note that some risk disclosures would already be addressed in proposed Rule 15Fh–3(b) discussed above, which would require an SBS Entity to disclose the material risks of the transaction, the burden for which is discussed above. We expect this discussion of material risks of the transaction to be included in the documentation for the security-based swap. Furthermore, proposed Rule 15Fh–3(g) is based on existing FINRA rules so for the 16 registered broker-dealers that are expected to register as SBS Entities, they already would be subject to similar requirements with respect to other securities pursuant to NASD Rules 3010 and 3012. In addition, for the SBS Entity's own risk management purposes, currently for certain products, its existing marketing materials already include a general statement of risks that accompany a general description of the security-based swap. For the remaining 39 SBS Entities, the Commission assumes that SBS Entities would likely send their existing marketing materials to outside counsel for review and comment. As a result, the Commission estimates that each SBS Entity will likely incur $6,000 in legal costs, or $234,000 in the aggregate initial burden, to draft or review statements of potential opportunities and corresponding risks in the marketing materials for equity swaps, credit default swaps and total return swaps, which comprise the vast majority of security-based swaps.[344] For more bespoke transactions, the cost of outside counsel to review the marketing materials will depend on the complexity, novelty and nature of the product, but the Commission would expect a much longer review for more novel products.

[333] The estimate is based on the following calculation: (55 SBS Entities) × (4 persons) × (2,000 hours).

[334] The estimate is based on the following calculation: (55 SBS Entities) × (2 persons) × (2,000 hours).

[335] *See* note 26, *supra,* regarding FINRA Rules 2090 and 2111 (effective July 9, 2012).

[336] To the extent that an SBS Dealer is a registered broker or dealer, it should already have processes and procedures in place to comply with similar requirements with respect to other securities. *See* FINRA Rule 2090 (requiring broker-dealers to know and retain essential facts, ''concerning every customer and concerning the authority of each person acting on behalf of such customer'').

[337] *See* Risk Management of Financial Derivatives, Office of Comptroller of the Currency Banking Circular No. 277 (Oct. 27, 1993).

[338] *See* note 320, *supra,* regarding banks engaged in security-based swaps.

[339] *See* Books and Records Requirements for Brokers and Dealers under the Securities Exchange Act of 1934, Exchange Act Release No. 44992 (Oct. 26, 2001), 67 FR 58284 (Nov. 2, 2001).

[340] The Commission is conservatively using the high end of the range for the purposes of estimating these reporting burdens.

[341] The estimate is based on the following calculation: (47,000 transactions with non-SBS Dealer counterparties) × 30 minutes/60 minutes. *See* note 325 regarding the number of transactions with non-SBS Dealer counterparties.

[342] To the extent that the SBS Dealer is unfamiliar with the counterparty, the Commission would expect a greater time burden and as an SBS Dealer becomes more familiar with the particular counterparty, the Commission would expect a lesser time burden. As a result, we use 30 minutes as an average estimate.

[343] *See* Sections IV.C and D.

[344] The Commission estimates the review of the marketing materials for each of these categories would require 5 hours of outside counsel time at a cost of $400 per hour. This estimate also assumes that each SBS Entity engages in all three categories of transactions.

5. Supervision

Proposed Rule 15Fh–3(h) is based on existing FINRA rules so to the extent that an SBS Entity is a registered broker-dealer, we expect that the SBS Entity would already be complying with similar requirements with respect to other securities pursuant to NASD Rules 3010 and 3012.[345] Broker-dealers presently maintain lists of principals or branch managers responsible for supervising each of their offices pursuant to NASD 3010 and 3012 and other applicable SRO rules, and that they also have lists of associated persons who operate out of each office location. These rules currently require a broker-dealer to have supervisory systems in place that include similar obligations to achieve compliance with applicable securities laws, regulations and rules.[346] Banking agencies have also issued guidance to national banks regarding similar procedures.[347]

The estimates in this paragraph reflect the foregoing information and the Commission's experience with and burden estimates for similar collections of information. While each of the policies and procedures required by proposed Rule 15Fh–3(h) will vary in exact cost, the Commission estimates that such policies and procedures would require an average of 210 hours per respondent per policy and procedure to prepare and implement,[348] or an average of 1,890 burden hours per SBS Entity, resulting in an aggregate initial burden of 103,950 hours.[349] The Commission also expects that many SBS Entities would engage outside counsel to assist them in preparing for the collection of information required under this rule at a rate of $400 per hour [350] for an average of 450 hours per respondent for a minimum of nine policies and procedures,[351] resulting in an outside initial cost burden of $180,000 per respondent or an aggregate initial cost of $9,900,000. Once these policies and procedures are established, the Commission estimates, that on average each SBS Entity would spend approximately 540 hours (approximately 60 hours per policy and procedure [352]) each year to maintain these policies and procedures, yielding a total ongoing annual burden of approximately 29,700 hours (55 SBS Entities × 540 hours). Based on the Commission's experience in other contexts, the Commission preliminarily believes that this maintenance of policies and procedures will be conducted internally.[353]

6. SBS Dealers Acting as Advisors to Special Entities

Consistent with the requirements of proposed Rule 15Fh–2(a), parties have generally included representations in standard security-based swap documentation that both counterparties are acting as principals and that the counterparty is not relying on any communication from the SBS Dealer as investment advice. Under proposed Rule 15Fh–5, the SBS Dealer is required to have a reasonable basis to believe that the special entity has a qualified independent representative. The reporting burdens for this reasonable basis belief requirement are analyzed below in connection with the discussion of reporting burdens of ''SBS Entities Acting as Counterparties to Special Entities.'' In addition, we believe that parties are likely to provide the necessary representations and disclosures under proposed Rule 15Fh–2(a) so that the SBS Dealer would not fall within the definition of acting as an advisor, particularly for transactions in which the SBS Dealer is the counterparty to the transaction. Accordingly, we believe for these transactions that it is unlikely the SBS Dealer will be required to collect the information to determine the best interests of the special entity. Based on consultations by the Commission staff with market participants, the Commission preliminarily believes that the 50 SBS Dealers would each need approximately five hours to revise the existing representations to comply with this requirement or an aggregate initial burden of 250 hours. The Commission preliminarily believes that once each of the SBS Dealers has revised the language of the representation, such language would become part of the standard security-based swap documentation and, accordingly, there would be no further ongoing associated burden.

For transactions in which the SBS Dealer is not the counterparty and chooses to act as an advisor, the Commission estimates that an SBS Entity would require approximately 20 hours to collect the requisite information from each special entity for an aggregate initial burden of approximately 4,000 hours.[354]

7. SBS Entities Acting as Counterparties to Special Entities

When a special entity is a counterparty to a security-based swap, proposed Rule 15Fh–5 would require that an SBS Entity must have a reasonable basis for believing that the special entity has an independent representative that: (1) Has sufficient knowledge to evaluate the transaction and risks; (2) is not subject to a statutory disqualification; (3) undertakes a duty to act in the best interests of the special entity; (4) makes appropriate and timely disclosures to the special entity of material information concerning the security-based swap; (5) will provide written representations to the special entity regarding fair pricing and the appropriateness of the security-based swap; (6) in the case of employee benefit plans subject to ERISA, is a fiduciary as defined in section 3(21) of that Act (29 U.S.C. 1002(21)); and (7) in the case of a special entity defined in §§ 240.15Fh–2(e)(2) or (4) and a non-employee, third-party independent representative, is a person that is subject to rules of the Commission, the CFTC, or an SRO subject to the jurisdiction of the Commission or the CFTC, that prohibit it from engaging in specified activities if certain political contributions have been made. The Commission expects that written representations are likely to form much of the basis of the SBS Entity's belief as to the qualifications of the independent representative. The Commission also expects that in connection with its own prudent business practices the SBS Entity would confirm the status of whether the independent representative is subject to statutory disqualifications by a search on BrokerCheck or any other database available to it.[355] Furthermore, the SBS Entity is likely to have procedures in place to determine whether any of its associated persons are subject to a statutory disqualification, which it

[345] *See* Section II.C.6.

[346] *See* NASD Rule 3010.

[347] *See* Risk Management of Financial Derivatives, Office of Comptroller of the Currency Banking Circular No. 277 (Oct. 27, 1993).

[348] *See* SDR Registration Release.

[349] The estimate is based on the following calculation: (210 hours) × (9 policies and procedures) × (55 SBS Entities).

[350] *See* SDR Registration Release. The same estimate for the hourly cost for legal services was used by the Commission in the proposed consolidated audit trail rule. Consolidated Audit Trail, Exchange Act Release No. 62174 (May 26, 2010), 75 FR 32556 (June 8, 2010).

[351] *See* SDR Registration Release.

[352] *Id.*

[353] *Id.*

[354] The estimate is based on available market data for November 2006–September 2010 provided by DTCC that indicates 201 trading relationships between SBS Dealers and special entities that do not have a third-party investment adviser. For the purposes of estimating these reporting burdens, we approximate the number of trading relationships between SBS Dealers and special entities at 200. This estimate includes the following calculation: (20 hours) × (200 trading relationships).

[355] *See* Section II.D.5.c.ii and solicitation for comments thereunder.

could likely use or modify.[356] The Commission preliminarily believes that the burden to determine that the independent representative is independent of the SBS Entity would likely depend on the size of the independent representative, the size of the SBS Entity and the volume of transactions in which each is engaged. The estimates in this paragraph reflect the Commission staff's discussions with market participants. The Commission preliminarily believes that each SBS Entity initially would require written representations regarding each independent representative, but would only require updates with respect to the representations in subsequent dealings. The Commission does not currently have data regarding the number of independent representatives with which each SBS Entity interacts. As a result, for the purposes of these estimates the Commission has assumed that each SBS Entity would interact with approximately 150 third-party independent representatives and 30 in-house independent representatives, and that each SBS Entity, on average, would initially require approximately 15 hours per independent representative to collect the information necessary to comply with this requirement, or an aggregate initial burden of 148,500 hours (15 hours × 180 independent representatives × 55 SBS Entities). In addition, the Commission estimates that subsequent transactions with third-party, non-employee independent representatives would likely require an average of approximately 10 hours annually to update these representations and verifications or an aggregate initial burden of 82,500 hours (10 hours × 150 independent representatives × 55 SBS Entities). The Commission solicits comments as to the accuracy of this information.

The collection of information by the SBS Entity, would also impose some burden on the independent representatives to collect the information and provide the information to the SBS Entity and/or the special entities. The estimates in this paragraph reflect the Commission staff's discussions with market participants. The Commission expects that the main burden for the independent representatives is likely providing the representations on which the SBS Entity can rely. As a result, the Commission conservatively estimates that the reporting burden will likely be approximately 1 hour for each transaction of an annual average of 8,300 transactions [357] for the estimated 60 in-house independent representatives, equivalent to an average burden of approximately 138 hours per year per in-house independent representative.

With respect to third-party independent representatives, the Commission does not expect that any additional information would need to be collected pursuant to proposed Rule 15Fh–5(a)(6) because the independent representative would have undertaken this analysis under ERISA to confirm that it is subject to the fiduciary standards of ERISA and to determine whether it falls within one of the ''prohibited transaction exemptions'' promulgated by the Department of Labor. Similarly, under proposed Rule 15Fh–5(a)(7), the independent representative would have already determined whether it is subject to pay to play prohibitions to comply with those prohibitions. With respect to the transaction-specific requirements in proposed Rule 15Fh-5(a)(4) to (5), the Commission preliminarily believes that the reporting burden for the independent representative would likely consist of providing written representations to the SBS Entity and/or the special entity it represents. The Commission preliminarily believes that the burden on the independent representative to determine that it is independent of the SBS Entity would likely depend on the size of the independent representative, the size of the SBS Entity and the volume of transactions in which each is engaged. The estimates in this paragraph reflect the foregoing and the Commission staff's discussions with market participants. As a result, the Commission conservatively estimates that the reporting burden would likely average approximately 20 hours for each of the approximately 1,000 unique trading relationships between SBS Entities and special entities using a third-party independent representative for an aggregate initial burden of 20,000 hours or an average of approximately 62 hours for each of the estimated 325 third party independent representatives.[358]

8. Political Contributions

As noted above, the Commission estimates there will be approximately 50 SBS Dealers and has conservatively estimated that all of them will provide, or will seek to provide, security-based swap services to municipal entities. In addition, SBS Dealers' covered associates would also need to collect and provide the information required by the proposed rule to the SBS Dealer. The estimates herein take into account the burden of the covered associates and the SBS Dealers. These estimates reflect the Commission's experience with and burden estimates for similar requirements, as well as our discussions with market participants.[359] The Commission estimates that it would take, on average, approximately 185 hours per SBS Dealer and a total initial burden of 9,250 hours [360] to collect the information regarding the political contributions of the SBS Dealers and their covered associates.

Additionally, we expect some SBS Dealers may incur one-time costs to establish or enhance current systems to assist in their compliance with the proposed rule. These costs would vary widely among firms. Some SBS Dealers may not incur any system costs if they determine a system is unnecessary due to the limited number of employees they have or the limited number of municipal entity counterparties they have. Like other large firms, SBS Dealers likely already have devoted significant resources to automating compliance and reporting with existing applicable prohibitions on certain political contributions, and the proposed rule could cause them to enhance their existing systems that had originally been designed to comply with MSRB Rules G–37 and G–38 and Advisers Act Rule 206(4)–5. We believe that the cost of enhancing such a system could range from the tens of thousands of dollars for simple reporting systems, to hundreds of thousands of dollars for complex systems.[361]

9. Chief Compliance Officer

Under proposed Rule 15Fk–1, an SBS Entity's CCO would be responsible for, among other things, establishing

[356] *See* Section 15F(b)(6) of the Exchange Act, Public Law 111–203, 124 Stat. 1376, 1785 (to be codified at 15 U.S.C. 78o–10(b)(6)).

[357] The estimate is based on available market data for November 2006–September 2010 provided by DTCC that indicates 32,521 transactions during that time that involve special entities trading without an investment adviser. To obtain an approximate annual average number of transactions based on this data, we divided 32,521 transactions by 47 months and multiplied by 12 months and rounded to 8,300.

[358] The estimate is based on available market data for November 2006–September 2010 provided by DTCC that indicates approximately 1,000 unique trading relationships between SBS Entities and special entities using a third-party investment adviser during that time.

[359] *See* Political Contributions by Certain Investment Advisers, Investment Advisers Act Release No. 2910 (July 1, 2010), 75 FR 41018, 41061–41065 (July 14, 2010).

[360] The estimate is based on the following calculation: (185 hours × 50 SBS Dealers).

[361] *See* Political Contributions by Certain Investment Advisers, note 33, *supra* (adopting Advisers Act Rule 206(4)–5).).

policies and procedures reasonably designed: to ensure compliance by the SBS Entity with the Exchange Act and the rules and regulations thereunder relating to its business as an SBS Entity; to remediate promptly noncompliance issues identified by the CCO; and for prompt handling, management response, remediation, retesting, and resolution of noncompliance issues. As described above, the Commission estimates that a total of 55 respondents would be subject to this requirement. Based on the Commission's experience with and burden estimates for similar collections of information,[362] it estimates that on average the establishment and administration of the policies and procedures required under proposed Rule 15Fk–1 would require 630 hours to create and 180 hours to administer per year per respondent, for a total burden of 34,650 hours initially and 9,900 hours per year on average, on an ongoing basis. The Commission estimates that a total of $60,000 in outside legal costs will be incurred as a result of this burden per respondent, for a total initial outside cost burden of $3,300,000.[363]

A CCO would also be required under proposed Rule 15Fk–1 to prepare and submit annual compliance reports to the Commission and the SBS Entity's board of directors. Based upon the Commission's estimates for similar annual reviews by CCOs, the Commission estimates that these reports would require on average 92 hours per respondent per year.[364] Thus, the Commission estimates an ongoing annual burden of 5,060 hours.[365] Because the report will be submitted by an internal CCO, the Commission does not expect any external costs associated therewith. The Commission solicits comments as to the accuracy of this information and these estimates.

[362] *See* SDR Registration Release (citing Regulation NMS: Final Rules and Amendments to Joint Industry Plans, Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496 (June 29, 2005)); Registration and Regulation of Security-Based Swap Execution Facilities, Exchange Act Release No. 63825 (Feb. 2, 2011), 76 FR 10948 (Feb. 28, 2011).

[363] This figure is the result of an estimated $400 per hour cost for outside legal services times 150 hours for 3 policies and procedures for 55 respondents. *See* SDR Registration Release.

[364] *See* Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2107, 68 FR 7038 (Feb. 11, 2003); SDR Registration Release; Registration and Regulation of Security-Based Swap Execution Facilities, Exchange Act Release No. 63825 (Feb. 2, 2011), 76 FR 10948 (Feb. 28, 2011).

[365] The estimate is based on the following calculation: (92 hours) × (55 SBS Dealers).

E. Collection of Information Is Mandatory

The collections of information relating to verification of the status of the counterparty would be mandatory for all SBS Entities. The collections of information relating to disclosures by SBS Entities would be mandatory for all SBS Entities. The collections of information relating to knowing the counterparty and for suitability obligations would be mandatory for all SBS Dealers. The collection of information relating to fair and balanced communications would be mandatory for all SBS Entities. The collections of information relating to supervision would be mandatory for all SBS Entities. The collection of information relating to acting as an advisor to a special entity would be mandatory for all SBS Dealers. The collection of information relating to SBS Entities acting as counterparties to special entities would be mandatory for all SBS Entities. The collection of information relating to pay to play restrictions would be mandatory for all SBS Dealers. The collection of information relating to CCO obligations would be mandatory for all SBS Entities.

F. Responses to Collection of Information Will Be Kept Confidential

The Commission preliminarily believes the collection of information pursuant to proposed Rules 15Fh–3 to 15Fh–6 and 15Fk–1 would not be publicly available. To the extent that the Commission receives confidential information pursuant to this collection of information, such information would be kept confidential, subject to the provisions of the Freedom of Information Act (''FOIA'').

G. Request for Comment

We invite comment on these estimates. Pursuant to 44 U.S.C. 3506(c)(2)(B), we request comment in order to:

- Evaluate whether the proposed collection of information is necessary for the performance of our functions, including whether the information will have practical utility;
- Evaluate the accuracy of our estimates of the burdens of the proposed collections of information;
- Determine whether there are ways to enhance the quality, utility and clarity of the information to be collected; and
- Evaluate whether there are ways to minimize the burden of the collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements of the proposed rules should direct them to (1) the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503; and (2) Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–1090, with reference to File No. S7–XX–XX. Requests for materials submitted to OMB by the Commission with regard to this collection of information should be in writing, with reference to File No. S7–XX–XX, and be submitted to the Securities and Exchange Commission, Office of Investor Education and Advocacy, 100 F Street, NE, Washington, DC 20549–0213. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, so a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication.

V. Cost-Benefit Analysis

The Commission is sensitive to the costs and benefits imposed by its rules. The proposed rulemaking is intended to implement the requirements under Section 15F(h) of the Exchange Act as added by Section 764(a) of the Dodd-Frank Act concerning external business conduct standards for SBS Entities. Section 15F of the Exchange Act provides the Commission with both mandatory and discretionary rulemaking authority to impose business conduct requirements on SBS Entities in their dealings with counterparties, including special entities. In addition to the reporting burdens associated with certain of the proposed rules described in Section IV.D above, the discussion below focuses on other potential costs and benefits of the decisions made by the Commission, together with the other agencies, to fulfill the mandates of the Dodd-Frank Act within its permitted discretion. As part of this analysis, we do not consider the costs and benefits of the mandates of the Dodd-Frank Act itself.[366]

As discussed in Section I.C.3, in addition to business conduct requirements expressly addressed by Title VII of the Dodd-Frank Act, we are proposing for comment certain other

[366] The Paperwork Reduction Act analysis in Section IV.D., however, describes collections of information under the proposed rules, regardless of whether the rules are proposed pursuant to mandatory or discretionary authority.

business conduct requirements for SBS Dealers that we preliminarily believe further the principles that underlie the Dodd-Frank Act. These include details of the daily mark for uncleared security-based swaps; certain disclosures related to the provision of a daily mark for uncleared security-based swaps; certain ''know your counterparty'' and suitability obligations for SBS Dealers; provisions intended to prevent SBS Dealers and independent representatives of special entities from engaging in certain ''pay to play'' activities; certain minimum requirements for the annual compliance reports to be provided by the CCO; and a requirement of board approval for decisions related to compensation or removal of the CCO.

A. Costs and Benefits of Rules Relating to Daily Mark

Section 15F(h)(3)(B)(iii) of the Exchange Act requires the Commission to adopt rules requiring the disclosure to counterparties of the daily mark. For cleared security-based swaps, upon request from the counterparty, the rule must require an SBS Entity to provide the daily mark, which under proposed Rule 15Fh–3(c) would be the daily end of day settlement price received from the appropriate clearing agency. For uncleared security-based swaps, the rules must require the SBS Entity to provide the daily mark. However, the method for computing the daily mark is not provided in the statute. Proposed Rule 15h–3(c)(2) would require that the SBS Entity meet this disclosure requirement for any uncleared security-based swap by providing the midpoint between the bid and offer, or the calculated equivalent thereof, as of the close of business unless the parties agree in writing otherwise. The SBS Entity would also be required to disclose the data sources and describe the methodology and assumptions used to prepare the daily mark. The provision of a daily mark along with the data sources, assumptions, and methodology used in its preparation, should provide a useful reference point for the counterparty.

In the absence of current valid quotes from which to calculate the mid-market price, a model would be used to estimate the daily mark. When markets are illiquid the mark provided by a model may provide a better estimate of the value of the security-based swap than a stale market price. However, the mark would only be as good as the model from which it is derived and security-based swap market participants would need to evaluate the data sources, methodology and assumptions employed to fully appreciate model-derived daily marks. Further, the model price would not necessarily reflect the price at which the security-based swap could be executed. While the market-wide disclosure of these marks could raise the quality of the model-derived daily marks, there would likely be variability in the models and data sources, methodology and assumptions, leading to different daily marks being established for similar security-based swaps. As a result, security-based swap market participants that consider the daily mark as one indicator in the reporting of their positions might present different values for similar security-based swap market positions on their respective balance sheets.

Potential limitations of a model-based daily mark notwithstanding, counterparties to SBS Entities will benefit from a good faith effort by SBS Entities to value uncleared SBS transactions. Daily marks will allow counterparties to better understand their financial relationships with SBS Entities and provide a frequently updated basis for variation margin requirements. And although daily marks would not necessarily represent a price at which at a counterparty could enter or exit the position, it would provide a meaningful reference point against which to assess, among other things, the calculation of variation margin for a security-based swap or portfolio of security-based swaps, and otherwise inform the counterparty's understanding of its financial relationship with the SBS Entity. Moreover, because SBS Entities would be required to provide the same valuation to all of their counterparties, and because counterparties could interact with multiple SBS Entities, counterparties would be assured of equal treatment and would have the ability to observe when valuations differ among SBS Entities.

The costs to SBS Entities of providing daily marks should be minimal other than the disclosure burdens previously described. Proper risk management at SBS Entities entails assessing end-of-day values. In this respect, an SBS Entity would simply be passing along a valuation similar to one that the SBS Entity currently performs, even without a rule requiring disclosure.

B. Costs and Benefits of Rules Concerning Verification of Counterparty Status, Knowing Your Counterparty, and Recommendations of Security-Based Swaps or Trading Strategies

Proposed Rule 15Fh–3(a)(2) would require an SBS Entity to verify whether a counterparty is a special entity before entering into a security-based swap with that counterparty. Although the Dodd-Frank Act does not require an SBS Entity to verify whether a counterparty is a special entity, we are mindful that Congress established a set of additional provisions addressing solely the interactions between SBS Entities and special entities in connection with security-based swaps, and we preliminarily believe that such verification would help to ensure that these counterparties do, in fact, receive the benefit of such provisions, as well as our proposed rules thereunder. The verification requirement would not apply if an SBS Entity is entering into a transaction with a special entity on a SEF or an exchange and for which the SBS Entity does not know the identity of the counterparty.

Proposed Rule 15Fh–3(e) would establish a ''know your counterparty'' requirement for SBS Dealers that would require an SBS Dealer to obtain and retain a record of essential facts regarding a counterparty that are necessary for conducting business with such a counterparty. The ''essential facts concerning a counterparty'' are those required to (1) comply with applicable laws, regulations and rules; (2) implement the SBS Dealer's credit and operational risk management policies in connection with transactions entered into with such counterparty; (3) information regarding the authority of any person acting for such counterparty; and (4) if the counterparty is a special entity, such background information regarding the independent representative as the SBS Dealer reasonably deems appropriate. To the extent that the SBS Dealer does not already collect and retain this information as a part of its normal course of business, this requirement would increase the cost to the SBS Dealer of entering into security-based swaps. The increased cost is likely to be reflected in the terms offered to the counterparty. To the extent that an SBS Dealer is unable to recover the added costs from the counterparty, the rule would provide a disincentive for recommending bespoke transactions.

Proposed Rule 15Fh–3(f) would require that the SBS Dealer have a reasonable basis to believe: (i) Based on reasonable diligence, that the recommended security-based swap or trading strategy involving a security-based swap is suitable for at least some counterparties; and (ii) that a recommended security-based swap or trading strategy is suitable for the counterparty based on relevant information the SBS Dealer has or has obtained regarding the counterparty, including the counterparty's investment

profile, trading objectives and its potential to absorb losses associated with the recommended security-based swap or trading strategy. This requirement could potentially benefit counterparties by requiring that an SBS Dealer recommend only suitable security-based swaps or trading strategies. While the proposed requirement that an SBS Dealer know essential facts regarding its counterparties to evaluate the suitability of trades for its counterparties would be a responsibility that would go beyond disclosure of material risks and so, could increase the costs to SBS Dealers in transacting with counterparties, particularly for counterparties with which an SBS Dealer has had no prior transactions, we anticipate that SBS Dealers would seek to rely on proposed Rule 15Fh–3(f)(2), which would allow an SBS Dealer to fulfill its obligations with respect to a particular counterparty if (1) The SBS Dealer reasonably determined that the counterparty, or the counterparty's agent to whom the counterparty has delegated decision making authority, is capable of exercising independent judgment, (2) the counterparty or agent affirmatively represented that it is exercising independent judgment in evaluating the recommendations, and (3) the SBS Dealer disclosed that it was acting in its capacity as a counterparty and was not undertaking to assess the suitability of the security-based swap or trading strategy for the counterparty. This provision would benefit counterparties by helping to ensure that they are in fact capable of exercising independent judgment in evaluating security-based swaps and trading strategies.

Some SBS Dealers may already have an obligation to make suitable recommendations of a security-based swap or trading strategy through other regulatory regimes to which they may be subject. For example, FINRA imposes a suitability requirement on recommendations by broker-dealers. Municipal securities dealers also have a suitability obligation when recommending municipal securities transactions to a customer. Federally regulated banks have a suitability obligation as well when acting as broker-dealers in connection with the purchase or sale of government securities. Proposed rule 15Fh–3(f) would subject SBS Dealers to similar suitability requirements. In addition, the suitability obligation would not apply to an SBS Dealer in dealings with an SBS Entity, swap dealer, or major swap participant.

One potential concern is that relatively unsophisticated counterparties would not qualify for the exception that would be provided by proposed Rule 15Fh–3(f)(2) and that the costs to SBS Dealers associated with determining suitability may be sufficiently large or difficult to assess given that SBS Dealers would choose not to engage in over-the-counter security-based swaps with certain counterparties, particularly less sophisticated counterparties. However, our analysis of the credit default swaps market over the four years prior to the passage of the Dodd-Frank Act finds that non-institutional counterparties generally have third-party representation. In particular, as previously noted, more than 95% of all trades by special entities are executed through third party investment advisers, and the remaining trades are predominantly by large, well known endowments and pension plans who would generally be characterized as sophisticated security-based swap market participants. Moreover, all counterparties may nonetheless be able to enter into security-based swaps that are traded on a registered national securities exchange, even if they are unable to find a SBS Dealer to enter a bespoke security-based swap.

C. Costs and Benefits of Rules Relating to Political Contributions by Certain SBS Entities and Independent Representatives of Special Entities

Proposed Rule 15Fh–6 would prohibit SBS Dealers from engaging in security-based swap transactions with a ''municipal entity'' if certain political contributions have been made to officials of such entities. The proposed rule is similar to rules adopted by the MSRB in Rule G–37: Political Contributions and Prohibitions on Municipal Securities Business and G–38: Solicitation of Municipal Securities Business, and by the Commission in Advisers Act Rule 206(4)–5: Political Contributions by Certain Investment Advisers.[367]

Proposed Rule 15Fh–5(a)(7) would include in the list of qualifications for a ''qualified independent representative'' that the independent representative is subject to rules of the Commission, the CFTC, or a self-regulatory organization subject to the jurisdiction of the Commission or the CFTC, that prohibit it from engaging in specified activities if certain political contributions have been made. The proposed rule would not apply if the independent representative was an employee of the special entity.

The proposed rules should yield several direct and indirect benefits. The proposed rules are intended to address pay to play relationships that interfere with the legitimate process by which ''municipal entities'' and other special entities enter into security-based swaps to mitigate risk. The proposed rules should reduce the occurrence of fraudulent conduct resulting from pay to play. Addressing pay to play practices would help protect public pension plans, investments by the public in government-sponsored savings and retirement plans and programs, and taxpayers by addressing situations in which the municipal entity, in part based on a conflict of interest, enters into a security-based swap that may be without merit or for which there exists a better alternative. Allocative efficiency would be enhanced if special entities enter into security-based swaps based on hedging needs or the characteristics of the security-based swap rather than any influence from pay to play, either from the SBS Dealer or the independent representative.

These proposed rules would encourage (1) SBS Dealers to compete for the business of municipal entities based on the merits of the transaction rather than their ability or willingness to make political contributions, and (2) independent representatives to compete based on their qualifications, service, and cost. Taxpayers may benefit from the rule because they would enjoy the benefits of appropriate risk management or investment strategies that make use of security-based swaps, and they might otherwise bear the financial burden of bailing out a municipal entity that had entered into an inappropriate security-based swap because of pay to play practices. The proposed rule may also lower transaction costs paid by ''municipal entities'' since it would not be necessary for SBS Dealers to recover expenses incurred by pay to play practices.[368]

Proposed Rule 15Fh–6 would require an SBS Dealer to incur costs to monitor contributions it and its covered associates make and to establish procedures to comply with the rule. The

[367] Political Contributions by Certain Investment Advisers, Investment Advisers Act Release No. 2910, 75 FR 41018, 41061–41065 (July 14, 2010). Many of the economic issues associated with rules relating to political contributions by SBS entities are similar to those relating to investment advisers addressed in Rule 206(4)–5.

[368] Academic research provides evidence that gross spreads on negotiated bid deals for municipal bonds were reduced following adoption of a pay to play rule prohibiting investment houses that make political contributions from selling bonds from that city/state for two years. *See* Alexander W. Butler, Larry Fauver, and Sandra Mortal, *Corruption, Political Connections, and Municipal Finance,* 22 The Review of Financial Studies 2873 (2009).

initial and ongoing compliance costs imposed by the proposed rule would vary significantly among firms, depending on a number of factors. These factors include the number of covered associates of the SBS Dealer, the degree to which compliance procedures are automated (including policies and procedures that could require pre-clearance), and the extent to which the SBS Dealer has a preexisting policy under its code of ethics or compliance program. A smaller SBS Dealer, for example, would likely have a small number of covered associates, and thus expend fewer resources to comply with the proposed rule.

An SBS Dealer subject to the proposed rule would develop compliance procedures to monitor the political contributions made by the SBS Dealer and its covered associates. We estimate that the costs imposed by the proposed rule would be higher initially, as firms establish and implement procedures and systems to comply with the rule. We expect that compliance expenses would then decline to a relatively constant amount in future years, and that annual expenses would likely be lower for smaller SBS Dealers as the systems and processes should be less complex than for larger SBS Dealers.

An SBS Dealer with municipal entity counterparties, as well as covered associates of the SBS Dealer, also may be less likely to make contributions to government officials, including candidates, at or above the *de minimis* level, potentially resulting in less funding by SBS Dealers and their covered associates for these officials' campaigns. Under the rule, SBS Dealers and covered associates would be subject to new limitations regarding which campaigns they may support and the amounts that they may contribute. In addition, these same persons would be prohibited from soliciting others to contribute or from coordinating contributions to government officials, including candidates, or payments to political parties in certain circumstances. These limitations, and any additional prohibitions imposed by firms that choose to adopt more restrictive policies or procedures, could be perceived by the individuals subject to them as a cost in the sense that they limit those individuals' ability to give direct contributions to certain candidates above the *de minimis* level.

An SBS Dealer that becomes subject to the prohibitions of the proposed rule would be prohibited from offering to enter into, or entering into, a security-based swap with a particular municipal entity counterparty, which would result in a direct loss to the SBS Dealer of revenues and profits relating to that government counterparty. However, this prohibition would likely result in a reallocation as to which SBS Dealer would generate these revenues and profits, not an overall loss to the market. The two-year time out could also limit the number of SBS Dealers able to offer to enter into or enter into security-based swap contracts with potential municipal entity counterparties.

D. Costs and Benefits Relating to the Specification of Minimum Requirements of the Annual Compliance Report and the Requirement of Board Approval of Compensation or Removal of a Chief Compliance Officer

Section 15F(k) of the Exchange Act requires an SBS Entity to designate a CCO, and imposes certain duties and responsibilities on that CCO. Proposed Rule 15Fk–1 would incorporate the provisions of Exchange Act Section 15F(k) in addition to certain provisions that are based on the current and proposed compliance obligations applicable to CCOs of other Commission-regulated entities.

The submission of the CCO's annual compliance report as required by the proposed rule would help the Commission monitor the compliance activities of SBS Entities. This report would also assist the Commission in carrying out its oversight of SBS Entities by providing the Commission with the information necessary to review compliance with rules relating to external business conduct.

Section 15Fk–1(2)(A) of the Exchange Act requires that the CCO report directly to the board or the senior officer of the SBS Entity. Proposed Rule 15Fk–1(d) would also require that the compensation and removal of the CCO would require the approval of a majority of the board of directors of the SBS Entity. The elevation of compensation and termination decisions to the board should reduce the inherent conflict of interest that arises when such decisions are made by individuals whose compliance with applicable law and regulations the CCO is responsible for monitoring. The potential separation of general supervisory responsibility of the CCO, which may reside with the senior officer of the SBS Entity, from the responsibility for compensation decisions may reduce the quality of those decisions.

In addition to the time involved with the reporting burdens, the direct costs of $3,300,000 in the aggregate associated with the submission of the annual compliance report are discussed in more detail in Section IV.D.9 above.

Request for Comments

The Commission also seeks comment on the accuracy of any of the benefits and costs it has identified and/or described above. The Commission encourages commenters to identify, discuss, analyze, and supply relevant data, information, or statistics regarding any such costs or benefits. Because the structure of the security-based swaps market and the behavior of its market participants is likely to change after the effective date of the Dodd-Frank Act and implementation of the Commission's rules promulgated thereunder, the impact of, and the costs and benefits that may result from proposed Rules 15Fh–1 through 15Fh–6 and 15Fk–1 may change over time. As commenters review the proposed rules, we urge them to consider generally the role that regulation may play in fostering or limiting the development of the market for security-based swaps.

VI. Consideration of Burden on Competition and Promotion of Efficiency, Competition and Capital Formation

Section 3(f) of the Exchange Act requires that the Commission, whenever it engages in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action would promote efficiency, competition, and capital formation.[369] In addition, Section 23(a)(2) of the Exchange Act requires the Commission, when adopting rules under the Exchange Act, consider the effect such rules would have on competition.[370] Section 23(a)(2) of the Exchange Act also prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

Security-based swaps are currently executed and traded in the OTC market, with five large commercial banks representing 97% of the total U.S. banking industry notional amounts outstanding of derivatives.[371] The gross notional amount of credit default swaps as of the end of 2009 was approximately $30 trillion.[372]

Section 15F(h) of the Exchange Act as added by Section 764(a) of the Dodd-Frank Act provides the Commission

[369] 15 U.S.C. 78c(f).

[370] 15 U.S.C. 78w(a)(2).

[371] *See* Office of the Comptroller of the Currency, Quarterly Report on Bank Trading and Derivatives Activities, First Quarter 2010.

[372] Data available at *http://www.isda.org/statistics/pdf/ISDA-Market-Survey-results1987-present.xls.*

with both mandatory and discretionary rulemaking authority to impose business conduct requirements on SBS Entities in their dealings with counterparties, including special entities.[373] The proposed rules to implement business conduct requirements would apply to all SBS Entities. Therefore the Commission preliminarily believes that the effect on competition among SBS Entities would be small. The Commission also preliminarily believes that the proposed business conduct standards for SBS Entities, including those for disclosure of material risks and for fair and balanced communications, would reduce information asymmetries between SBS Entities and their counterparties. The reduction of information asymmetries should promote price efficiency, promote more informed decision-making, and reduce the incidence of fraudulent or misleading representations.

Proposed Rule 15Fh–3(e) would require an SBS Dealer to use reasonable due diligence to obtain and retain a record of the essential facts concerning each counterparty whose identity is known to the SBS Dealer prior to the execution of the transaction and the authority of any person acting for such counterparty. Proposed Rule 15h–3(f) would require that the SBS Dealer have a reasonable basis to believe: (i) based on reasonable diligence, that the recommended security-based swap or trading strategy involving a security-based swap is suitable for at least some counterparties; and (ii) that a recommended security-based swap or trading strategy is suitable for the counterparty based on information the SBS Dealer has obtained through reasonable due diligence regarding the counterparty's investment profile, and the potential risks and rewards associated with the recommended security-based swap or trading strategy.

Requiring SBS Dealers to evaluate the suitability of trades for counterparties is a responsibility that goes beyond disclosure of material risks and would further increase the costs to SBS Dealers in transacting with counterparties, particularly for counterparties with which the SBS Dealer has had no prior transactions. These costs are likely to be largest when the SBS Dealer is dealing directly with small, relatively unsophisticated counterparties where a greater level of inquiry would be required. If these costs result in SBS Dealers refraining from interacting with these counterparties, and these counterparties are otherwise unable to enter into security-based swaps and lose access to risk management methods that employ security-based swaps, the suitability requirement may come at a net cost to these counterparties and would place them at a disadvantage relative to larger, more sophisticated competitors. To the extent that these counterparties do not participate in the security-based swap market as a result of these costs, liquidity could drop, increasing the hedging costs and ultimately the cost of raising capital. However, as we noted previously, current market practices reveal that relatively few counterparties enter into security-based swap agreements with an SBS Dealer without third-party representation, particularly among special entities. As a result of this third-party representation and the SBS Dealer's ability to fulfill its suitability obligations by making the determination that a counterparty's agent is capable of independently evaluating investment risk, we do not believe that market access is likely to be restricted, even for small, relatively unsophisticated counterparties. Rather, we believe that it is possible that suitability requirements would add to the integrity of, and codify, current market practices, which can in some circumstances enhance the protections for such counterparties.

The practices that are proposed in the rules would also help regulators perform their functions in an effective manner. The resulting increase in market integrity would likely affect capital formation in our capital markets positively.

Request for Comments

The Commission also seeks comment on the accuracy of any of the competitive effects it has identified and/or described above. The Commission encourages commenters to identify, discuss, analyze, and supply relevant data, information, or statistics regarding any such effects. Because the structure of the security-based swaps market and the behavior of its market participants is likely to change after the effective date of the Dodd-Frank Act and implementation of the Commission's rules promulgated thereunder, the impacts that may result from proposed Rules 15Fh–1 through 15Fh–6 and 15Fk–1 may change over time. As commenters review the proposed rules, we urge them to consider generally the role that regulation may play in fostering or limiting the development of the market for security-based swaps.

VII. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or ''SBREFA,'' [374] the Commission must advise the OMB as to whether the proposed regulation constitutes a ''major'' rule. Under SBREFA, a rule is considered ''major'' where, if adopted, it results or is likely to result in: (1) An annual effect on the economy of $100 million or more (either in the form of an increase or a decrease); (2) a major increase in costs or prices for consumers or individual industries; or (3) significant adverse effect on competition, investment or innovation. If a rule is ''major,'' its effectiveness will generally be delayed for 60 days pending Congressional review.

The Commission requests comment on the potential impact of proposed Rules 15Fh–1 through 15Fh–7 and 15Fk–1 on the economy on an annual basis, any potential increase in costs or prices for consumers or individual industries, and any potential effect on competition, investment or innovation. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

VIII. Regulatory Flexibility Act Certification

The Regulatory Flexibility Act (''RFA'') [375] requires Federal agencies, in promulgating rules, to consider the impact of those rules on small entities. Section 603(a) [376] of the Administrative Procedure Act,[377] as amended by the RFA, generally requires the Commission to undertake a regulatory flexibility analysis of all proposed rules, or proposed rule amendments, to determine the impact of such rulemaking on ''small entities.'' [378] Section 605(b) of the RFA states that this requirement shall not apply to any proposed rule or proposed rule amendment, which if adopted, would not have a significant economic impact on a substantial number of small entities.[379]

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[373] *See* Exchange Act Section 15F(h)(2)(C), 15 U.S.C. 78o–10(h)(2)(C).

[374] Public Law. 104–121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

[375] 5 U.S.C. 601 *et seq.*

[376] 5 U.S.C. 603(a).

[377] 5 U.S.C. 551 *et seq.*

[378] Although Section 601(b) of the RFA defines the term ''small entity,'' the statute permits agencies to formulate their own definitions. The Commission has adopted definitions for the term small entity for the purposes of Commission rulemaking in accordance with the RFA. Those definitions, as relevant to this proposed rulemaking, are set forth in Rule 0–10, 17 CFR 240.0–10. *See* Securities Exchange Act Release No. 18451 (Jan. 28, 1982), 47 FR 5215 (Feb. 4, 1982).

[379] *See* 5 U.S.C. 605(b).

For purposes of Commission rulemaking in connection with the RFA, a small entity includes: (i) When used with reference to an ''issuer'' or a ''person,'' other than an investment company, an ''issuer'' or ''person'' that, on the last day of its most recent fiscal year, had total assets of $5 million or less,[380] or (ii) a broker-dealer with total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a–5(d) under the Exchange Act,[381] or, if not required to file such statements, a broker-dealer with total capital (net worth plus subordinated liabilities) of less than $500,000 on the last day of the preceding fiscal year (or in the time that it has been in business, if shorter); and is not affiliated with any person (other than a natural person) that is not a small business or small organization.[382] With respect to investment companies in connection with the RFA, the term ''small business'' or ''small organization'' means an investment company that, together with other investment companies in the same group of related investment companies, has net assets of $50 million or less as of the end of its most recent fiscal year.

A. Market Participants in Security-Based Swaps

Based on the Commission's existing information about the security-based swap market, the Commission preliminarily believes that the security-based swap market, while broad in scope, is largely dominated by large entities such as those that would be covered by the ''security-based swap dealer'' definition and their large institutional customers.[383] Under current law, all security-based swap market participants are effectively required to be ''eligible contract participants.'' [384] The basic thresholds under the definition of eligible contract participant are currently $10 million in total assets for natural persons, and $25 million in total assets for corporations and other legal entities.[385] Because the definition of ''small entity'' requires that issuers or persons other than broker-dealers and investment companies must have total assets of $5 million or less, by definition they cannot be eligible contract participants. Based on its knowledge of registered broker-dealers and feedback from industry participants about the security-based swap markets, the Commission preliminarily believes that registered broker-dealers that participate, or will participate after the Dodd-Frank Act becomes effective, in the security-based swap markets exceed the threshold defining when broker-dealers are ''small entities'' set out above. Finally, based on its review of data provided by the Warehouse Trust Company, a subsidiary of the Depository Trust and Clearing Corporation, to the Commission, and feedback from industry participants, the Commission preliminarily believes that investment companies that participate in the security-based swap markets exceed the threshold defining when investment companies are ''small businesses'' or ''small organizations'' set out above. Thus, the Commission preliminarily believes it is unlikely that the proposed business conduct standards rules would have a significant economic impact on a substantial number of small entities.

B. Certification

In the Commission's preliminary view, the proposed rules would not have a significant economic impact on a substantial number of small entities. For the foregoing reasons, the Commission certifies that these proposed rules would not have a significant economic impact on a substantial number of small entities for purposes of the RFA. The Commission encourages written comments regarding this certification. The Commission requests that commenters describe the nature of any impact on small entities and provide empirical data to illustrate and support the extent of the impact.

[380] *See* 17 CFR 240.0–10(a).

[381] *See* 17 CFR 240.17a–5(d).

[382] *See* 17 CFR 240.0–10(c).

[383] *See supra* notes 4 and 5.

[384] Otherwise, the security-based swap would either be a security subject to the federal securities laws, including a registration requirement under the Securities Act, or an illegal future, depending on its economic terms and the security, commodity or other asset that it references. In practice, this has meant that such transactions do not occur.

[385] Note that the definition of ''eligible contract participant'' has been amended by Congress in Section 721(a)(9) of the Dodd-Frank Act. *See* Pub. L. 111–203, 124 Stat. 1376, 1660, § 721(a)(9) (to be codified at 7 U.S.C. 1a(18)). *See also* Definitions Release at 42 (explaining that this amendment has the effect of ''(1) raising a threshold that governmental entities may use to qualify as [eligible contract participants], in certain situations, from $25 million in discretionary investments to $50 million in such investments; and (2) replacing the 'total asset' standard for individuals to qualify as [eligible contract participants] with a discretionary investment standard,'' but noting that for individuals, while the threshold remains $10 million, under the amended definition this amount would be based on discretionary investments rather than total assets).

Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants

Statutory Authority

Pursuant to the Act and, particularly, Sections 2, 3(b), 3C, 9, 10, 11A, 15, 15F, 17(a) and (b), and 23(a) thereof (15 U.S.C. 78b, 78c(b), 78i(i), 78i(j), 78j, 78k–1, 78o, 78o–10, 78q(a) and (b), and 78w(a)), the Commission is proposing a new series of rules, Rules 15Fh–1 through 15Fh–6, and Rule 15Fk–1, to address the business conduct obligations of security-based swap dealers and major security-based swap participants.

List of Subjects in 17 CFR Part 240

Brokers, Reporting and recordkeeping requirements, Securities.

Text of the Proposed Rule

For the reasons set forth in the preamble, the Securities and Exchange Commission proposes to amend Title 17, Chapter II of the Code of Federal Regulations, as follows:

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for part 240 is revised to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77z–3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78b, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j–1, 78k, 78k–1, 78*l,* 78m, 78n, 78o, 78o–4, 78o–10, 78p, 78q, 78s, 78u–5, 78w, 78x, 78dd(b) and (c), 78*ll,* 78mm, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4, 80b–11, and 7201 *et seq.;* 18 U.S.C. 1350, and 12 U.S.C. 5221(e)(3), unless otherwise noted.

* * * * *

Sections 240.15Fh–1 through 240.15Fh–6 and 240.15Fk–1 are also issued under sec. 943, Pub. L. 111–203, 124 Stat. 1376.

* * * * *

2. Add §§ 240.15Fh–1 through 240.15Fh–6 to read as follows:

Sec.

§ 240.15Fh–1 Scope.

Sections 240.15Fh–1 through 240.15Fh–6, and 240.15Fk–1 are not

intended to limit, or restrict, the applicability of other provisions of the federal securities laws, including but not limited to Section 17(a) of the Securities Act of 1933 and Sections 9 and 10(b) of the Act, and rules and regulations thereunder, or other applicable laws and rules and regulations. Sections 240.15Fh–1 through 240.15Fh–6, and 240.15Fk–1 apply, as relevant, in connection with entering into security-based swaps and continue to apply, as appropriate, over the term of executed security-based swaps.

§ 240.15Fh–2 Definitions.

As used in §§ 240.15Fh–1 through 240.15Fh–6:

(a) Act as an advisor to a special entity. A security-based swap dealer *acts as an advisor to a special entity* when it recommends a security-based swap or a trading strategy that involves the use of a security-based swap to the special entity, unless:

(1) The special entity represents in writing that:

(i) The special entity will not rely on recommendations provided by the security-based swap dealer; and

(ii) The special entity will rely on advice from a qualified independent representative as defined in § 240.15Fh–5(a); and

(2) The security-based swap dealer has a reasonable basis to believe that the special entity is advised by a qualified independent representative as defined in § 240.15Fh–5(a); and

(3) The security-based swap dealer discloses to the special entity that it is not undertaking to act in the best interest of the special entity, as otherwise required by Section 15F(h)(4) of the Act.

(b) Eligible contract participant means any person as defined in Section 3(a)(66) of the Act.

(c) Independent representative of a special entity means:

(1) A representative of a special entity must be independent of the security-based swap dealer or major security-based swap participant that is the counterparty to a proposed security-based swap.

(2) A representative of a special entity is independent of a security-based swap dealer or major security-based swap participant if the representative does not have a relationship with the security-based swap dealer or major security-based swap participant, whether compensatory or otherwise, that reasonably could affect the independent judgment or decision-making of the representative.

(3) A representative of a special entity will be deemed to be independent of a security-based swap dealer or major security-based swap participant if:

(i) The representative is not and, within one year, was not an associated person of the security-based swap dealer or major security-based swap participant; and

(ii) The representative has not received more than ten percent of its gross revenues over the past year, directly or indirectly from the security-based swap dealer or major security-based swap participant.

(d) Security-based swap dealer or major security-based swap participant includes, where relevant, an associated person of the security-based swap dealer or major security-based swap participant.

(e) Special entity means:

(1) A Federal agency;

(2) A State, State agency, city, county, municipality, or other political subdivision of a State;

(3) Any employee benefit plan, as defined in section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002);

(4) Any governmental plan, as defined in section 3(32) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002(32)); or

(5) Any endowment, including an endowment that is an organization described in section 501(c)(3) of the Internal Revenue Code of 1986.

(f) A person is *subject to a statutory disqualification* for purposes of § 240.15Fh–5 if that person would be subject to a statutory disqualification under the provisions of Section 3(a)(39) of the Act.

§ 240.15Fh–3 Business conduct requirements.

(a) *Counterparty Status.*

(1) *Eligible contract participant.* A security-based swap dealer or a major security-based swap participant shall verify that a counterparty whose identity is known to the security-based swap dealer or a major security-based swap participant prior to the execution of the transaction meets the eligibility standards for an eligible contract participant, before entering into a security-based swap with that counterparty other than on a registered national securities exchange or registered security-based swap execution facility.

(2) *Special entity.* A security-based swap dealer or a major security-based swap participant shall verify whether a counterparty whose identity is known to the security-based swap dealer or a major security-based swap participant prior to the execution of the transaction is a special entity, before entering into a security-based swap with that counterparty.

(b) *Disclosure.* Before entering into a security-based swap, a security-based swap dealer or major security-based swap participant shall disclose to the counterparty, other than a security-based swap dealer, major security-based swap participant, swap dealer or major swap participant, information concerning the security-based swap in a manner reasonably designed to allow the counterparty to assess:

(1) *Material risks and characteristics.* The material risks and characteristics of the particular security-based swap, including, but not limited to, the material factors that influence the day-to-day changes in valuation, the factors or events that might lead to significant losses, the sensitivities of the security-based swap to those factors and conditions, and the approximate magnitude of the gains or losses the security-based swap will experience under specified circumstances.

(2) *Material incentives or conflicts of interest.* Any material incentives or conflicts of interest that the security-based swap dealer or major security-based swap participant may have in connection with the security-based swap, including any compensation or other incentives from any source other than the counterparty in connection with the security-based swap to be entered into with the counterparty.

(3) *Record.* The security-based swap dealer or major security-based swap participant shall make a written record of the non-written disclosures made pursuant to paragraph (b) of this section, and provide a written version of these disclosures to its counterparties in a timely manner, but in any case no later than the delivery of the trade acknowledgement of the particular transaction pursuant to § 240.15Fi–1.

(c) *Daily Mark.* A security-based swap dealer or major security-based swap participant shall disclose the daily mark to the counterparty, other than a security-based swap dealer, major security-based swap participant, swap dealer or major swap participant, which shall be:

(1) For a cleared security-based swap, upon the request of the counterparty, the daily end-of-day settlement price that the security-based swap dealer or major security-based swap participant receives from the appropriate clearing agency; and

(2) For an uncleared security-based swap, the midpoint between the bid and offer, or the calculated equivalent thereof, as of the close of business,

unless the parties agree in writing otherwise to a different time, on each business day during the term of the security-based swap. The daily mark may be based on market quotations for comparable security-based swaps, mathematical models or a combination thereof. The security-based swap dealer or major security-based swap participant shall also disclose its data sources and a description of the methodology and assumptions used to prepare the daily mark, and promptly disclose any material changes to such data sources, methodology and assumptions during the term of the security-based swap.

(d) *Disclosure Regarding Clearing Rights.* A security-based swap dealer or major security-based swap participant shall disclose the following information to a counterparty, other than a security-based swap dealer, major security-based swap participant, swap dealer or major swap participant:

(1) *For security-based swaps subject to clearing requirement.* Before entering into a security-based swap subject to the clearing requirement under Section 3C(a) of the Act, a security-based swap dealer or major security-based swap participant shall:

(i) Disclose to the counterparty the names of the clearing agencies that accept the security-based swap for clearing, and through which of those clearing agencies the security-based swap dealer or major security-based swap participant is authorized or permitted, directly or through a designated clearing member, to clear the security-based swap; and

(ii) Notify the counterparty that it shall have the sole right to select which of the clearing agencies described in paragraph (d)(1)(i) shall be used to clear the security-based swap.

(2) *For security-based swaps not subject to clearing requirement.* Before entering into a security-based swap not subject to the clearing requirement under Section 3C(a) of the Act, a security-based swap dealer or major security-based swap participant shall:

(i) Determine whether the security-based swap is accepted for clearing by one or more clearing agencies;

(ii) Disclose to the counterparty the names of the clearing agencies that accept the security-based swap for clearing, and whether the security-based swap dealer or major security-based swap participant is authorized or permitted, directly or through a designated clearing member, to clear the security-based swap through such clearing agencies; and

(iii) Notify the counterparty that it may elect to require clearing of the security-based swap and shall have the sole right to select the clearing agency at which the security-based swap will be cleared, provided it is a clearing agency at which the security-based swap dealer or major security-based swap participant is authorized or permitted, directly or through a designated clearing member, to clear the security-based swap.

(3) *Record.* The security-based swap dealer or major security-based swap participant shall make a written record of the non-written disclosures made pursuant to paragraph (d) of this section, and provide a written version of these disclosures to its counterparties in a timely manner, but in any case no later than the delivery of the trade acknowledgement of the particular transaction pursuant to § 240.15Fi–1.

(e) *Know Your Counterparty.* Each security-based swap dealer shall establish, maintain and enforce policies and procedures reasonably designed to obtain and retain a record of the essential facts concerning each counterparty whose identity is known to the security-based swap dealer, that are necessary for conducting business with such counterparty. For purposes of this section, the *essential facts concerning a counterparty* are:

(1) Facts required to comply with applicable laws, regulations and rules;

(2) Facts required to implement the security-based swap dealer's credit and operational risk management policies in connection with transactions entered into with such counterparty;

(3) Information regarding the authority of any person acting for such counterparty; and

(4) If the counterparty is a special entity, such background information regarding the independent representative as the security-based swap dealer reasonably deems appropriate.

(f) *Recommendations of Security-Based Swaps or Trading Strategies.*

(1) A security-based swap dealer that recommends a security-based swap or trading strategy involving a security-based swap to a counterparty, other than a security-based swap dealer, major security-based swap participant, swap dealer, or major swap participant, must have a reasonable basis to believe:

(i) Based on reasonable diligence, that the recommended security-based swap or trading strategy involving a security-based swap is suitable for at least some counterparties; and

(ii) That a recommended security-based swap or trading strategy involving a security-based swap is suitable for the counterparty. To establish a reasonable basis for a recommendation, a security-based swap dealer must have or obtain relevant information regarding the counterparty, including the counterparty's investment profile, trading objectives, and its ability to absorb potential losses associated with the recommended security-based swap or trading strategy.

(2) A security-based swap dealer may also fulfill its obligations under paragraph (g)(1) with respect to a particular counterparty if:

(i) The security-based swap dealer reasonably determines 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 security-based swap or trading strategy involving a security-based swap;

(ii) The counterparty or its agent affirmatively represents in writing that it is exercising independent judgment in evaluating the recommendations of the security-based swap dealer; and

(iii) The security-based swap dealer discloses that it is acting in its capacity as a counterparty, and is not undertaking to assess the suitability of the security-based swap or trading strategy for the counterparty.

(3) A security-based swap dealer will be deemed to have satisfied its obligations under paragraph (f)(1) of this section with respect to a special entity if:

(i) The security-based swap dealer is acting as an advisor to the special entity and complies with the requirements of § 240.15Fh–4(b); or

(ii) The security-based swap dealer is deemed not to be acting as an advisor to the special entity pursuant to § 240.15Fh–2(a).

(h) *Fair and Balanced Communications.* A security-based swap dealer or major security-based swap participant shall communicate with counterparties in a fair and balanced manner based on principles of fair dealing and good faith. In particular:

(1) Communications must provide a sound basis for evaluating the facts with regard to any particular security-based swap or trading strategy involving a security-based swap;

(2) Communications may not imply that past performance will recur or make any exaggerated or unwarranted claim, opinion or forecast; and

(3) Any statement referring to the potential opportunities or advantages presented by a security-based swap shall be balanced by an equally detailed statement of the corresponding risks.

(i) *Supervision.*

(1) *In general.* A security-based swap dealer or major security-based swap

participant shall establish, maintain and enforce a system to supervise, and shall diligently supervise its business and its associated persons, with a view to preventing violations of the provisions of applicable federal securities laws and the rules and regulations thereunder relating to its business as a security-based swap dealer or major security-based swap participant, respectively.

(2) *Minimum requirements.* The system required by paragraph (g)(1) of this section shall be reasonably designed to achieve compliance with applicable securities laws and the rules and regulations thereunder, and at a minimum, shall provide for:

(i) The designation of at least one person with authority to carry out the supervisory responsibilities of the security-based swap dealer or major security-based swap participant for each type of business in which it engages for which registration as a security-based swap dealer or major security-based swap participant is required;

(ii) The use of reasonable efforts to determine that all supervisors are qualified and meet standards of training, experience, and competence necessary to effectively supervise the security-based swap activities of the persons associated with the security-based swap dealer or major security-based swap participant;

(iii) Establishment, maintenance and enforcement of written policies and procedures addressing the supervision of the types of security-based swap business in which the security-based swap dealer or major security-based swap participant is engaged that are reasonably designed to achieve compliance with applicable securities laws and the rules and regulations thereunder, and that include, at a minimum:

(A) Procedures for the review by a supervisor of transactions for which registration as a security-based swap dealer or major security-based swap participant is required;

(B) 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 security-based swap dealer's or major security-based swap participant's business involving security-based swaps;

(C) Procedures for a periodic review, at least annually, of the security-based swap business in which the security-based swap dealer or major security-based swap participant engages that is reasonably designed to assist in detecting and preventing violations of, and achieving compliance with, applicable federal securities laws and regulations;

(D) Procedures to conduct a reasonable investigation regarding the character, business repute, qualifications, and experience of any person prior to that person's association with the security-based swap dealer or major security-based swap participant;

(E) Procedures to consider whether to permit an associated person to establish or maintain a securities or commodities account in the name of, or for the benefit of such associated person, at another security-based swap dealer, broker, dealer, investment adviser, or other financial institution; and if permitted, procedures to supervise the trading at the other security-based swap dealer, broker, dealer, investment adviser, or financial institution, including the receipt of duplicate confirmations and statements related to such accounts;

(F) A description of the supervisory system, including the titles, qualifications and locations of supervisory persons and the specific responsibilities of each person with respect to the types of business in which the security-based swap dealer or major security-based swap participant is engaged;

(G) Procedures prohibiting an associated person who performs a supervisory function from supervising his or her own activities or reporting to, or having his or her compensation or continued employment determined by, a person or persons he or she is supervising; and

(H) Procedures preventing the standards of supervision from being reduced due to any conflicts of interest of a supervisor with respect to the associated person being supervised.

(iv) Written policies and procedures reasonably designed, taking into consideration the nature of such security-based swap dealer's or major security-based swap participant's business, to comply with the duties set forth in Section 15F(j) of the Act.

(3) *Failure to supervise.* A security-based swap dealer or major security-based swap participant or an associated person of a security-based swap dealer or major security-based swap participant shall not be deemed to have failed to diligently supervise any other person, if such other person is not subject to his or her supervision, or if:

(i) The security-based swap dealer or major security-based swap participant has established and maintained written policies and procedures, and a documented system for applying those policies and procedures, that would reasonably be expected to prevent and detect, insofar as practicable, any violation of the federal securities laws and the rules and regulations thereunder relating to security-based swaps; and

(ii) The security-based swap dealer or major security-based swap participant, or associated person of the security-based swap dealer or major security-based swap participant, has reasonably discharged the duties and obligations required by the written policies and procedures and documented system and did not have a reasonable basis to believe that the written policies and procedures and documented system were not being followed.

(4) *Maintenance of written supervisory procedures.* A security-based swap dealer or major security-based swap participant shall:

(i) Promptly amend its written supervisory procedures as appropriate when material changes occur in applicable securities laws or rules or regulations thereunder, and when material changes occur in its business or supervisory system; and

(ii) Promptly communicate any material amendments to its supervisory procedures throughout the relevant parts of its organization.

§ 240.15Fh–4 Special requirements for security-based swap dealers acting as advisors to special entities.

(a) *In general.* It shall be unlawful for a security-based swap dealer or major security-based swap participant:

(1) To employ any device, scheme, or artifice to defraud any special entity or prospective customer who is a special entity;

(2) To engage 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

(3) To engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative.

(b) A security-based swap dealer that acts as an advisor to a special entity regarding a security-based swap shall comply with the following requirements:

(1) *Duty.* The security-based swap dealer shall have a duty to act in the best interests of the special entity.

(2) *Reasonable Efforts.* The security-based swap dealer shall make reasonable efforts to obtain such information that the security-based swap dealer considers necessary to make a reasonable determination that a security-based swap or trading strategy involving a security-based swap is in the best interests of the special entity.

This information shall include, but not be limited to:

(i) The authority of the special entity to enter into a security-based swap;

(ii) The financial status of the special entity, as well as future funding needs;

(iii) The tax status of the special entity;

(iv) The investment or financing objectives of the special entity;

(v) The experience of the special entity with respect to entering into security-based swaps, generally, and security-based swaps of the type and complexity being recommended;

(vi) Whether the special entity has the financial capability to withstand changes in market conditions during the term of the security-based swap; and

(vii) Such other information as is relevant to the particular facts and circumstances of the special entity, market conditions and the type of security-based swap or trading strategy involving a security-based swap being recommended.

(3) *Exemption.* The requirements of this § 240.15Fh–4(b) shall not apply with respect to a security-based swap if:

(i) The transaction is executed on a registered security-based swap execution facility or registered national securities exchange; and

(ii) The security-based swap dealer does not know the identity of the counterparty, at any time up to and including execution of the transaction.

§ 240.15Fh–5 Special requirements for security-based swap dealers and major security-based swap participants acting as counterparties to special entities.

(a) A security-based swap dealer or major security-based swap participant that offers to enter into or enters into a security-based swap with a special entity must have a reasonable basis to believe that special entity has a qualified independent representative. For these purposes, a qualified independent representative is an independent representative that:

(1) Has sufficient knowledge to evaluate the transaction and risks;

(2) Is not subject to a statutory disqualification;

(3) Undertakes a duty to act in the best interests of the special entity;

(4) Makes appropriate and timely disclosures to the special entity of material information concerning the security-based swap;

(5) Will provide written representations to the special entity regarding fair pricing and the appropriateness of the security-based swap; and

(6) In the case of employee benefit plans subject to the Employee Retirement Income Security Act of 1974, is a fiduciary as defined in section 3(21) of that Act (29 U.S.C. 1002(21)); and

(7) In the case of a special entity defined in §§ 240.15Fh–2(e)(2) or (4), is a person that is subject to rules of the Commission, the Commodity Futures Trading Commission or a self-regulatory organization subject to the jurisdiction of the Commission or the Commodity Futures Trading Commission prohibiting it from engaging in specified activities if certain political contributions have been made, *provided that* this paragraph (a)(7) shall not apply if the independent representative is an employee of the special entity.

(b) Before initiation of a security-based swap with a special entity, a security-based swap dealer shall disclose to the special entity in writing the capacity in which the security-based swap dealer is acting and, if the security-based swap dealer engages in business, or has engaged in business within the last twelve months, with the counterparty in more than one capacity, the security-based swap dealer shall disclose the material differences between such capacities in connection with the security-based swap and any other financial transaction or service involving the counterparty.

(c) The requirements of this § 240.15Fh–5 shall not apply with respect to a security-based swap if:

(1) The transaction is executed on a registered security-based swap execution facility or registered national securities exchange; and

(2) The security-based swap dealer or major security-based swap participant does not know the identity of the counterparty, at any time up to and including execution of the transaction.

§ 240.15Fh–6 Political contributions by certain security-based swap dealers.

(a) *Definitions.* For the purposes of this section:

(1) The term *contribution* means any gift, subscription, loan, advance, or deposit of money or anything of value made:

(i) For the purpose of influencing any election for state or local office;

(ii) For payment of debt incurred in connection with any such election; or

(iii) For transition or inaugural expenses incurred by the successful candidate for state or local office.

(2) The term *covered associate* means:

(i) Any general partner, managing member or executive officer, or other person with a similar status or function;

(ii) Any employee who solicits a municipal entity to enter into a security-based swap with the security-based swap dealer and any person who supervises, directly or indirectly, such employee; and

(iii) A political action committee controlled by the security-based swap dealer or by a person described in paragraphs (c)(2)(i) and (c)(2)(ii) of this section.

(3) The term *executive officer of a security-based swap dealer* means:

(i) The president;

(ii) Any vice president in charge of a principal business unit, division or function (such as sales, administration or finance);

(iii) Any other officer of the security-based swap dealer who performs a policy-making function; or

(iv) Any other person who performs similar policy-making functions for the security-based swap dealer.

(4) The term *municipal entity* is defined in Section 15B(e)(8) of the Act.

(5) The term *official of a municipal entity* means any person (including any 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:

(i) Is directly or indirectly responsible for, or can influence the outcome of, the selection of a security-based swap dealer by a municipal entity; or

(ii) Has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the selection of a security-based swap dealer by a municipal entity.

(6) The term *payment* means any gift, subscription, loan, advance, or deposit of money or anything of value.

(7) The term *regulated person* means:

(i) A person that is subject to rules of the Commission, the Commodity Futures Trading Commission or a self-regulatory organization subject to the jurisdiction of the Commission or the Commodity Futures Trading Commission prohibiting it from engaging in specified activities if certain political contributions have been made, or its officers or employees;

(ii) A general partner, managing member or executive officer of such person, or other individual with a similar status or function; or

(iii) An employee of such person who solicits a municipal entity for the security-based swap dealer and any person who supervises, directly or indirectly, such employee.

(8) The term *solicit* means a direct or indirect communication by any person with a municipal entity for the purpose of obtaining or retaining an engagement related to a security-based swap.

(b) *Prohibitions and Exceptions.*

(1) It shall be unlawful for a security-based swap dealer to offer to enter into,

or enter into, a security-based swap, or a trading strategy involving a security-based swap, with a municipal entity within two years after any contribution to an official of such municipal entity was made by the security-based swap dealer, or by any covered associate of the security-based swap dealer.

(2) The prohibition in paragraph (b)(1) does not apply:

(i) If the only contributions made by the security-based swap dealer to an official of such municipal entity were made by a covered associate:

(A) To officials for whom the covered associate was entitled to vote at the time of the contributions, *if* the contributions in the aggregate do not exceed $350 to any one official per election; or

(B) To officials for whom the covered associate was not entitled to vote at the time of the contributions, *if* the contributions in the aggregate do not exceed $150 to any one official, per election;

(ii) To a security-based swap dealer as a result of a contribution made by a natural person more than six months prior to becoming a covered associate of the security-based swap dealer, *however,* this exclusion shall not apply if the natural person, after becoming a covered associate, solicits the municipal entity on behalf of the security-based swap dealer to offer to enter into, or to enter into, security-based swap, or a trading strategy involving a security-based swap; or

(iii) With respect to a security-based swap that is initiated by a municipal entity on a registered national securities exchange or registered security-based swap execution facility and the security-based swap dealer does not know the identity of the counterparty to the transaction at any time up to and including execution of the transaction.

(3) No security-based swap dealer or any covered associate of the security-based swap dealer shall:

(i) Provide or agree to provide, directly or indirectly, payment to any person to solicit a municipal entity to offer to enter into, or to enter into, a security-based swap or any trading strategy involving a security-based swap with that security-based swap dealer unless such person is a regulated person; or

(ii) Coordinate, or solicit any person or political action committee to make, any:

(A) Contribution to an official of a municipal entity with which the security-based swap dealer is offering to enter into, or has entered into, a security-based swap security-based swap, or a trading strategy involving a security-based swap; or

(B) Payment to a political party of a state or locality with which the security-based swap dealer is offering to enter into, or has entered into, a security-based swap security-based swap, or a trading strategy involving a security-based swap.

(c) *Circumvention of Rule.* No security-based swap dealer shall, directly or indirectly, through or by any other person or means, do any act that would result in a violation of paragraph (a) or (b) of this section.

(d) *Requests for Exemption.* The Commission, upon application, may conditionally or unconditionally exempt a security-based swap dealer from the prohibition under paragraph (a)(1) of this section. In determining whether to grant an exemption, the Commission will consider, among other factors:

(1) Whether the exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes of the Act;

(2) Whether the security-based swap dealer:

(i) Before the contribution resulting in the prohibition was made, adopted and implemented policies and procedures reasonably designed to prevent violations of this section;

(ii) Prior to or at the time the contribution which resulted in such prohibition was made, had no actual knowledge of the contribution; and

(iii) After learning of the contribution:

(A) Has taken all available steps to cause the contributor involved in making the contribution which resulted in such prohibition to obtain a return of the contribution; and

(B) Has taken such other remedial or preventive measures as may be appropriate under the circumstances;

(3) Whether, at the time of the contribution, the contributor was a covered associate or otherwise an employee of the security-based swap dealer, or was seeking such employment;

(4) The timing and amount of the contribution which resulted in the prohibition;

(5) The nature of the election (*e.g.,* state or local); and

(6) The contributor's apparent intent or motive in making the contribution that resulted in the prohibition, as evidenced by the facts and circumstances surrounding the contribution.

(e) *Prohibitions Inapplicable.*

(1) The prohibitions under paragraph (b) of this section shall not apply to a contribution made by a covered associate of the security-based swap dealer if:

(i) The security-based swap dealer discovered the contribution within 120 calendar days of the date of such contribution;

(ii) The contribution did not exceed $350; and

(iii) The covered associate obtained a return of the contribution within 60 calendar days of the date of discovery of the contribution by the security-based swap dealer.

(2) A security-based swap dealer may not rely on paragraph (1) of this section more than twice in any 12-month period.

(3) A security-based swap dealer may not rely on paragraph (1) of this section more than once for any covered associate, regardless of the time between contributions.

3. Add § 240.15Fk–1 to read as follows:

§ 240.15Fk–1 Designation of Chief Compliance Officer for security-based swap dealers and major security-based swap participants.

(a) *In General.* A security-based swap dealer and major security-based swap participant shall designate an individual to serve as a chief compliance officer on its registration form.

(b) *Duties.* The chief compliance officer shall:

(1) Report directly to the board of directors or to the senior officer of the security-based swap dealer or major security-based swap participant;

(2) Review the compliance of the security-based swap dealer or major security-based swap participant with respect to the security-based swap dealer and major security-based swap participant requirements described in Section 15F of the Act, and the rules and regulations thereunder, where the review shall include establishing, maintaining, and reviewing written policies and procedures reasonably designed to achieve compliance with Section 15F of the Act and the rules and regulations thereunder, by the security-based swap dealer or major security-based swap participant;

(3) In consultation with the board of directors or the senior officer of the security-based swap dealer or major security-based swap participant, promptly resolve any conflicts of interest that may arise;

(4) Be responsible for administering each policy and procedure that is required to be established pursuant to Section 15F of the Act and the rules and regulations thereunder;

(5) Establish, maintain and review policies and procedures reasonably

designed to ensure compliance with the Act and the rules and regulations thereunder relating to its business as a security-based swap dealer or major security-based swap participant;

(6) Establish, maintain and review policies and procedures reasonably designed to remediate promptly non-compliance issues identified by the chief compliance officer through any:

(i) Compliance office review;

(ii) Look-back;

(iii) Internal or external audit finding;

(iv) Self-reporting to the Commission and other appropriate authorities; or

(v) Complaint that can be validated; and

(7) Establish and follow procedures reasonably designed for the prompt handling, management response, remediation, retesting, and resolution of non-compliance issues.

(c) *Annual Reports.*

(1) In general. The chief compliance officer shall annually prepare and sign a report that contains a description of:

(i) The compliance of the security-based swap dealer or major security-based swap participant with respect to the Act and the rules and regulations thereunder relating to its business as a security-based swap dealer or major security-based swap participant; and

(ii) Each policy and procedure of the security-based swap dealer or major security-based swap participant described in paragraph (b) of this section, (including the code of ethics and conflict of interest policies).

(2) *Requirements.*

(i) Each compliance report shall also contain, at a minimum, a description of:

(A) The security-based swap dealer or major security-based swap participant's enforcement of its policies and procedures relating to its business as a security-based swap dealer or major security-based participant;

(B) Any material changes to the policies and procedures since the date of the preceding compliance report;

(C) Any recommendation for material changes to the policies and procedures as a result of the annual review, the rationale for such recommendation, and whether such policies and procedures were or will be modified by the security-based swap dealer or major security-based swap participant to incorporate such recommendation; and

(D) Any material compliance matters identified since the date of the preceding compliance report.

(ii) A compliance report under paragraph (c)(1) of this section also shall:

(A) Accompany each appropriate financial report of the security-based swap dealer or major security-based swap participant that is required to be furnished to or filed with the Commission pursuant to Section 15F of the Act and rules and regulations thereunder;

(B) Be submitted to the board of directors and audit committee (or equivalent bodies) and the senior officer of the security-based swap dealer or major security-based swap participant at the earlier of their next scheduled meeting or within 45 days of the date of execution of the required certification;

(C) Include a written representation that the chief executive officer(s) (or equivalent officer(s)) has/have conducted one or more meetings with the chief compliance officer(s) in the preceding 12 months, the subject of which addresses the obligations in this section, including:

(1) The matters that are the subject of the compliance report;

(2) The SBS Entity's compliance efforts as of the date of such a meeting; and

(3) Significant compliance problems and plans in emerging business areas relating to its business as a security-based swap dealer or major security-based swap participant; and

(D) Include a certification that, under penalty of law, the compliance report is accurate and complete.

(iii) Confidentiality. If compliance reports are separately bound from the financial statements, the compliance reports shall be accorded confidential treatment to the extent permitted by law.

(d) *Compensation and Removal.* The compensation and removal of the chief compliance officer shall require the approval of a majority of the board of directors of the security-based swap dealer or major security-based swap participant.

(e) *Definitions.* For purposes of this rule, references to:

(1) The board or board of directors shall include a body performing a function similar to the board of directors.

(2) The senior officer shall include the chief executive officer or other equivalent officer.

(3) Complaint that can be validated shall include any written complaint by a counterparty involving the security-based swap dealer or major security-based swap participant or person associated with a security-based swap dealer or major security-based swap participant that can be supported upon reasonable investigation.

(4) A material compliance matter means any compliance matter about which the board of directors of the security-based swap dealer or major security-based swap participant would reasonably need to know to oversee the compliance of the security-based swap dealer or major security-based swap participant, and that involves, without limitation:

(i) A violation of the federal securities laws relating to its business as a security-based swap dealer or major security-based swap participant, by the firm or its officers, directors, employees or agents;

(ii) A violation of the policies and procedures relating to its business as a security-based swap dealer or major security-based swap participant by the firm or its officers, directors, employees or agents; or

(iii) A weakness in the design or implementation of the policies and procedures relating to its business as a security-based swap dealer or major security-based swap participant.

By the Commission.

Dated: June 29, 2011.

Elizabeth M. Murphy,

Secretary.

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